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2018 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Tax Policy Elegy

MARTIN J. MCMAHON, JR.*

Prologue

I sincerely thank the Board of Regents of the American College of Tax Counsel for inviting me to give this lecture. It is a great honor to be asked to speak to an audience of the country's foremost tax lawyers. Prior speakers have been giants of the Tax Bar, many of whom have held important government positions, have served as Chair of the Tax Section, or were professors at the nation's most prestigious law schools. I am none of these. After only five years in private practice in New Hampshire, I spent the next 38 years before my retirement on the faculty of a couple of state university law schools, with only a year of government service as a Professor-in Residence in the Office of Chief Counsel in the mid-1980s.

It is customary at this event to pay homage to and talk about the speaker's connection to Erwin Griswold. However, my contact with Dean Griswold was virtually non-existent, being limited to sitting in the audience as a young tax lawyer in the mid- to late-1970s at the semi-annual New England Tax Institute, where Dean Griswold presided.

Those of you of my vintage might recall how different the tax system was in the mid-1970s. The corporate tax rate was 48 percent, the highest individual marginal rate was 70 percent. Capital gains generally were taxed at half the ordinary rate, but the top rate could reach 49 percent, and earned income was subject to a maximum rate of 50 percent.¹ Most businesses other than real estate, some natural resources, and professional practices were conducted in C corporation form. And the estate tax kicked-in at \$60,000, with a maximum marital deduction of one-half.

Oh my, how the tax world has changed!

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¹ In 1977 and 1978, the maximum tax rate on capital gains reached 39.875% under the minimum tax and 49.875% under an interaction with the maximum tax. See Leonard Burman & Deborah Kobes, *Preferential Capital Gains Tax Rates*, 102 TAX NOTES (TA) 411 (Jan. 19, 2004); see generally GREGG A. ESENWEIN, CONG. RESEARCH SERV., 98-473, INDIVIDUAL CAPITAL GAINS INCOME: LEGISLATIVE HISTORY (2007).

I. Introduction

In *Hillbilly Elegy*, J.D. Vance laments the plight of the Appalachian people and their failure to see their own contributions to that plight, blaming others for drug and alcohol addiction, under-education, and unemployment. Vance's observations that the Appalachian people fail to appreciate their own contributions to their plight is paralleled by taxpayers, tax professionals, and politicians' lamentations over the state of the federal tax system. For over four decades there have been unrelenting calls to make the tax code "fair, simple, and efficient." But despite nine major tax acts between 1969 and 2003,² along with many less extensive tax acts, the refrain for a "fair, simple, and efficient" tax code has continued to be heard. This continuing plea is not surprising, because over the decades the tax system has evolved to ask the highest income earners to pay less in taxes, become ever more complex, and eschewed "efficiency" in favor of the allowance of an ever-increasing number of tax preferences. Tax act after tax act failed to produce a fair, simple, and efficient tax code. The recently enacted Tax Cuts and Jobs Act³ is simply another failure to enact tax reform that provides a fair, simple, and efficient tax code.

The call for a "fair, simple, and efficient" tax code has become a mere trope.

So, what is "tax reform"? True "tax reform" entails revising the tax code better to meet normative tax policy criteria. Serious policy analysis of tax reform proposals requires an analytical examination of fairness, simplicity, and efficiency. Furthermore, there are some realities that we must recognize.

First, the tax system should adequately fund the government. In 2018, in light of persistent deficits, the ever-growing ratio of national debt to GDP, and the aging of the population, with the attendant increased spending on Social Security and Medicare, this criterion calls for increased taxes, not lower

²Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of 26 U.S.C.); Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.); Tax Reform of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.); Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (codified as amended in scattered sections of 26 U.S.C.); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (codified as amended in scattered sections of 26 U.S.C.); Economic Growth Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of 26 U.S.C.).

³Act of Dec. 22, 2017, Pub. L. No. 115-97, 131 Stat. 2054. The legislation included the short title "Tax Cuts and Jobs Act," but the name was stricken by the Senate Parliamentarian immediately prior to the Senate's passage of the final bill.

taxes.⁴ Notwithstanding the beliefs of many taxpayers, politicians, and tax professionals, the United States is not a high tax country. To the contrary, it is a low tax country. Among the advanced economies in the OECD, the United States ranks near the bottom in the percentage of GDP collected in taxes, taking into account not just federal taxes, but all taxes imposed at all levels.⁵

Second, the significant income and wealth inequality in the United States⁶ must be taken into account in structuring both the income tax base and rates, as well as the estate tax. This distribution is particularly relevant when considering rate and base issues that provide tax relief to income from capital relative to income from wages, since capital income is even more highly concentrated at the top of the income pyramid than total income.⁷

Third, we need to recognize how path dependency often constrains tax reform. I will focus on a few path dependencies that I believe led to wrong turns and missed opportunities in the 2017 tax legislation.

⁴A fair argument can be made that even the middle class in the United States does not need tax relief. See Kirk J. Stark & Eric M. Zolt, Opinion, *We Don't Need Tax Cuts for the Middle Class*, WASH. POST, Oct. 18, 2017, https://www.washingtonpost.com/opinions/we-dont-need-tax-cuts-for-the-middle-class/2017/10/18/4ce2f378-b37c-11e7-a908-a3470754bbb9_story.html?utm_term=.72ca41c282a3 (“Data from the Organization for Economic Cooperation and Development reveal that American families with children face substantially lower average income-tax rates (in some cases, less than half) than similar families in other developed countries. And this is before factoring in consumption taxes, which represent a large share of middle-class tax burdens in most countries, but not in the United States.”). For the OECD data, see Org. for Econ. Co-operation & Dev. [OECD], *Taxing Wages—Comparative Tables: Average Tax Wedge*, OECD.STAT, Feb. 20, 2018, <http://stats.oecd.org/Index.aspx?QueryId=55129>. Income taxes as a percentage of AGI do not exceed ten percent until income exceeds \$100,000. See Martin A. Sullivan, *Will Reform Undo Income Tax Regressivity at the High End?*, 157 TAX NOTES (TA) 301 (Oct. 16, 2017).

⁵OECD, REVENUE STATISTICS 2016: TAX REVENUE TRENDS IN THE OECD 4 (2016); OECD, REVENUE STATISTICS: 1965–2015 (2015).

⁶See CONG. BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2013 6 (2016) (“Market income is highly skewed toward households at the top of the income distribution (see Figure 3). In 2013, households in the lowest quintile of market income earned about \$8,300 per household, on average. Households in the middle quintile earned about \$58,600, and households in the top quintile earned about \$259,900. Within the top quintile of households, market income is also skewed toward the very top of the distribution. The 1.2 million households in the top 1 percent of the market income distribution earned about \$1.6 million per household, on average, which accounted for approximately 17 percent of total market income in 2013.”); see also ROBERT J. GORDON, THE RISE AND FALL OF AMERICAN GROWTH 605–20 (2016) (describing increasing income inequality); THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 347–50 (Arthur Goldhammer trans., Harvard Univ. Press 2014) (2013) (documenting inequality of wealth in the United States).

⁷See CONG. BUDGET OFFICE, *supra* note 6, at 8; Thomas Piketty, Emmanuel Saez & Gabriel Zucman, *Distributional National Accounts: Methods and Estimates for the United States*, Q. J. Econ. (forthcoming 2018), <https://eml.berkeley.edu/~saez/PSZ2017.pdf> [hereinafter Piketty et al., *Distributional National Accounts*].

The first path dependency is that there is an inherent meaning to the concept of a “capital asset,” and that gains realized on the sale of capital assets should be taxed at preferential rates.⁸

The second path dependency is the persistence in individual income taxation of the adjusted gross income concept, which sorts deductions into two tranches, favoring some with universal deductibility and relegating others to the category of “itemized deductions,” which reduce taxable income only if their sum total exceeds a specified standard deduction.

The third path dependency is rigidity over many decades of the classification of certain personal deductions as tax expenditures.

The final path dependency is the notion that pass-through taxation of non-corporate business income, as well as the overlay of a pass-through regime for qualifying corporate entities in Subchapter S, is inviolate.

II. What Does the Phrase “Fair, Simple, and Efficient” Mean?

So what does the phrase “fair, simple, and efficient mean?”

A. *Fairness—Horizontal and Vertical Equity*

In tax policy analysis, the word “fair” standing alone has no normative content. From the perspective of traditional tax policy criteria, the extent to which the tax system is fair depends on the extent to which it achieves both horizontal and vertical equity.

Horizontal equity means that the tax burden on similarly situated taxpayers should be equal. The difficulty in satisfying this criterion lies in determining similarity. If a dollar is a dollar, then two taxpayers (or households) with equal incomes, however derived, should pay equal income taxes. But it is more complicated than that, because different people spend their incomes differently, and we need to determine whether different spending patterns might render individuals with identical incomes to be differently situated.

Vertical equity means that taxpayers with greater income than others should pay appropriately greater taxes. Expressed this way, it might be argued that all that is required to satisfy vertical equity is proportional tax rates. Historically, however, this criterion has been interpreted to call for imposing graduated progressive rates, including very high marginal rates on extraordinarily high incomes, based on the ability to pay principle, reflecting the diminishing marginal utility of money.⁹ This rate structure was in place from the 1940s until the early 1980s.

Since 1981, however, with a few exceptions, the focus has been on reducing the higher marginal rates and flattening the rate schedule. This focus is

⁸The preference was first introduced in 1921 and has taken various forms over the years.

⁹For extensive discussion of the diminishing marginal utility of money, ability to pay, and vertical equity, see Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004); Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998).

grounded on the assertions that (1) lower taxes on high incomes will lead to a surge in investment and productivity, (2) incomes at all levels will rise, and (3) the famous Laffer-curve argument that tax cuts pay for themselves through significant increases in the GDP. The problem with all three of these assertions is that they are rejected by far more economists than accept them, and none of them have been demonstrated empirically to be true when income tax rates have been reduced. To the contrary, the empirical data indicate that all three assertions generally are false.¹⁰ Economists generally agree that the revenue maximizing top rate can be much higher than it is now.¹¹

B. *Simplicity*

What is meant by calls for “simplicity”?¹² In reality, the tax system cannot be simple. For one thing, business and investment transactions, particularly transactions involving sophisticated financial instruments and investment vehicles, are complicated even apart from their tax consequences.

¹⁰ See, e.g., Thomas Piketty, Emmanuel Saez & Gabriel Zucman, *Economic Growth in the United States: A Tale of Two Countries*, WASH. CTR. FOR EQUITABLE GROWTH, Dec. 6, 2016, <http://equitablegrowth.org/research-analysis/economic-growth-in-the-united-states-a-tale-of-two-countries> [hereinafter Piketty et al., *A Tale of Two Countries*] (from 1980 to 2014, for example, none of the growth in per-adult national income went to the bottom 50%, while 32% went to the middle class (defined as adults between the median and the 90th percentile), 68% to the top 10%, and 36% to the top 1%; share of national income earned by the bottom 50% collapsed from 20% in 1980 to 12.5% in 2014. Over the same period, the share of incomes going to the top one percent surged from 10.7% in 1980 to 20.2% in 2014); Oguzhan Akgun, David Bartolini & Boris Cournède, *The Capacity of Governments to Raise Taxes* (Org. for Econ. Co-operation and Dev., Econ. Dep’t, Working Paper No. 1407, 2017), http://www.oecd-ilibrary.org/economics/the-capacity-of-governments-to-raise-taxes_gbee2df9-en (U.S. tax rate at 167% of average income and progressivity of U.S. are below the revenue maximization rate); Sandra Lizarazo, Adrian Peralta-Alva & Damien Puy, *Macroeconomic and Distributional Effects of Personal Income Tax Reforms: A Heterogenous Agent Model Approach for the U.S. 1* (IME, Working Paper No. 17/192, 2017) (personal income tax cuts “stimulate growth but the supply side effects are never large enough to offset the revenue loss from lower marginal tax rates.”).

The Laffer curve illustrates that the amount of revenue collected by the government is a function of the tax rate. This curve is represented by placing the tax rate on the vertical axis and tax revenue on the horizontal axis. The graph assumes that there is a tax rate beyond which supply response is so great that tax revenues will fall. “It . . . shows that when tax rates are very high, any increase in the tax rate could actually cause tax revenues to fall.” KARL E. CASE & RAY C. FAIR, *PRINCIPLES OF ECONOMICS* 289 (1989). For a more thorough explanation of the Laffer curve theory and a discussion of why it is discredited, see ANDRE MALABRE, *LOST PROPHETS: AN INSIDER’S HISTORY OF MODERN ECONOMICS* 181-82 (Beard Books 2003) (1993); see also JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE GREAT DEBATE OVER TAX REFORM* 124 (4th ed. 2008) (Laffer curve theory did not work).

¹¹ See Bruce Bartlett, *What Is the Revenue-Maximizing Tax Rate?*, 134 *TAX NOTES* (TA) 1013 (Feb. 20, 2012). Some conclude that it can be well above 50% for taxpayers at the very top of the income pyramid. Bartlett, *supra*; see also Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 *J. ECON. PERSP.* 165 (2011) (suggesting that the maximum rate could be as high as 73%).

¹² See Peter E. Boos, *Decoding the Code*, 156 *TAX NOTES* (TA) 323 (July 17, 2017).

Furthermore, if we want to tax individuals on their ability to pay, various deductions must be taken into account. All that we can ask is that the tax system is not unnecessarily unduly complex.

That means minimizing special rules that are not necessary accurately to determine economic income or ability to pay consistent with both horizontal and vertical equity principles.

Under the generally accepted Haig-Simons definition, income is the sum of (1) the market value of consumption and (2) the change in net worth, between two specified points in time.¹³ Complexity necessary to measure economic income under this definition is a necessary evil, while provisions designed to mismeasure income—with the exception of the realization requirement—generally generate unnecessary complexity.

Those special rules that mismeasure income or allow tax credits to encourage a particular activity—tax expenditures—must be carefully examined to determine if they add undue complexity or are better administered through the tax system rather than by direct spending.

Virtually all business related tax expenditures, with the possible exception of the MACRS depreciation system, create significant complexity. Enormous complexity is added by the large number of business-related credits, which have increased nearly eight-fold between 1988 and today.¹⁴

It is long past time to pay more attention to the wisdom advanced over fifty years ago by Stanley Surrey in his analysis of the systemic problems created by introducing spending provisions through tax expenditure preferences in the tax code.¹⁵

One final comment on simplicity. An almost never ending succession of temporary tax provisions that sunset after a few years, or a decade, unless extended, generates enormous unnecessary undue complexity.

¹³HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938).

¹⁴In 1988, there were very few business related tax credits; only five were discussed in one of the tax treatises. See BORIS I. BITTKER & MARTIN J. McMAHON, JR., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶¶ 16.1-16.6 (1988). Currently, the most recent edition of that treatise discusses 40 additional business tax credits—all of them tax expenditures—that have been introduced since, although a few were temporary and have lapsed. See BORIS I. BITTKER, MARTIN J. McMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶¶ 20.01-20.35 (3d ed. 2018).

¹⁵See Stanley S. Surrey, Asst. Sec'y of the Treas., *The U.S. Income Tax System—The Need for a Full Accounting*, Remarks Before The Money Marketeers (Nov. 15, 1967), in ANN'L REP'T OF THE SEC'Y OF THE TREAS. ON THE STATE OF THE FINANCES FYE JUNE 30, 1968, at 322; STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* (1973); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225 (1979); Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COMM. L. REV. 679 (1976); STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985).

One notable exception is the earned income credit, which is essentially a version of a negative income tax or a wage subsidy for low income earners and is generally agreed is more efficiently delivered through the tax system than through other means.

C. *Efficiency*

What do we mean when we ask for an “efficient” tax system? Obviously, we want a tax system that collects tax revenue with low transaction costs to both the fisc and to taxpayers. From the government’s side, by this measure we have one of the most efficient tax systems in the world. However, while many taxpayers do not incur significant transaction costs or spend inordinate amounts of time in fulfilling their obligation to pay taxes, for many other taxpayers complexity results in significant transaction costs and time expenditure.

The greatest inefficiency in the form of transaction costs is encountered by business taxpayers, particularly due to tax expenditure preferences and planning options, such as choice of entity issues, and the myriad of express or implicit options for structuring business transactions to produce different tax results for transactions that apart from taxes are substantially similar. Thus, it often is taxpayer-friendly complexity that increases taxpayer transaction costs, rather than ascertaining compliance with the revenue raising provisions of the Code.

But overwhelmingly, “efficiency” means economic efficiency. That requires structuring the tax system to minimize interference with economic decision-making. To the greatest extent possible, the tax law should be neutral, taxing every investment made by a particular taxpayer identically and taxing all industries identically. In this regard, the Internal Revenue Code is an abject failure. It is replete with special provisions—tax expenditures—favoring various investments by various industries to one extent or another.

Even MACRS is inefficient in this respect. To be neutral, depreciation must be based on actual economic depreciation. Prior to 1981, depreciation nominally approximated economic depreciation. But that was abandoned with the “simplification” and “economic growth” cost recovery rules of ACRS, and now MACRS. The result is widely disparate effective tax rates between different industries, which distort investment decisions.¹⁶

III. *Efficiency versus Equity*

Some analysts appear to treat avoiding interference with the efficiency of the market economy as the paramount tax policy goal.¹⁷ These analysts emphasize minimizing distortions with respect to deployment of capital, which leads them to support preferential treatment of income from capital.

¹⁶ See JANE G. GRAVELLE, *THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME* (1994).

¹⁷ See Michael Boskin, *Taxation, Savings, and the Rate of Interest*, 86 J. POL. ECON. 3, 18-25 (1978); David F. Bradford, *The Economics of Tax Policy Toward Savings*, in *THE GOVERNMENT AND CAPITAL FORMATION* 11, 20-28 (George von Furstenberg ed. 1980); Martin Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. 29 (1978).

This focus conflicts with equitable principles because capital income is highly concentrated at the very top of the income pyramid,¹⁸ and capital income represents a very high percentage of the income of taxpayers at the top of the pyramid.¹⁹ In 2016, 75 percent of the tax benefit of the preferential rates for capital income went to taxpayers with incomes over \$1 million.²⁰ Roughly one-half of all capital gains are realized by the top one-tenth of one percent of taxpayers.²¹

As Martin Sullivan of Tax Analysts has noted, “[T]he superrich actually pay tax at a lower effective rate than the regular rich.”²² Thus, the principal effect of the preferential rate appears to be the addition of a regressive feature that adds significant complexity to the income tax.²³

Tax preferences for capital income violate the tax policy criteria of horizontal and vertical equity. These criteria call for elimination of the preferential rates for capital gains, as well as the section 1014 tax-free basis step-up at death, which completely eliminates any tax on unrealized gains with respect to assets held until death.

However, the advocates of the efficiency argument theorize that as long as the size of the pie increases, even if all of the increase initially is realized by those at the top of the income pyramid, inevitably some portion of that increase will “trickle down” to those lower in the income pyramid. Almost 40 years of economic data, going back to the 1981 top-end tax cuts tell us that

¹⁸ See CONG. BUDGET OFFICE & JOINT COMMITTEE ON TAXATION, *THE DISTRIBUTION OF ASSET HOLDINGS AND CAPITAL GAINS* (2016); CONG. BUDGET OFFICE, *supra* note 6, at 8; Leonard E. Burman & Peter D. Rickoy, *Capital Gains and the People Who Realize Them*, 50 NAT'L TAX J. 432 (1997); Leonard E. Burman & Deborah I. Kodes, *Composition of Income Reported on Tax Returns*, 101 TAX NOTES (TA) 783 (Nov. 10, 2003); GREGG A. ESENWEIN & JANE G. GRAVELLE, CONG. RESEARCH SERV., RL31562, *AN ANALYSIS OF THE TAX TREATMENTS OF CAPITAL LOSSES 7-8* (2002); Jane G. Gravelle, *Effects of Dividend Relief on Economic Growth, the Stock Market, and Corporate Tax Preferences*, 56 NAT'L TAX J. 653, 654 (2003); *The Tax Break-Down: Preferential Rates on Capital Gains*, COMM. FOR A RESPONSIBLE FED. BUDGET: THE TAX BREAK-DOWN, Aug. 27, 2013, <http://www.crfb.org/blogs/tax-break-down-preferential-rates-capital-gains>.

¹⁹ Derek Thompson, *The Rise (and Rise and Rise) of the 0.01 Percent in America*, THE ATLANTIC, Feb. 13, 2014, <https://www.theatlantic.com/business/archive/2014/02/the-rise-and-rise-and-rise-of-the-001-percent-in-america/283793/>.

²⁰ *What is the Effect of a Lower Tax Rate for Capital Gains?, Capital Gains and Dividends*, TAX POL'Y CTR. BRIEFING BOOK (2016), <http://www.taxpolicycenter.org/briefing-book/what-effect-lower-tax-rate-capital-gains> (11% went to taxpayers with income under \$200,000 and 4.2% of the benefit went to taxpayers with income under \$100,000).

²¹ *The Tax Break-Down: Preferential Rates on Capital Gains*, *supra* note 18.

²² Martin A. Sullivan, *Will Reform Undo Income Tax Regressivity at the High End?*, 157 TAX NOTES (TA) 301 (2017).

²³ As Leonard Burman at the Tax Policy Center has pointed out, the preferential rate “(1) distort[s] work and investment decisions into activities that produce income taxed as capital gain instead of ordinary income, and (2) create[s] a giant loophole that can be exploited via tax shelters.” Leonard E. Burman, *Cutting Capital Gains Taxes is a Dead End, Not a Step on the Road to a Consumption Tax*, TAX POL'Y CTR.: TAXVOX, March 3, 2015, <http://www.taxpolicycenter.org/taxvox/cutting-capital-gains-taxes-dead-end-not-step-road-consumption-tax>.

this theory is not true.²⁴ The data indicate that the tax rate on capital gains is not a significant factor in stimulating economic growth,²⁵ and trickle-down does not command mainstream support among economists.²⁶

For four decades the real inflation-adjusted before-tax income of the overwhelming majority of American families has grown very slowly—the average annual growth rate of the first four quintiles was well below one percent²⁷—while only the top quartile has seen any significant increase in market-based income, and that increase is highly concentrated in the top one percent, with a growth rate of nearly four percent,²⁸ and within that select group in the top one-tenth of one percent, and within that elite group, the income growth of the top one-hundredth of one percent outstripped by far the income growth of the rest of the top one-tenth of one percent.²⁹ The result is ever increasing economic inequality.

²⁴ See also John W. Diamond & Pamela H. Moormau, *Issues in Analyzing the Macroeconomic Effects of Tax Policy*, 56 NAT'L TAX J. 447 (2003) (tax cuts shrink GDP if not offset by spending); Lizarazo, et al., *supra* note 10.

²⁵ Joel Slemrod, *The Truth About Taxes and Economic Growth*, 46 CHALLENGE 5 (2003); *The Tax Break-Down: Preferential Rates on Capital Gains*, *supra* note 18.

Moreover, because by statutory definition, all property is a capital asset unless excluded, preferential rates are extended to gains with respect to some types of property that have no hope of stimulating economic growth, including collectibles such as (1) works of art, (2) rugs and antiques, (3) metals, gems, stamps and coins, and (4) even fine old wines. The need to expressly exclude every type of gain that is not within the favored category, rather than specifically listing those that are within the favored category, has led to additional complexity in the Code and tax administration. See Martin J. McMahon, Jr., *Reinstating a Capital Gains Preference and Tax Expenditure Analysis*, 48 TAX NOTES (TA) 1437 (Sept. 10, 1990).

²⁶ See, e.g., JOSEPH E. STIGLITZ, *THE ROARING NINETIES* 286 (2003); Lee A. Sheppard, *Flat Tax and Politics at NYSBA*, 70 TAX NOTES (TA) 488 (Jan. 29, 1996) (recalling the 1980 Presidential campaign, the Economic Recovery Tax Act of 1981, and the failure of supply-side economics to deliver the promised growth, Larry Summers referred to the claimed economic efficiencies of the flat tax as “deja voodoo economics”); Lizarazo, et al., *supra* note 10.

²⁷ See CONG. BUDGET OFFICE, *supra* note 6.

²⁸ See CONG. BUDGET OFFICE, *supra* note 6; Piketty et al., *A Tale of Two Countries*, *supra* note 10 (From 1980 to 2014, for example, none of the growth in per-adult national income went to the bottom 50%, while 32% went to the middle class (defined as adults between the median and the 90th percentile), 68% to the top ten percent, and 36% to the top one percent; share of national income earned by the bottom 50% collapsed from 20% in 1980 to 12.5% in 2014. Over the same period, the share of incomes going to the top one percent surged from 10.7% in 1980 to 20.2% in 2014.).

The after-tax, after-transfer income for a working-class household of three has only grown three percent since 1997. See Chuck Marr, Brandon DeBot & Emily Horton, *How Tax Reform Can Raise Working-Class Incomes*, CTR. ON BUDGET & POLICY PRIORITIES (Sept. 13, 2017). The after-tax, after-transfer income of the top one percent has grown about four times faster than it has for low- and middle-income households. See CONG. BUDGET OFFICE, *supra* note 6.

²⁹ See Piketty et al., *Distributional National Accounts*, *supra* note 7; Edward D. Kleinbard, *What's a Government Good for? Fiscal Policy in an Age of Inequality* (USC CLASS Research Papers Series No. CLASS18-2, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3118406; Thompson, *supra* note 19.

Likewise, when evaluating a major reduction in the corporate income tax, distributional effects must be taken into account. In this respect, I believe that the argument that the burden of the corporate income tax is largely shifted to labor in the form of lower wages (or consumers in the form of higher prices) rather than borne by shareholders or the owners of capital generally, does not hold water. Corporate income represents less than one-half of total U.S. business income. Moreover, the stylized models that predict that the corporate tax is shifted to labor rely on a variety of unrealistic assumptions regarding international capital flows and international substitution of products.³⁰ The better view is that the burden of the corporate income tax is largely borne by shareholders or by the owners of capital generally.³¹ Thus, a corporate tax cut benefits individuals at the top of the income pyramid, where the ownership of corporate stock and other income producing capital is highly concentrated.³²

From this perspective, the Tax Cuts and Jobs Act, with its benefits disproportionately focused on taxpayers at the top of the income pyramid,³³ and providing special tax preferences for the owners of unincorporated businesses that are not available to wage earners is inconsistent with furthering both horizontal and vertical equity.

The dominant goal of tax reform should not be to improve efficiency to further enrich the already well-off, but rather to provide proper horizontal and vertical equity, and mitigate the economic inequality inevitably resulting from a *laissez-faire* free market economy.

IV. Family Allowances, Standard Deduction, and Itemized Deductions

The Tax Cuts and Jobs Act temporarily increased the credit for children under 17, added a much smaller credit for other dependent children, and eliminated personal exemptions, while roughly doubling the standard deduction, thus converting many itemizers into non-itemizers. These changes result in a tax cut for many families already claiming the standard deduction, but

³⁰ See JANE G. GRAVELLE, CONG. RESEARCH SERV., RL34229, CORPORATE TAX REFORM: ISSUES FOR CONGRESS (2017); Steven M. Rosenthal, *Slashing Corporate Taxes: Foreign Investors Are Surprise Winners*, 157 TAX NOTES (TA) 559 (Oct. 23, 2017).

³¹ See GRAVELLE, *supra* note 30.

³² See Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* (Nat'l Bureau of Econ. Research, Working Paper No. 24085, 2017) (almost half of all American households own some stock through direct purchases, mutual funds, ETFs or pensions, but the top ten percent of households now own 84% of all stocks).

³³ See *Analysis of the Tax Cuts and Jobs Act*, TAX POLICY CTR., Dec. 22, 2017, <http://www.taxpolicycenter.org/feature/analysis-tax-cuts-and-jobs-act>.

could increase the taxes for families who had been itemizing deductions.³⁴ Furthermore, the differing credit amounts for dependent children of different ages perpetuates different tax liabilities for family households who are identical in all respects other than the ages of the dependent children. Thus, this purported simplification conflicts with achieving greater equity.

In addition to increasing the standard deduction, the Tax Cuts and Jobs Act has eliminated or scaled back various itemized deductions. Thus, the role of itemized deductions and the standard deduction should be reconsidered.

When the standard deduction was first introduced, it was a relatively small amount and really was principally a simplification measure, relieving taxpayers with few itemized deduction expenses of the need to keep track of the amounts. Over the years before 2017, however, it had been increased in amount not so much for simplification purposes but to provide a low income allowance significantly in excess of the personal exemptions. After the Tax Cuts and Jobs Act, the standard deduction, along with the child tax credits, which do not well correlate to the personal exemptions of prior law, now constitute the cost of subsistence allowance.

I believe that having the standard deduction fulfil this dual purpose is a mistake.

However it is determined—by personal exemptions or credits—the amount of income that a household can receive tax-free as a cost of subsistence allowance should always be determined directly, and only, with reference to the size of the household. Cost of subsistence allowances should be provided through adequate personal exemptions and credits, and the standard deduction should be abolished. If deductions that are now classified as itemized deductions are normatively proper or are justifiable tax expenditures, they should be treated no differently than those deductions allowed in computing adjusted gross income.

It is true that the deductions historically classified as itemized deductions increase complexity, and scaling them back or eliminating them simplifies individual income taxation. However, it must be kept in mind that unnecessary or inappropriate simplification increases inequity. Thus, it is important to know whether a deduction is normatively proper or is a tax expenditure.

Some itemized deductions clearly are tax expenditures, while others clearly are normatively proper. For example, section 212 profit-seeking expenses and unreimbursed employee business expenses (including moving expenses), although historically classified as itemized deductions, are normatively proper deductions. They should be treated no differently than ordinary and necessary business expenses. Thus, their elimination by the Tax Cuts and Jobs Act

³⁴ See ELAINE MAAG & JULIA B. ISAACS, TAX POLICY CTR., IMPACT OF THE TAX CUTS AND JOBS ACT ON FAMILIES WITH YOUNG CHILDREN (2017), <http://www.taxpolicycenter.org/publications/impact-tax-cuts-and-jobs-act-families-young-children/full>; TAX POLICY CTR., UPDATED EFFECTS OF THE TAX CUTS AND JOBS ACT ON REPRESENTATIVE FAMILIES (2017), <http://www.taxpolicycenter.org/publications/updated-effects-tax-cuts-and-jobs-act-representative-families/full>.

violates traditional tax policy criteria, which dictate that all costs of earning income should be deductible.³⁵

The same is true of personal casualty losses. Under the Haig-Simons definition of income, a deduction for personal casualty losses is normatively proper. Such losses always should be deductible, although a reasonable threshold limitation is warranted for the sake of simplicity. The Tax Cuts and Jobs Act limitation of these losses to those incurred in presidentially declared disaster areas clearly violates the criteria of both horizontal and vertical equity because it fails to reflect ability to pay.

A. Home Mortgage Interest Deduction

The home mortgage interest deduction is not normative. It clearly is a tax expenditure, and it is a poorly structured one. Studies indicate that the home mortgage interest deduction “is unlikely to influence the homeownership rate,” but does lead to over-consumption of owner-occupied housing by those who were already inclined to own homes.³⁶ Furthermore, the home mortgage interest deduction likely results in home mortgage interest rates and the price of homes being higher than they otherwise would be, thereby shifting some of the benefit to home mortgage lenders, the owners of existing housing stock, and home builders,³⁷ rather than making home ownership less costly for home buyers.

In addition, to the extent inefficiency does not drive out inequity, the home mortgage interest deduction is an “upside down” subsidy. To the extent that the benefit of the home mortgage interest deduction is not captured by home

³⁵Distributional impacts also must be kept in mind. While itemized deductions are of the most benefit dollar for dollar to taxpayers in higher income tax brackets, different itemized deductions are claimed principally by taxpayers in different marginal tax brackets. Thus, eliminating or limiting itemized deductions to provide rate reduction principally to taxpayers in the highest tax brackets can result in tax decreases in the highest tax brackets and tax increases in lower tax brackets. The Tax Policy Center concluded that precisely this effect would result from the Republican Unified Framework for Fixing Our Broken Tax Code released in September. In 2018, more than a third of taxpayers making between about \$150,000 and \$300,000 would pay more, in taxes, principally due to repeal of a number of itemized deductions. TAX POLICY CTR., A PRELIMINARY ANALYSIS OF THE UNIFIED FRAMEWORK (2017), <http://www.taxpolicy-center.org/publications/preliminary-analysis-unified-framework/full>.

³⁶Edward L. Glaser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, 17 TAX POLY & ECON. 37, 40, 76-80 (2003); see also William G. Gale, Jonathan Gruber & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES (TA) 1171, 1179 (2007) (the home mortgage interest deduction “has little if any positive effect on homeownership”).

³⁷See, e.g., PAMELA J. JACKSON, CONG. RESEARCH SERV., RL33025, FUNDAMENTAL TAX REFORM: OPTIONS FOR THE MORTGAGE INTEREST DEDUCTION 21 (2005) (if the home mortgage interest deduction were repealed, mortgage interest rates would fall in response to the lower demand for mortgage debt); Michelle J. White & Lawrence J. White, *The Tax Subsidy to Owner-Occupied Housing: Who Benefits?*, 3 J. PUBLIC ECON. 111-26 (1977) (the value of the mortgage interest deduction is capitalized into housing prices).

sellers and lenders, the benefits of the deduction accrue primarily to upper income taxpayers, primarily the top one-quarter.³⁸

Nevertheless, the Tax Cuts and Jobs Act preserved this least conceptually sound itemized deduction, although at least scaling it back. It would have been better tax policy to eliminate it entirely, albeit with a phase-out period.

B. *Medical Expenses, State and Local Taxes, and Charitable Contributions*

Some other major itemized deductions — medical expenses, state and local taxes, and charitable contributions—are more difficult to characterize as *wholly* tax expenditures, even though they are so classified by both the JCT and the OMB. To some extent or another, these deductions might be appropriate to achieve proper horizontal and vertical equity.

1. *Medical Expenses*

Tax policy analysts differ in their views regarding whether medical expenses are an appropriate adjustment in determining a taxpayer's ability to pay taxes. William Andrews concluded that medical expenses do not reflect a choice regarding consumption and a deduction thus properly reflects ability to pay.³⁹ Stanley Surrey, on the other hand, criticized the medical expense deduction as a poorly designed tax subsidy that was more valuable to high-bracket taxpayers than to low bracket taxpayers.⁴⁰

I agree with Professor Andrews. Necessary medical expenses are a normative aspect of defining ability to pay, and they always should be allowed as a deduction. Of course, some line drawing is required regarding the meaning of "necessary medical expenses,"⁴¹ and, perhaps, a minimal floor—well below the current floor—should apply.

If a deduction for medical expenses is normative, then to properly measure ability to pay, individual costs for medical insurance also should be deductible by all taxpayers, not only by partners and the self-employed. In that case, then

³⁸According to estimates by the Staff of the Joint Committee on Taxation, almost 75% of the benefit of the home mortgage interest deduction goes to taxpayers with incomes of \$100,000 or more, and of that approximately 32% of the benefit goes to taxpayers with incomes of \$200,000 or more. STAFF OF THE JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013 at 54 tbl.3 (2010). Furthermore, when a tax expenditure is only partially capitalized, because demand at the highest tax brackets for the item receiving the tax preference is insufficient to clear the market, higher income taxpayers receive a windfall. See Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735, 744 (1979).

³⁹William Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 336 (1972) ("What distinguishes medical expenses . . . is a sense that large differences in their magnitude between people in otherwise similar circumstances are apt to reflect differences in need rather than choices among gratifications.")

⁴⁰Stanley Surrey, *Tax Incentives as Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 720 (1970).

⁴¹A starting point might be that the deduction should be limited to the types of medical care that would have been covered by Medicare. See Alan Feld, *Abortion to Aging: Problems of Definition in the Medical Expense Deduction*, 58 B.U. L. REV. 165, 166 (1978).

the exclusion for employer provided health insurance should not be treated as a tax expenditure. It is a tax expenditure only if all individuals are not allowed to deduct medical insurance costs in full.

2. *State and Local Taxes*

The deduction for non-business state and local taxes, which both the JCT and the OMB treat as a tax expenditure, historically has been the most commonly claimed itemized deduction.⁴² A 2016 CBO report described the deduction for state and local taxes as “a federal subsidy to state and local governments.”⁴³ Long before the tax expenditure concept was developed, Richard Musgrave argued that the deduction for state and local taxes was not normatively justified. His theory was that state and local taxes are benefit taxes that provide goods and services to taxpayers equal in value to the taxes paid.⁴⁴

Other tax policy analysts, however, believe that the state and local tax deduction is normatively proper.⁴⁵ They reason that the amount of state and local taxes paid by an individual does not correlate to the level of benefits received. Denying a federal income tax deduction for state and local taxes paid by the individual when those taxes exceed the benefits received results in over-taxation.

To the extent this is true, because some states are higher tax states and other states are lower tax states, elimination of this deduction would violate both horizontal and vertical equity principles. The federal taxes imposed on two different taxpayers who were otherwise identically situated, except that one lives in a high tax state and the other in a low tax state, would not accurately reflect ability to pay. Under this rationale, there should be no distinction between state sales taxes and state income taxes. At the state level, both serve the same purpose.

⁴² See Zoe Sagalow, *Most Prevalent Deduction Is for Taxes Paid, IRS Data Show*, 157 TAX NOTES (TA) 216, 216 (Oct. 9, 2017) (“Nearly 42.3 million returns included the taxes paid deduction in 2014, while more than 33.3 million included the interest paid deduction, according to the data.”).

⁴³ CONG. BUDGET OFFICE, *Revenues—Option 7: Limit the Deduction for State and Local Taxes*, in *OPTIONS FOR REDUCING THE DEFICIT: 2017 TO 2026* at 140 (2016), <https://www.cbo.gov/publication/52142>.

⁴⁴ RICHARD MUSGRAVE, *THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY* (1959); RICHARD MUSGRAVE & PEGGY MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 345 (5th ed. 1989).

⁴⁵ Brookes Billman & Noel Cunningham, *Nonbusiness State and Local Taxes: The Case for Deductibility*, 28 TAX NOTES (TA) 1107 (Sept. 2, 1985). Based on this theory, the President’s 1985 tax proposals recommended complete elimination of the deduction for state and local taxes. However, the Tax Reform Act of 1986, much of which was based on the president’s 1985 recommendations, repealed only the deduction for state and local sales taxes, and subsequent legislation restored the deduction for state and local sales taxes for itemizers who paid less in state and local income taxes than sales taxes.

However, there may be a distinction between state level taxes and local level taxes, particularly real estate taxes on owner-occupied housing. The latter might be considered to be matched by benefits received, while the former fund general welfare. So, if any state and local taxes should be singled out for disallowance of a deduction, it should be real estate taxes on owner-occupied housing.

I believe that state taxes are a normatively proper deduction that reflects ability to pay, rather than a subsidy, and the same might also be true of local real property taxes on owner occupied housing. The payment of these taxes is not voluntary and much of the benefit of local taxes, such as those that fund public schools and libraries, might be considered to be redistributive.

From this perspective, both such taxes should be fully deductible, and the Tax Cuts and Jobs Act \$10,000 limit on their deduction does not properly take into account ability to pay.

3. *Charitable Contributions*

The charitable contribution deduction is almost universally regarded as a tax expenditure,⁴⁶ although Paul McDaniel has advanced an interesting argument that the charitable contribution deduction for cash contributions, and for property in an amount limited to the donor's basis, is not a tax expenditure. He reasoned that the tax expenditure lies in the exclusion from gross income by the ultimate beneficiaries of the contribution—the individuals who are benefitted by the charitable organization's activities.⁴⁷ Under this view, the deduction is normatively justified in order to measure income correctly. But this position requires a narrow view of consumption. While many charitable contributions are redistributive, many charitable contributions go to organizations that provide, or have in the past provided, significant intangible benefits to the donor.

If any of the itemized deductions warrant limitation, the charitable contribution deduction, along with the home mortgage interest deduction, are the proper candidates. In light of my suggestion that the standard deduction be abolished and replaced by a more sophisticated system for allowing personal exemptions, the deduction for charitable contributions should be limited to an amount that exceeds a specified significant threshold percentage of the taxpayer's income.

⁴⁶The report of the House Ways and Means Committee on the Revenue Act of 1938 described the purpose of the deduction, first enacted in 1917, as follows: "The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial bur-den which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare." H.R. REP. No. 75-1860, at 19 (1939), *reprinted in* 1939-1 (Part 2) C.B. 738, 742.

⁴⁷Paul R. McDaniel, *The Charitable Contribution Deduction (Revisited)*, 59 SMU L. REV. 773 (2006).

V. Taxation of Business Income

The Tax Cuts and Jobs Act provided significant rate cuts for both C corporations and the owners of businesses conducted in a pass-through entity or a sole proprietorship, as well as significant changes to the tax base, some broadening the base and others narrowing the base—some rooted in sound tax policy, others not so much.

For quite a few years, tax policy analysts had reached a general consensus that the United States should reduce the statutory corporate tax rate,⁴⁸ and there were a variety of proposals to reduce the statutory rate and simultaneously to clean up the base by curbing or eliminating tax expenditures.⁴⁹ As Bill Gale, one of the nation's leading fiscal economists has said, "Everything you want to do in tax reform starts with broadening the base."⁵⁰

The various tax preferences for businesses that narrow the base are the reason why even though prior to 2018 the statutory U.S. corporate tax rate was the highest in the OECD, the United States has had an average effective corporate tax rate near the OECD average.⁵¹

While it is good tax policy to reduce the statutory corporate tax rate and reform the base so as to bring the statutory rate and effective rate closer together, reducing the rate without appropriate base expansion is merely a tax cut. It is not tax reform.

Changing the corporate tax rate and base has a ripple effect. The income of the majority of U.S. businesses is taxed directly to the businesses' owners under section 1, rather than to corporations under section 11, and in the aggregate, partnerships and S corporations realize almost double the taxable

⁴⁸ See, e.g., Karen C. Burke, *Is the Corporate Tax System "Broken"?*, 28 VA. TAX REV. 341 (2008); ROBERT CARROLL & THOMAS NEUBIG, ERNST & YOUNG, *THE ECONOMIC BENEFITS OF REDUCING THE U.S. CORPORATE INCOME TAX RATE* (2011).

⁴⁹ See, e.g., MARK P. KEIGHTLEY & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R42726, *THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM* 23-25, 28-31 (2014); Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014); STAFF OF THE JOINT COMMITTEE ON TAXATION, *TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014: A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE III—BUSINESS TAX REFORM* (2014); EXEC. OFFICE OF THE PRESIDENT & U.S. DEP'T OF TREAS., *THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM* (2012); Kimberly A. Clausing, *The Future of the Corporate Tax*, 66 TAX L. REV. 419 (2013); Jane G. Gravelle, *Reducing Depreciation Allowances to Finance a Lower Corporate Tax Rate*, 64 NAT'L TAX J. 1039 (2011); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011).

⁵⁰ William Hoffman, *Reduce Corporate Rates to Spur Economic Growth*, TPC Panel Says, 2014 TAX NOTES TODAY 175-5 (Sept. 10, 2014) (quoting William Gale).

⁵¹ See JANE G. GRAVELLE, CONG. RESEARCH SERV., R41743, *INTERNATIONAL CORPORATE TAX RATE COMPARISONS AND POLICY IMPLICATIONS* (2014); see also CONG. BUDGET OFFICE, *INTERNATIONAL COMPARISONS OF CORPORATE INCOME TAX RATES* (2017) (comparing nominal and average effective corporate tax rates in G-20 countries). The Treasury Department determined that the average tax paid by U.S. corporations' book earnings plus foreign dividends generally was only 22%. See OFFICE OF TAX ANALYSIS, U.S. DEP'T OF THE TREAS., *AVERAGE EFFECTIVE FEDERAL CORPORATE TAX RATES* 2 tbl.1 (2016).

income of C corporations.⁵² In light of the large and increasing percentage of business income realized by unincorporated businesses, either a simple tax cut for corporate income or corporate tax reform that involves broadening the base and reducing the rates could not thoughtfully be addressed without also reconsidering the taxation of unincorporated businesses. To reduce only the corporate tax rate would create a much more significant rate differential between the tax rate applicable to earnings retained by a C corporation compared to earnings retained by a partnership or S corporation or reinvested in a sole proprietorship. Unless something were done to mitigate this disparity, it arguably could lead to inefficient economic decisions.⁵³

The solution chosen by Congress in the Tax Cuts and Jobs Act is to provide a rate reduction—effected through a preferential deduction employing a complicated formula and replete with complicated definitions—for most business income taxed to individuals through pass-through entities and sole proprietorships.⁵⁴

Providing a preferential rate for income earned through and withdrawn from pass-through business entities for personal use by the owners is a terrible idea from a tax policy perspective.⁵⁵

⁵²MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R43104, A BRIEF OVERVIEW OF BUSINESS TYPES AND THEIR TAX TREATMENT 2 (2013).

⁵³See Martin A. Sullivan, *Relief for Passthrough Business Under Corporate Tax Reform*, 147 TAX NOTES (TA) 463 (Apr. 27, 2015). *But see* Amy S. Elliot, *Economists Shed Light on Who Owns Partnerships, Average Tax Rate*, 2015 TAX NOTES TODAY 95-4 (May 18, 2015) (researchers have found that 61% of partnership income allocated to U.S. households accrues to the top one percent (those with about \$375,000 or more in adjusted gross income); the average tax rate paid on business income by partners is 19.7%, which is lower than that of S corporations (at 24.7%) and C corporations (at 37%), taking into account tax at the shareholder level).

On the other hand, the result might simply be a return to the pre-1986 situation when even small businesses frequently were conducted in the form of C corporations. *See* Bret Wells, *Pass-Through Entity Taxation: A Tempest in a Teapot*, 2 HOUS. BUS. & TAX'N J. 1, 3-4 (2014) (“[L]owering corporate tax rates to 28% while maintaining the top individual rate at 39.6%, and maintaining a tax rate on capital gains and qualified dividends at 20%, should cause a broad cross-section of closely-held businesses to decide on their own to exit their pass-through entity structures and to opt for reincorporating their businesses back into C corporation form.”).

⁵⁴See WILLIAM G. GALE & AARON KRUPKIN, TAX POLICY CTR., NAVIGATING THE NEW PASS-THROUGH PROVISIONS: A TECHNICAL EXPLANATION (2018), <http://www.taxpolicycenter.org/publications/navigating-new-pass-through-provisions-technical-explanation/full>.

The rationale for that treatment is “that the corporate tax functions essentially as a tax on capital income, and hence lower rates should logically apply to noncorporate net business income as well.” Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1336 (2013). However, such a proposal does not necessarily comport with the rationale originally espoused for reducing the corporate tax rate, which was “the need to improve international competitiveness, not the desirability of reducing taxes on capital income generally.” Burke, *supra*.

⁵⁵Furthermore, section 199A is wholly unnecessary, because any unincorporated business could have availed itself of the 21% corporate tax rate simply by electing under the check-the-box regulations, Regulation sections 301.7701-1 through 301.7701-3, to be taxed as a corporation, and S corporations could have revoked their elections.

I will not examine the preferential rate for pass-through business income from a technical perspective here, but a number of commentators have already published analysis of the tax avoidance strategies that the new regime will encourage and enable.⁵⁶ Furthermore, the Byzantine system of taxing pass-through business income under the new law does not result in equivalent effective tax rates on the income of corporate and noncorporate businesses, whether retained in the business or distributed to the owners for personal use.

I firmly believe that the complexity of section 199A will turn out to be beyond the Pale. But it is not the complexity that troubles me the most.

Any regime providing a preferential rate for income earned through pass-through businesses will not be fair when fairness is measured by horizontal and vertical equity. Under such a system, the owner of a business pays less in taxes than a wage earner with the same income, and very well might pay less in taxes than a wage earner with a lower income. That most pass-through income historically has been received by individuals in the higher ordinary income tax brackets⁵⁷ assures that preferential rates for pass-through income disproportionately benefit those at the very top of the income pyramid.

Personal income should be taxed at the same rate whether it is realized in the form of wages or in the form of business profits,⁵⁸ particularly if it is withdrawn from the business for consumption or for another investment unrelated to the business.

From a perspective of traditional tax policy criteria, new section 199A is a colossal blunder. It is not equitable, simple, or efficient.

⁵⁶E.g., Michael L. Schler, *Reflections on the Pending Tax Cuts and Jobs Act*, 157 TAX NOTES (TA) 1731 (Dec. 18, 2017); David Kamin et al., *The Games They Will Play: An Update on the Conference Committee Tax Bill* (Dec. 18, 2017) (unpublished working paper), <http://ssrn.com/abstract=3089423>.

⁵⁷See Amy S. Elliot, *Economists Shed Light on Who Owns Partnerships, Average Tax Rate*, 2015 TAX NOTES TODAY 95-4 (May 18, 2015). Researchers have found that 61% of partnership income allocated to U.S. households accrues to the top one percent (those with about \$375,000 or more in adjusted gross income). In 2006, over 82% of net pass-through income was earned by taxpayers with an adjusted gross income (AGI) over \$100,000 (23% of returns). And most of that amount was earned by very high-income taxpayers. Taxpayers with AGI over \$250,000 (six percent of returns) received 62% of pass-through income, with 35% being earned by taxpayers with AGI of over \$1 million. MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42359, WHO EARNS PASS-THROUGH BUSINESS INCOME? AN ANALYSIS OF INDIVIDUAL TAX RETURN DATA 2 (2012). Most pass-through entities are not “mom and pop” small businesses. See Martin A. Sullivan, *Relief for Passthrough Business Under Corporate Tax Reform*, 147 TAX NOTES (TA) 463 (Apr. 27, 2015).

⁵⁸In any event, trying to distinguish compensatory income from the return to capital investment is a fool’s errand. For most private businesses it is impossible to separate the return to labor from the remaining business profits. See Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165, 181 (2011).

As I have proposed previously in an article in *The Tax Lawyer*,⁵⁹ pass-through taxation should be abolished and replaced by a new regime under which all privately held businesses, whether organized as a corporation, partnership, limited liability company, or conducted as an unorganized sole proprietorship, would be taxed at the entity level under a uniform rate schedule, regardless of the form of organization. Applying an entity level tax to all privately held businesses, however organized, would reduce distortions in the choice of business entity due solely to tax planning.

The tax base—the net calculation of gross income, business deductions, and credits—and the tax rate applied to earnings retained by businesses for expansion should be uniform regardless of the form of organization of the business and whether the business is publicly traded or privately held. Because all businesses would pay taxes at an identical single rate, section 1231 (along with sections 1245 and 1250) would be repealed.⁶⁰

The only distinction between publicly traded business entities and business entities that are not publicly traded is with respect to distributions. Distributions from publicly traded business entities would continue to be taxed as dividends.⁶¹

Distributions from privately held businesses would be taxed under a different regime.

This proposal originates from decades-long problems with the administration of Subchapter K and the incoherence of having three separate regimes—Subchapter C, Subchapter K, and Subchapter S—apply to privately held businesses, depending on the form of organization and available elections. It is not a response to the Tax Cuts and Jobs Act, but it does offer a simpler, more equitable, and more efficient alternative to the pass-through provisions in that Act.

⁵⁹Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses*, 69 *TAX LAW.* 345 (2015).

⁶⁰There is nothing sacred about the “heads the taxpayer wins, tails the fisc loses” feature of section 1231. Prior to World War II, no depreciable property or land held for use in a trade or business was accorded capital gains treatment; ordinary gain or loss was the order of the day. See H.R. REP. NO. 2333, 77th Cong., 2d Sess., reprinted in 1942-2 C.B. 372,415. Section 1231 owes its origins to wartime exigencies. See BORIS I. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* § 54.1.1 (1981). Seventy years after the end of World War II, it is time we return to the pre-war regime for taxing such gains and losses.

⁶¹Because the corporate tax rate has been reduced, then the preferential tax rate on dividends and capital gains should be eliminated or at least increased to something higher than it is currently. See Rosanne Altshuler, Benjamin H. Harris & Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, 30 *VA. TAX REV.* 355 (2010) (taxing capital gains and dividends as ordinary income (subject to a maximum 28% rate on long-term capital gains) would finance a cut in the corporate tax rate from 35% to about 26%).

Despite its superficial elegance, Subchapter K is a failed regime.⁶² At first blush, the basic paradigm appears to be sensible in theory, but for many reasons, in execution it does not work well.

When Subchapter K was enacted in 1954, it was designed to deal with small businesses,⁶³ with very simple profit sharing arrangements, and limited leverage. Currently, however, it is being employed by very large enterprises,⁶⁴ which often have extraordinarily complex profit sharing arrangements and significant leverage. Over the years, the simple provisions and general rules of Subchapter K as enacted in 1954 have metamorphosed into a maze of special transaction-specific and anti-abuse rules, which are supplemented by voluminous regulations.⁶⁵

The basic premise of the section 704 safe harbor rules, which are at the core of the pass-through regime, is to compare annual allocations of partnership profits and losses among the partners with the change in the amount they would have received upon a hypothetical liquidation of the partnership from one year end to the next. But many modern profit and loss sharing allocations,

⁶² See Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 429 (1999); see also Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343 (2003); Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381 (2009); Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465 (2011); Andrea Monroe, *Integrity in Taxation: Rethinking Partnership Tax*, 64 ALA. L. REV. 289 (2012); Philip L. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451 (2001).

⁶³ See 100 CONG. REC. 3,425 (1954) (statement of Rep. Reed of New York) (“[The partnership provisions] . . . will be of great benefit to thousands of small businesses which traditionally operate in the partnership form.”); 100 CONG. REC. 3,554 (1954) (statement of Rep. Knox of Michigan) (“Small businesses frequently operate in the form of a partnership . . . the easily workable methods outlined in the bill are important because many partners are taxpayers with small incomes.”); INTERNAL REVENUE ACTS OF THE UNITED STATES, THE REVENUE ACT OF 1954 WITH LEGISLATIVE HISTORIES AND CONGRESSIONAL DOCUMENTS 1363, 1364 (Bernard D. Reams, ed., Hein Publishing Co. 1982) (remarks of Mr. F.N. Bard, of Barrington, Illinois, made before the House Ways & Means Committee’s Hearings on August 4, 1953, asking for a synchronization of tax treatment between the lower corporate tax rates and the tax rates for the “[eight] million businessmen” operating in unincorporated form); see also J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey, Carolyn K. Tenen & William C. Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183 (1954).

⁶⁴ See Matthew Knittel et al., *Methodology to Identify Small Businesses and Their Owners* (U.S. Dept of the Treas., Office of Tax Analysis, Technical Paper 4, 2011).

⁶⁵ See Lawrence Lokken, *As the World of Partnership Turns*, 56 SMU L. REV. 365, 367 (2003) (“The revolutionary accretion of detail in subchapter K is largely a response to aggressive uses of partnerships for tax avoidance, resembling a steady build-up in the arsenal of an army caught in an unwinnable guerilla war.”).

often referred to as “targeted allocations,”⁶⁶ cannot easily be analyzed under this method, because the partnership profit and loss sharing provisions are based on the premise that the partnership will continue beyond the current year and that the portion of the current year’s income to which one or more partners will be entitled (or loss the partner will suffer) depends on future years’ income and losses. These allocations must be evaluated under a vague standard based on consistency with a “partner’s interest in the partnership.”⁶⁷

Other problems arise with respect to the rules under section 752 governing the inclusion of partnership level debt in partners’ outside bases and the determination of each partner’s share of partnership debt.⁶⁸ The application of these rules, which are quite manipulable,⁶⁹ provides the underpinning for the overwhelming majority of the tax shelters that have long plagued the tax system.⁷⁰

In addition to facilitating the creation of artificial losses, the rules governing allocation of partnership-level debt among partners can be manipulated to permit a tax-free distribution of cash to a partner vastly disproportionate to that partner’s share of partnership profits.

Subchapter K is deeply flawed and particularly prone to abuse. As stated by the court in *Chemtech Royalty Associates*, “many abusive tax-avoidance schemes are designed to exploit the Code’s partnership provisions.”⁷¹

A radical change is necessary.

Thus, I propose an entirely new regime for privately held businesses. Subchapter K and Subchapter S would be repealed entirely. The current corporate tax rules would apply only to publicly-traded corporations and their affiliates.

⁶⁶ See, e.g., N.Y. STATE BAR ASS’N TAX SECTION, REPORT ON PARTNERSHIP TARGET ALLOCATIONS (2010); Todd Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—But Don’t Bet Your Life On It)*, TAXES, Mar. 2009, at 157; Terrence Cuff, *Several Thoughts on Drafting Target Allocation Provisions*, TAXES, Mar. 2009, at 171; Terrence Cuff, *Working With Target Allocations—Idiot-Proof or Drafting for Idiots?*, 35 REAL EST. TAX’N 116 (2008); Terrence Cuff, *Working With Target Allocations—Drafting in Wonderland*, 35 REAL EST. TAX’N 162 (2008); Brian J. O’Connor & Steven R. Schneider, *Capital Account Based Liquidations: Gone With the Wind, or Here to Stay?*, 102 J. TAX’N 21 (2005); Thomas C. Lenz, *Using the Targeted Capital Account Approach to Allocate Income and Loss—Is it Better than the Traditional Layered Approach?*, 5 J. PASS-THROUGH ENTITIES 25 (2002).

⁶⁷ See, e.g., Bradley Borden, *The Allure and Illusion of Partners’ Interest in the Partnership*, 79 CINN. L. REV. 1077 (2011); Sheldon I. Banoff, *Identifying Partners’ Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, TAXES, Mar. 2007, at 197.

⁶⁸ Reg. § 1.752-1 to -4, -6 to -7.

⁶⁹ See Section 707 Regarding Disguised Sales, Generally, 79 Fed. Reg. 4826 (proposed Jan. 30 2014) (proposing major changes to the regulations governing the allocation of partnership debt among the partners for purposes of determining partners’ bases in their partnership interests).

⁷⁰ Calvin H. Johnson, *Better Twice Measured: Partner Basis from Partnership Debt*, 147 TAX NOTES (TA) 79, 81 (Apr. 6, 2015).

⁷¹ *Chemtech Royalty Associates, LP v. United States*, 766 F.3d 453 (5th Cir. 2014).

Profits and losses of private business entities would not be passed through to the owners.

Net operating losses would carryover at the entity level.

Taxing all businesses at the entity level would greatly reduce tax planning and avoidance.⁷² Because income and losses would not be passed through to owners, and taxation of owners would turn solely on the receipt of distributions, the tax law no longer would be concerned about partnership allocations. The labyrinthine section 704 regulations would be consigned to the dust bin of history, with no comparable provision replacing them. Similarly, the continuing role, if any, of the complex section 465 at-risk rules and the section 469 passive activity loss rules would be very limited.

The entity-level tax would, in effect, be converted to a withholding tax by applying the imputation-credit model for corporate tax integration to all distributions.⁷³ Each entity would maintain a “taxes paid account,” which would be applied to any distribution.⁷⁴ Current distributions would be grossed up by the entity-level tax attributable to the distributed amount, and that grossed up amount would be subject to tax at the owners’ appropriate tax rates. A credit for the allocable entity-level tax would be allowed to the distributee owner. For taxable U.S. owners, the credit would be refundable. The taxes paid account would be reduced by the gross-up/credit amount for any distribution.

Privately held businesses could deduct all compensation to employee/owners of the business, regardless of whether the owner is a shareholder, partner, LLC member, or sole proprietor.⁷⁵ Because there would be only a single level

⁷²See Martin J. McMahon, Jr., *Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters*, 98 TAX NOTES (TA) 1721, 1732 (Mar. 17, 2003) (“There is no important societal interest in being overly concerned with drawing a bright-line between ‘legitimate tax planning’ and impermissible tax avoidance. ‘Pure tax planning,’ apart from business planning, is not a goal to be valued by the legal system.”).

⁷³For the imputation-credit model, see ALI FEDERAL INCOME TAX PROJECT, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES 50-52 (1993); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431, 436-49. (1992). For a dividend exclusion model, see U.S. DEP’T OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992).

⁷⁴The “taxes paid account” would resemble the starting point for the “excludable dividends account” in the Bush Administration’s proposal that would have permitted corporations to distribute nontaxable dividends to their shareholders to the extent that those dividends were paid out of income previously taxed by the United States at the corporate level. See U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2004 REVENUE PROPOSALS 13-14 (2003).

The amount of the gross up would be based on the assumption that the entity had paid the statutory rate of tax, even if tax preferences reduced the effective rate. This in effect passes through the benefit of tax preferences, as long as there remains a balance in the actual “taxes paid” account. For the issue of passing through business income tax preferences, see FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES 58-90 (AM. LAW INST. 1993).

⁷⁵For sole proprietors, current Schedule C, with some modifications, would be converted into an entity tax return.

of tax, current law limiting the deduction for compensation to employee/shareholders to a “reasonable amount”⁷⁶ would be repealed.

Thus, the tax regime I am proposing is a single-level tax with a rate structure ultimately determined by the individual owners’ income, thereby reflecting the individual progressive rate structure.

Because the entity-level tax rate would be lower—likely significantly lower—than the tax rate of many individual owners,⁷⁷ there would be a great temptation to “shelter” in business entities earnings in excess of the needs of the business that could and would be invested in nonbusiness assets, such as publicly traded stock and securities.⁷⁸ Accordingly, a vigorous accumulated earnings tax along the lines of current sections 531-537 would apply to all privately-held business entities.⁷⁹

The same considerations militate in favor of application of an analogue to the personal holding company tax in sections 541-547, which like the accumulated earnings tax would apply to all business entities regardless of the form of organization.

A complete liquidation of an entity would result in gain and loss being recognized at the entity level with respect to property, with an entity-level tax

⁷⁶I.R.C. § 162(a)(1); Reg. § 1.162-7, -8.

⁷⁷Currently, a very large percentage of pass-through business income is reported by relatively high income taxpayers. See MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42359, WHO EARNS PASS-THROUGH BUSINESS INCOME? AN ANALYSIS OF INDIVIDUAL TAX RETURN DATA (2012).

[O]ver 82% of net pass-through income is earned by taxpayers with an adjusted gross income (AGI) over \$100,000, although these taxpayers account for just 23% of returns filed. A significant fraction of passthrough income is concentrated among upper-income earners. Taxpayers with AGI over \$250,000, for example, receive 62% of pass-through income, but account for just over 6% of returns with pass-through income. A closer look at S corporations and partnerships shows passive income accounts for 10% and 25%, respectively, of their total income.

KEIGHTLEY, *supra*, at *Summary*. Moreover, almost 60% is earned by taxpayers with AGI over \$250,000, with 35% being earned by taxpayers with AGI of over \$1 million. See also Amy S. Elliot, *Economists Shed Light on Who Owns Partnerships, Average Tax Rate*, 2015 TAX NOTES TODAY 95-4 (May 18, 2015) (researchers have found that 61% of partnership income allocated to U.S. households accrues to the top one percent (those with about \$375,000 or more in adjusted gross income); the average tax rate paid on business income by partners is 19.7%, which is lower than that of S corporations (at 24.7%) and C corporations (at 37%, taking into account tax at the shareholder level)).

⁷⁸See Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1335-36 (2013) (“If corporate tax rates fall and individual tax rates rise, C corporations could again become attractive as tax shelters Permitting closely held corporations to benefit from reduced rates would greatly magnify the tax shelter problem.”).

⁷⁹Consideration should be given to subjecting all publicly traded financial interests held by a private firm to the accumulated earnings tax unless some threshold percentage of the entity’s assets, for example 80% or 90%, consists of publicly traded financial interests and cash.

being imposed.⁸⁰ Each owner's amount realized would be grossed up by the owner's proportionate share of the taxes paid account that had not previously been applied to prior distributions. After computing gain or loss realized and recognized on the liquidating distribution and the resulting owner-level tax, a refundable credit would be allowed to taxable U.S. persons.

Redemptions should be treated in much the same way as liquidations.⁸¹

No special rules would apply to sales of interests to a person other than the entity. There would be no gross-up or credit allowed to the seller.⁸² The entity's taxes paid account would remain unchanged. The sale would be treated as the sale of a unitary asset; there would be no "look-through" akin to section 751(a). Because privately held businesses would not be subject to a double tax regime, there should not be any preferential rates.⁸³ The value of an interest in a privately held business frequently, and virtually always in the case of a small business in which the owners are significantly active (with the possible exception of passive rental businesses), largely reflects unrealized income from the efforts of the entrepreneur-owners.⁸⁴

VI. Conclusion

In conclusion, the Tax Cuts and Jobs Act missed the mark in delivering a fair, simple, and efficient tax code. It was not true "tax reform" under traditional tax policy criteria. The Tax Cuts and Jobs Act is yet another story of wrong turns and missed opportunities. And the plea for a fair, simple, and efficient tax code will continue to echo in years to come.

⁸⁰ See Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 153-58 (1991) (suggesting requiring recognition upon the distribution of property by partnerships); Andrea Monroe, *Taxing Reality: Rethinking Partnership Distributions*, 47 LOY. L.A. L. REV. 657 (2014) (suggesting that liquidating distributions by partnerships be a recognition event).

⁸¹ See Monroe, *supra* note 80 (suggesting that partnership liquidating distributions should be treated as taxable exchanges in which the partner receives cash or property from the partnership in exchange for relinquishing her interest in the partnership and its underlying property).

⁸² This differs from the 2003 Treasury Department proposals, which would have permitted corporations to allocate throughout the year all or a portion of their excludable dividends account to increase their shareholders' basis in their stock. See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 14 (2003). But even under the 2003 Treasury Department proposal, the basis increase would not have been automatic.

⁸³ Cf. Rosanne Altshuler, Benjamin Harris & Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355 (2010) (the authors made a convincing case for that approach suggesting that if the corporate tax were integrated and set at a reasonably low rate, on both fairness and efficiency grounds the preferential rate on dividends and capital gains could be eliminated); ERIC TODER & ALAN VIARD, MAJOR SURGERY NEEDED: A CALL FOR STRUCTURAL REFORM OF THE U.S. CORPORATE INCOME TAX 26 (2014), <http://www.taxpolicycenter.org/publications/major-surgery-needed-call-structural-reform-us-corporate-income-tax/full> (suggesting replacement of corporate tax with a shareholder-level mark-to-market tax at ordinary income rates).

⁸⁴ See Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165, 181 (2011); Calvin H. Johnson, *Capitalize Costs of Software Development*, 124 TAX NOTES (TA) 603 (Aug. 10, 2009).