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# The Tax Reform Act of 1986: An Overview

*Daniel L. Simmons**

The Tax Reform Act of 1986 (the 1986 Act)[1] represents a significant change in the direction of United States tax policy. Tax policy makers purchased a major reform in terms of a broadened tax base, that is, an expanded definition of income subject to the income tax, at the cost of substantially reduced marginal rates of tax on upper income taxpayers and a lesser reduction of marginal rates on others. Limitations on the use of losses generated by passive investment vehicles,[2] specifically tax shelter limited partnerships, and elimination of the preferential treatment previously afforded to long-term capital gains[3] represent major improvements in terms of the fairness and complexity of the Internal Revenue Code. The base broadening is far from complete, however, as the Code remains riddled with tax incentives for particular economic behavior that are coupled with complex provisions such as the alternative minimum tax,[4] at-risk rules,[5] and the newly enacted passive loss limitation[6] to prevent taxpayers from taking undue advantage of the remaining incentives.

The first part of this article contrasts ability-to-pay, the standard that loosely guided income taxation before 1986, with the divergent philosophical underpinnings of the 1986 Act. The analysis focuses on the difference between fairness under an ability-to-pay concept and the economic incentives that motivated the campaign for modified flat tax rates. The article next explores the tax reform plan's assumption that fairness is compatible with the continued tax incentives available for preferred investment activities. The article concludes by presenting guide-

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.
2. *Id.* § 501 (adding I.R.C. § 469).
3. *Id.* §§ 301, 311.
4. I.R.C. §§ 55-57 (1982).
5. I.R.C. § 465 (1982).
6. I.R.C. § 469 (West Supp. 1987).

lines that may appear too simple for practical application, but which, because of their inherent simplicity, provide a workable analytical tool for evaluating the next round of adjustments to the tax base.

## I. Fairness, Ability-to-pay and Economic Incentive

### A. *An Historical Overview of Fairness*

The history of taxation in the United States is marked by a continuing debate on the allocation of tax burdens between those who possess capital and those who consume their wealth. Prior to the Civil War, the United States derived its revenue from customs duties and excise taxes.[7] The burden of these taxes fell on the consumers of taxed articles. Accumulations of wealth from manufacturing and capital investment were not subject to taxation. The first income tax act[8] was promulgated as part of the Civil War finance package because of opposition from western states to allocating the burden of Civil War finance solely with an apportioned direct land tax.[9] Following the War, the income tax was allowed to lapse and ninety percent of the federal revenue was derived from excise taxes on liquor and tobacco.[10]

Excise taxes on particular goods can be enacted with perfect horizontal and vertical equities, the two concepts often used to judge the fairness of a tax system.[11] Vertical equity refers to the allocation of relative tax burdens among different groups. Progressive vertical equity says that persons with the greatest measure of the thing subject to tax should make the greatest contribution to revenue needs, and, conversely, persons with a lesser quantity should make a relatively smaller contribution. An excise tax on alcohol measured by quantity is vertically equitable in the sense that a consumer of a full-pint pays more tax than the consumer of a half-pint. The vertical equity is proportional because the tax increases in a straight-line as the quantity of the thing taxed increases. The rate of tax increase may also be graduated, as where the tax rate itself increases as the quantity of

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7. S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 2 (1972) [hereinafter S. Surrey].

8. Revenue Act of 1861, ch. 45, 12 Stat. 292, 309.

9. S. Surrey, *supra* note 7, at 3.

10. *Id.* at 4.

11. *See* Musgrave, *In Defense of an Income Concept*, 81 Harv. L. Rev. 44, 45 (1967).

the taxed item increases. An excise on alcohol under this latter model would impose a greater tax on the second half-pint than on the first.

The concept of vertical equity is useful only to examine changes or shifts in relative tax burdens. Vertical equity does not prescribe the appropriate relative allocation of tax burden among different segments of the tax-paying population. Thus, in an income tax system, vertical equity refers only to the relative allocation of tax burdens to taxpayers in different income categories.

Horizontal equity demands that persons in the same relative position with respect to the measure of tax bear equal burdens of tax. Horizontal equity is achieved in the case of an excise tax on alcohol or tobacco because the excise falls equally on persons who consume the same amount of the taxed item. On the other hand, if Congress should decide to favor alcohol produced in Kentucky over alcohol produced in West Virginia by imposing a lower tax rate on Kentucky alcohol, horizontal equity is disturbed because the consumer of a pint of Kentucky alcohol bears a lower tax burden than the consumer of West Virginia alcohol.

Deviations from the standard of measurement in the form of preferences for selected parts of the tax base simultaneously affect both horizontal and vertical equity.[12] Horizontal equity is reduced where persons who use or possess the preferred item pay lower taxes than others possessing similar non-favored items. Vertical equity is disturbed by imposing a relatively smaller burden on groups of taxpayers who have a greater measure of the thing taxed. For example, if an excise on alcohol consumption taxes all consumers in proportion to consumption, a preference for Kentucky alcohol, in addition to imposing a greater tax on consumers of alcohol produced outside of Kentucky, disturbs vertical equity by imposing a higher proportion of the tax burden on West Virginia alcohol consumers relative to Kentucky alcohol consumers.

Vertical and horizontal equities do not make an excise system fair in a broader sense. "Fairness" also requires a measure of tax liability that fairly allocates the burden of government finance to an appropriate taxpaying population.[13] Government fi-

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12. *Id.* at 51.

13. *See* Bittker, *Effective Tax Rates, Fact or Fancy?*, 122 U. PA. L. REV. 780, 805

nance based solely on consumption of alcohol and tobacco may have perfect internal vertical and horizontal equity, but the burden of government may not be equitably distributed among the beneficiaries of governmental services.[14] The choice of the measure itself thus has a major impact on where the burden of tax will fall. The income tax was born out of a demand to reallocate the burden of government finance among different segments of the economy.

In the latter part of the nineteenth century, Populist demands for a greater contribution to the federal revenue by the wealthy and a shift of the tax burden away from farm and labor groups in Southern and Western states led to enactment of a federal income tax.[15] The principal opposition to graduated income taxation came from eastern business interests.[16] Thus, the battle lines were formed between the wage earners and agricultural interests who bore the burden of excise taxes on consumable items, and the industrial interests deriving income from capital not then subject to tax. Political victory in state and national elections by the former groups during the first decade of this century resulted in ratification of the sixteenth amendment, which permitted a tax on income without apportionment among the states, and the subsequent congressional enactment of the Revenue Act of 1913.[17]

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(1974).

14. *See* Ture, *Chairman Packwood's Excise Tax and Tariff Changes*, 31 TAX NOTES 65 (1986). Commenting on Senator Packwood's proposals to increase excise taxes on alcohol, tobacco and motor fuels and to disallow deductibility of all excises and tariffs by business income taxpayers as a device to raise revenue and provide lower income tax rates, Ture says:

> Against all significant criteria of good tax policy, the proposed excise tax and tariff changes would be a major step backward. The excise taxes and tariffs in the federal revenue system are selective taxes; they are imposed at differing rates on selected products and services rather than being levied at the same rate on all the products and services produced and sold in the economy. . . . The redistribution of tax burdens that would result from these tax changes would be substantial; there is no reason to believe that these shifts in tax burdens would conform with any acceptable standards of either economic efficiency or tax fairness.

*Id.* at 66.

15. S. SURREY, *supra* note 7, at 4-5.

16. *Id.* at 4. The authors reprint the comments of an opposition Senator who decried graduated income taxation saying that, "In a republic like ours, where all men are equal, this attempt to array the rich against the poor or the poor against the rich is socialism, communism, devilism." *Id.* at 5.

17. Revenue Act of 1913, ch. 16, 38 Stat. 114, 166. *See* S. SURREY, *supra* note 7, at 8-10. The sixteenth amendment was preceded by the Revenue Act of 1894 which was de-

History illustrates a continuing tension in the allocation of government revenue needs between consumption by the mass of citizens and the income and/or capital of wealthier individuals.[18] Adoption and continued use of income as the measure of graduated tax liability has been based on the principle that burdens of taxation should be distributed in accordance with ability-to-pay measured by the amount of money available to the taxpayer from income.[19]

### B. *Declining Marginal Rates and Shifting Tax Burdens Since 1954*

Two significant phenomena mark the history of income taxation over the past three decades—declining marginal rates of tax at the top income brackets, and a shift of the burden of tax to lower- and middle-income taxpayers.

The Internal Revenue Code of 1954 was enacted with a pro-

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clared unconstitutional in Pollack v. Farmers Loan & Trust Co., 157 U.S. 429 (1895), as a direct tax in violation of the requirements of article 1, section 2, clause 3, and section 9, clause 4, that direct taxes be apportioned among the states in accordance with population.

The impact of the 1913 Act was limited in scope with a one percent tax on income above a personal exemption of $3,000 and an additional $1,000 exemption for married persons. The tax included a graduated surtax on income above $20,000. The six percent bracket applied to incomes above $500,000. Revenue Act of 1913, ch. 16, 38 Stat. 114, 166-68.

18. The appellant's argument in *Pollack* is illustrative. Mr. Joseph H. Choate described the 1894 Revenue Act as "communistic in its purposes and tendencies, and is defended here upon principles as communistic, socialistic — what shall I call them — populistic as ever have been addressed to any political assembly in the world." *Pollack*, 157 U.S. at 532. Mr. Choate complained further of the possibility that the exemption levels could be increased by Congress with higher rates on incomes above the exemption and exclaimed that "one of the fundamental objects of all civilized government was the preservation of the rights of private property." *Id.* at 534. He then told the court that "[n]o member of this Court will live long enough to hear a case which will involve a question of more importance than this, the preservation of the fundamental rights of private property and equality before the law . . . ." *Id.* at 553.

19. Graetz, *Can the Income Tax Continue to be the Major Revenue Source?*, in OPTIONS FOR TAX REFORM 39, 64 (J. Pechman ed. 1984) (Brookings Dialogues on Public Policy).

> In the crudest sense, ability-to-pay means only the possession of resources than can be turned over to the state . . . .
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> . . . .
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> Ability-to-pay taxes is the capacity for paying without undue hardship on the part of the person paying or an unacceptable degree of interference with objectives that are considered socially important by other members of the community.

R. GOODE, THE INDIVIDUAL INCOME TAX 17 (rev. ed. 1976) (Brookings Institute Studies of Government Finance).

gressive rate schedule based on a range of marginal tax rates from 20% at the bottom to 91% at the top.[20] The 91% top marginal rate meant that for each additional dollar of taxable income received by an individual in the highest income bracket, 91 cents was payable to the U.S. Treasury.[21] Corporate rates were 30% with a 22% surtax resulting in a combined marginal rate of 52% on taxable income in excess of the $25,000 surtax exemption.[22] The Revenue Act of 1964 (the 1964 Act) lowered individual rates to a range of 14% to 70%.[23] The 1964 Act also reduced the maximum rate on corporate income to 48%.[24] The Tax Reform Act of 1969 again significantly reduced maximum individual tax rates by limiting the maximum marginal rate on earned income to 50%.[25] The Revenue Act of 1978 reduced the top corporate rate from 48% to 46%.[26] Finally, the Economic Recovery Tax Act of 1981 reduced the top marginal rate on investment income from 70% to 50%.[27] Thus, the past thirty years have brought a steady decline in top marginal tax brackets.

Unfortunately, the decline in top marginal rates does not tell the whole story. In spite of significant reductions in rates for the highest marginal income brackets, a growing number of individual taxpayers in the middle- and lower-income bands have found themselves paying an increasingly larger percentage of their marginal income in taxes. In 1954, the lowest rate bracket,

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20. Int. Rev. Code of 1954, ch. 736, § 1, 68A Stat. 3. The Treasury Department's 1984 tax reform proposal, DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984) [hereinafter TREASURY PROPOSAL], states that, "Compared to today, the 1954 income tax was simpler, more neutral, and fairer, in many respects. Perhaps more importantly, it was probably seen to be fair by most taxpayers, and the perception of fairness helped maintain the voluntary compliance so crucial to the American system of taxation." 1 Treasury Proposal 3. The *Treasury Proposal* adds, however, that the high marginal rates were an important defect of the 1954 income tax. *Id.* at 2.

21. Marginal rates, the rate of tax imposed on the last dollar of taxable income, must be distinguished from effective rates of tax, which are determined by dividing the total amount of tax by a figure for overall income. Effective rate determinations often vary by whether rate is a percentage of economic income or the tax concepts of either gross income (income determined without deductions) or adjusted gross income (gross income less the deductions allowed by the Code for the costs of earning income including accelerated capital recovery and the preference for capital gains).

22. Int. Rev. Code of 1954, ch. 736, § 11, 68A Stat. 11.

23. Rev. Act of 1964, Pub. L. No. 88-272 § 111, 78 Stat. 19, 20-21.

24. *Id.* § 121, 78 Stat. at 25.

25. Tax Reform Act of 1969, Pub. L. No. 91-172, § 804, 83 Stat. 487, 685-86 (enacting I.R.C. § 1348).

26. Revenue Act of 1978, Pub. L. No. 95-600, § 301, 92 Stat. 2763, 2820.

27. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176.

20%, applied to 90% of taxpayers filing returns.[28] The steeply progressive rates of the 1954 version of the Code applied only to taxpayers at the very top of the income distribution.[29] In contrast, almost one-half of all taxpayers who filed tax returns for 1981 were subject to marginal rates in excess of 20%.[30]

The tax reform plan drafted by the Department of the Treasury in 1984 (the *Treasury Proposal*)[31] and the substitute proposal submitted by President Reagan (the *Reagan Plan*)[32] recommended a top marginal bracket of 35%. In 1964 only 1% of all returns were subject to marginal rates in excess of this 35% figure.[33] By 1981, the percentage of taxpayers paying taxes at marginal rates above 35% increased to 13.7%.[34] In 1981, 9.2% of all returns paid tax at marginal rates above 40%, and 1.6% of all filers paid taxes at marginal rates of 50% or above.[35]

The statistics also demonstrate that while only a small (but growing) proportion of taxpayers had been subject to the highest marginal income tax rates, increasingly large numbers of taxpayers were being subjected to higher marginal rates throughout the middle bands of the rate tables. This phenomenon is referred to as bracket creep. As incomes grew because of inflation and other causes, taxpayers were pushed into higher tax brackets.[36]

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28. 1 TREASURY PROPOSAL, *supra* note 20, at 2-3.

29. *Id.* at 3.

30. Thompson & Hicks, *Average and Marginal Tax Rates, 1981*, 3 STATISTICS OF INCOME BULL. 41, 44 (Fall 1983) (table 1).

31. 1 TREASURY PROPOSAL, *supra* note 20.

32. THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985) [hereinafter the REAGAN PLAN].

33. BARRO & SAHASAKUL, MEASURING THE AVERAGE MARGINAL TAX RATE (National Bureau of Economic Research Working Paper No. 1060, 1983). Barro and Sahasakul trace fluctuations in the average marginal tax rate from 1916-1980. They state that the average marginal rate in 1954 was 22%, increasing to 30% in 1980.

34. Thompson & Hicks, *supra* note 30.

35. *Id.* The reduction of marginal rates to 50% by the Economic Recovery Tax Act of 1981 affected only this last group. Pechman indicates that depending upon particular assumptions with respect to who bears the incidence of certain forms of taxation, most significantly corporate tax, overall effective tax rates for 1980 were either mildly progressive or slightly regressive. Under the most progressive assumptions, overall effective rates vary from 20.3% on the lowest income families to 31% of economic income of $1 million and above. J. PECHMAN, WHO PAID THE TAXES 1966-85, at 44-48 (Brookings Institute Studies of Government Finance 1985).

36. Since the mid-1960s, inflation and bracket creep have made graduated rates a reality for an increasing fraction of the population and by 1979 progressive rates applied to virtually the entire range of incomes subject to tax. By then roughly a third of low-income tax returns were subject to marginal rates below those prevailing at the same point in the distribution of tax returns in 1961. By comparison, almost half of tax returns showed marginal tax rates higher, in

In 1965 a family of four earning the median income faced a marginal tax rate of 17%. By 1980 the median income of a family of four increased sufficiently to put it in the 24% bracket, a 41% increase in the tax rate on marginal income.[37]

On the other hand, and contrary to the assertions of some commentators, inflation was not freely allowed to increase overall tax burdens through the 1970s. The Congressional Budget Office reported that during the period 1969-1979 Congress came close to offsetting the effect of inflation on tax rates with tax reductions.[38] Most of these reductions were in the form of an increase in the threshold level of tax that benefited lower-income taxpayers relatively more than higher-income taxpayers.[39] Tax liabilities of low-income taxpayers were offset by increased standard deductions (generally available to taxpayers who do not have sufficient interest and state and local taxes to itemize deductions, mostly nonhomeowners or persons not subject to substantial state income taxes), higher personal exemptions, and low income credits. Nonetheless, the tax liability of low-income taxpayers increased.[40] At the other end of the economic spectrum the reduction in top marginal rates occurring between 1954 and the present,[41] coupled with the growth of available tax preferences, reduced the relative burden of tax on upper income groups. The moderate- to upper-income wage earner was subjected to higher marginal rates below the maximum brackets, but without any sort of substantial mitigating tax relief.[42] Policy makers might have reasonably concluded

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> some cases substantially higher, than paid by their counterparts in 1961, even under the much more progressive rate structure prevailing earlier. The across-the-board rate reductions in the Economic Recovery Tax Act of 1981 lowered rates, but they did not substantially affect the ubiquity of progressivity.

McClure, Comment in OPTIONS FOR TAX REFORM, *supra* note 19, at 134, 136.

37. R. HALL & A. RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX 9 (1983).

38. CONGRESSIONAL BUDGET OFFICE, INDEXING THE INDIVIDUAL INCOME TAX FOR INFLATION 14-15 (1980).

39. *Id.* at 15 n.4.

40. *See* Steuerle & Wilson, *The Taxation of Poor and Lower Income Workers*, 34 TAX NOTES 695 (1986).

41. *See supra* text accompanying notes 20-27.

42. Indeed, this group has been subject to tax increases by most recent tax reform acts that eliminated certain forms of itemized deductions. For example, repeal of the deduction for gasoline taxes in 1978 (Revenue Act of 1978, Pub. L. No. 95-600, § 111, 92 Stat. 2763, 2777), and higher thresholds for other itemized deductions such as medical expenses, increased from 3% of adjusted gross income to 5% by the 1982 Act (Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 § 202(a), 96 Stat. 324, 421), and then to 7.5% of adjusted gross income by the 1986 Act (Pub. L. No. 99-514, §

from this that the greatest need was not for a reduction in top marginal rates, but for an adjustment in the marginal rates of middle-income taxpayers in order to shift relative tax burdens on marginal income closer to their 1954 levels.

The Economic Recovery Tax Act of 1981 (ERTA) mitigated the problem to some extent with reductions of marginal rates throughout the rate schedule.[43] The major rate reduction, however, was the elimination of the 70% maximum rate and the institution of 50% as the top marginal bracket.[44] Marginal rates below 50% were reduced by values ranging from 2% to 6%.[45] Threshold amounts for each rate bracket were also lowered. At least one study concluded that the 1981 reduction of effective tax rates was primarily reflected in the tax burdens of the top decile of economic income.[46] Income statistics for 1982 demonstrate that ERTA reduced the numbers of taxpayers in higher rate brackets.[47] Only 1% of all 1982 returns paid marginal rates of 50%. The percentage of returns above the 35% marginal bracket was reduced to 8.3%, down from 13.7% in 1981. The

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133, 100 Stat. 2085, 2116).

43. S. Rep. No. 144, 97th Cong., 1st Sess., 25-26 (1981).

44. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176.

45. S. Rep. No. 144, *supra* note 43, at 25-26.

46. J. Pechman, *supra* note 35, at 69. Pechman found that under the most progressive set of assumptions used in his study the 1981 tax cuts contributed to a reduction in progressivity. *Id.* at 8. He states that between 1980 and 1985 effective individual income tax rates rose in the first seven deciles by an average of about one percentage point, remained about the same in the eighth and ninth deciles, and declined 1.2 points in the top decile. *Id.* at 69. Pechman adds that, "At the top end, the federal individual income tax burden declined from 11.5% of adjusted family income to 10.3% because the rate reductions and other structural changes of the 1981 Act . . . more than offset the effect of income increases in this decile." *Id.* at 70.

Other analysts argue that the 1981 Act resulted in the wealthy taxpayers shouldering a larger share of the federal tax burden. Vedder & Watel, *The Impact of Marginal Income Tax Rate Changes in the United States 1954-82*, 25 Tax Notes 711 (1984) (prepared for the Congressional Joint Economic Committee, S. Print 98-236). The study indicates that the highest income taxpayers increased their tax payments after the 1981 Act. It identifies upper income taxpayers on the basis of adjusted gross income, rather than economic income. Adjusted gross income is determined after the deductions for increased capital recovery and the 60% preference given to long-term capital gains, two of the major tax reducing provisions of the 1981 Act. The study is, therefore, not comparable to Pechman's work. The preferential treatment of capital gains, which grants tax relief mostly to the upper-income group, reduces progressivity at upper-income levels. Musgrave, *supra* note 11, at 51. *See also* Pechman, *Individual Income Tax Provisions of the Revenue Act of 1964*, 20 J. Fin. 260 (1965).

47. Holik, *Individual Income Tax Rates, 1982*, 4 Statistics of Income Bull. 6 (Spring 1985) (table 1).

percentage of taxpayers subject to rates in excess of 20% also declined, from just over one-half to 47.2%.

As middle-income taxpayers found themselves subjected to higher marginal rates of tax, the cumulative burdens of tax in the United States became more regressive.[48] Consistent with the Congressional Budget Office's 1980 study of inflation,[49] Pechman in his study, *Who Paid the Taxes, 1966-85*, indicates that total federal, state and local taxes as a percent of adjusted family income varied only slightly during the period 1966-1985.[50] Pechman found, however, that under the most progressive set of assumptions used in the study, the burden of all federal, state and local taxes increased in the lower part of the income scale, declined sharply at the top, and remained roughly the same or rose slightly in between.[51] Although total taxation as a percent of family income remained relatively stable, the importance of different tax sources varied significantly, causing an overall decline in progressivity. Pechman attributes the change to a decline in the progressivity of federal taxes.[52] The major cause for the increased tax burden at the lower end of the economic income scale was the increase in payroll taxes.[53] Pechman also states that individual income taxes rose significantly at the low income levels.[54] He adds that there was a

48. "A tax is regressive when the ratio of tax to income falls as income rises; a tax is proportional when the ratio of tax to income is the same for all income classes; and a tax is progressive when the ratio of tax to income rises as income rises." J. PECHMAN, *supra* note 35, at 1 n.2.

49. CONGRESSIONAL BUDGET OFFICE, *supra* note 38.

50. J. PECHMAN, *supra* note 35, at 66. He indicates that total taxes as a percentage of adjusted family income rose from 25.2% in 1966 to 26.1% in 1970, then declined to 24.5% in 1985.

51. *Id.* at 8. Pechman indicates that the crucial factors in determining the degree of progressivity are the assumptions made with respect to the incidence of the corporation income tax and property taxes. If these are treated as taxes on corporate shareholders and owners of property the taxes are highly progressive. If, however, one-half of the corporate income tax is a tax on consumption and property taxes on improvements are viewed as taxes on shelter and consumption, the progressivity of these taxes virtually disappears. *Id.* at 57.

52. *Id.* at 8. State and local taxes became somewhat more progressive, or at least retained the same degree of progressivity during the period of the study.

53. Steuerle & Wilson, *supra* note 40, at 10, suggest that when considered as a whole, including the benefits received and the taxes paid over a worker's lifetime, the social security system is inherently progressive.

54. J. PECHMAN, *supra* note 35, at 66-67. Overall payroll taxes increased from 4.4% of adjusted family income in 1966 to 6.2% in 1985. In the lowest income decile, however, payroll taxes increased from 2.6% of family income in 1966 to 9.4% in 1985. Individual income taxes in the lowest income decile rose in that period from 1.1% to 4.2% of ad-

decline in the relative importance of the corporation income tax and the property tax and a rise in the payroll taxes. Since the former two are generally thought of a progressive tax sources and the latter is regressive, the effect of these changes was to reduce the progressivity of the tax system.[55]

We thus find three major trends in income taxation since adoption of the 1954 Code: (i) the reduction of top rates and relative tax burdens in the upper income groups, (ii) increasingly large numbers of taxpayers being subjected to higher marginal rates in the middle income bands, and (iii) an overall increase in relative tax burdens for lower income individuals attributable in large part to higher payroll taxes. Each of the tax reform plans preceding the 1986 Act contained a two-fold response to these trends. First, the threshold levels of taxation were raised so that a family below the poverty level would not be subject to tax.[56]

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justed family income "partly as a result of the failure to adjust the personal exemptions and standard deduction for the inflation in the late 1970's and partly as a result of income growth during the entire period." *Id.* at 67.

55. *Id.* at 8.

56. Under the *Treasury Proposal*, a married couple with two dependents and one wage earner in the household, making full use of the earned income credit, would receive $11,800 of income before reaching the tax threshold. 2 TREASURY PROPOSAL, *supra* note 20, at 8. This is accomplished with an increase in the zero bracket amount to $2,800 for single returns, $3,800 for joint and surviving spouse returns, $1,900 for returns of married individuals filing separately and $3,500 for heads of households. The personal exemption would be increased to $2,000. *Id.* at 6. The maximum earned income credit and the adjusted gross income or earned income limit would be indexed for inflation. *Id.* at 16.

The *Reagan Plan* is more generous at the lowest income levels. A family of four with a single wage earner making full use of the earned income credit would be allowed $12,798 of income before incurring income tax liability. REAGAN PLAN, *supra* note 32, at 10. The zero bracket amount would be increased to $2,900 for single returns, $4,000 for joint and surviving spouse returns, $2,000 for married individuals filing separately, and $3,600 for head of household returns. The personal exemption would be increased to $2,000. *Id.* at 7. The earned income credit and the income limits on which the credit is based would also be increased. *Id.* at 18.

The reform plan adopted by the House Ways and Means Committee puts the threshold for taxation for a family of four with full use of the earned income credit at $14,820. HOUSE COMM. ON WAYS AND MEANS, REPORT ON H.R. 3838, H.R. REP. No. 426, 99th Cong., 1st Sess. 84 (1985). [Hereinafter the WAYS AND MEANS PLAN]. The zero bracket is returned to its former status as a standard deduction and would be increased to $2,950 for single returns, $4,800 for joint and surviving spouse returns, and $4,200 for head of household returns. *Id.* at 91. The personal exemption would be increased to $2,000. *Id.* Both the rate and the maximum allowable earned income credit are increased. *Id.* at 94-95.

Under the plan recommended by the Senate Finance Committee, the threshold for a family of four is set at $15,380. Beginning in 1988, the standard deduction is increased to $3,000 for single individuals, $5,000 for married couples filing jointly, and $4,400 for

Second, modified flat-rate schedules were amended to significantly lower top marginal rates and reduce the number of tax brackets.

### C. Development of the 1986 Act

The recent tax reform process began in earnest in November 1984, when the Treasury Department submitted its comprehensive proposal (the *Treasury Proposal*) to lower tax rates while broadening the tax base by removing incentives and deductions from the Code.[57] President Reagan followed in May 1985 with a proposal (the *Reagan Plan*) which, although similar to the Treasury plan, reopened the tax reform door to incentives for particular industries and types of investment.[58] In December 1985 the Democratic-controlled House of Representatives passed its own version of tax reform over substantial Republican objection.[59] The House adopted, without amendment, a plan written by the Committee on Ways and Means (the *Ways and Means*

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heads of households. SENATE FINANCE COMMITTEE, REPORT TO ACCOMPANY H.R. 3838, S. REP. No. 313, 99th Cong., 2d Sess. 33, 39 (1986) [hereinafter the SENATE PLAN]. The personal exemption would be $2,000 ($1,900 in 1987). *Id.* at 40.

None of these proposals actually exclude the tax threshold amounts from taxable income. Because the threshold is based in part on the disappearing earned income credit only persons earning less than these figures may take advantage of the full amounts. The availability of the earned income credit would decline for amounts in excess of $6,500 of adjusted gross income or earned income, and disappear at an adjusted gross income or earned income figure of $11,000 under the *Treasury Proposal* (2 TREASURY PROPOSAL, *supra* note 20, at 15-16), decline for incomes above $6,500 and disappear when income reaches $13,500 under the *Reagan Plan* (REAGAN PLAN, *supra* note 32, at 18), decline for incomes above $9,000 and disappear when income reaches $16,000 under the *Ways and Means Plan* (WAYS AND MEANS PLAN, *supra*, at 95) or decline for incomes above $6,500 and disappear when income reaches $17,000 under the *Senate Plan* (SENATE PLAN, *supra*, at 44).

57. 1 TREASURY PROPOSAL, *supra* note 20. Arguably, the drive for tax reform had its roots in a December 10, 1981, article in the *Wall Street Journal* by Robert Hall and Alvin Rabushka advocating a flat tax. At least Hall and Rabushka so claim. R. HALL & A. RABUSHKA, *supra* note 37, at 19. Precursors of current major reform plans also include the Bradley-Gephardt proposal first submitted in 1982 (S. 2817, 97th Cong., 2d Sess., 128 CONG. REC. 9,959-64 (1982); H.R. 6944, 97th Cong., 2d Sess. (1982)) which was reintroduced in 1983 (S. 1421, 98th Cong., 1st Sess., 129 CONG. REC. 7,838-45 (1983); H.R. 3271, 98th Cong., 1st Sess. (1983)), and again in 1985 (S. 409, 99th Cong., 1st Sess., 131 CONG. REC. 1,173-81 (1985); H.R. 800, 99th Cong., 1st Sess. (1985)) and the Kemp-Kasten FAST tax plan reintroduced with changes in 1985 (S. 1006, 99th Cong., 1st Sess., 131 CONG. REC. S4751 (daily ed. Apr. 25, 1985); H.R. 777, 99th Cong., 1st Sess. (1985)).

58. REAGAN PLAN, *supra* note 32.

59. H.R. 3838, 99th Cong., 1st Sess., 131 CONG. REC. 12,243-44 (1985) (passed by the House of Representatives on December 17, 1985).

*Plan*)[60] which also accepted the concept of lower tax rates across income levels but adopted rates slightly higher than the Treasury and Reagan plans.[61]

The initial effort of the Senate Finance Committee to markup a reform bill failed as the members attached revenue-losing-preferences to the Committee Chair's initial proposal. The Committee rebounded in the spring of 1986 with its broad-based 15 and 27% bracket plan[62] which was overwhelmingly adopted by the full Senate (the *Senate Plan*). To finance its drastically reduced rate schedules, the Finance Committee broadened the tax base even more than its counterpart in the House. The House Senate Conference Committee ultimately retained the *Senate Plan's* basic rate structure but added a 1% increase to the top rate and substantially revised other provisions to shift a larger portion of the tax burden to business.

The leading reform proposals evidenced substantial unity on the principal directions of the reform, an agreement on basic philosophy that is reflected in the 1986 Act. First, the tax base continues to depend on income as the principal measure for the tax. Consumption measured by cash flow did not seriously interest policy makers, although the idea has been favored by many

60. WAYS AND MEANS PLAN, *supra* note 56.

61. The *Ways and Means Plan* attempted to reduce the benefit to the highest income levels received under the *Treasury Proposal* and *Reagan Plan* by adopting a top marginal rate of 38% for taxable incomes of married couples filing a joint return in excess of $100,000, and in excess of $60,000 for single persons. *Id.* at 90. The proposal also adopted a more stringent alternative minimum tax in order to compensate for the reduction of marginal tax rates to high-income taxpayers. *Id.* at 306. The *Ways and Means Plan* also would have subjected a significantly larger band of middle and upper-middle income taxpayers to the 35% rate than the *Reagan Plan*. The rate schedules proposed in the two plans for joint returns and single individuals are as follows:

| Tax Rate | Joint Return | | Single | |
|---|---|---|---|---|
| | Reagan | Ways & Means | Reagan | Ways & Means |
| 15% | 4,000-29,000 | 0-22,500 | 2,900-18,000 | 0-12,500 |
| 25% | 29,000-70,000 | 22,500-43,000 | 18,000-42,000 | 12,500-30,000 |
| 35% | 70,000 or more | 43,000-100,000 | 42,000 or more | 30,000-60,000 |
| 38% | | Over 100,000 | | Over 60,000 |

REAGAN PLAN, *supra* note 32, at 3; WAYS AND MEANS PLAN, *supra* note 56, at 90.

62. SENATE PLAN, *supra* note 56, at 38.

academicians.[63] Additionally, income tax liabilities were significantly reduced for persons at the very bottom of the income spectrum under all the major proposals.

The major tax reductions for the lowest income levels provided by the 1986 Act represent a major improvement in progressivity. Incomes below a certain threshold, determined by reference to estimates of existing poverty levels, are no longer taxed. The reduction is accomplished with increased personal and dependent allowances, a higher standard deduction and increased low-income credits.[64] Each of the reform proposals affirmed the efficacy of ability-to-pay as a guideline for tax policy in its justification for these provisions.[65]

The outstanding feature of the 1986 Act, however, is its expansion of the tax base to allow for a sharp reduction in top marginal tax rates from 50% to 28% for individuals,[66] and from 46% to 34% for corporations.[67] For taxpayers above the tax threshold, the plan contains a nominal two bracket rate struc-

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63. *See, e.g.*, H. AARON & H. GALPER, ASSESSING TAX REFORM, 66-107 (1986); Andrews, *A Consumption Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

64. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 102, 103, 111, 100 Stat. 2085, 2099, 2102, 2107. The personal exemption is increased to $1900 for 1987, $1950 for 1988, and $2,000 thereafter. *Id.* § 103. The personal exemption is to be adjusted for inflation beginning in 1990. The zero bracket amount concept reverts to a standard deduction set at $5,000 for married individuals filing jointly and $3,000 for single individuals. *Id.* § 102. The refundable earned income credit is increased from 11% of the first $5,000 of earned income to 14% of the first $5,714 of earned income, beginning in 1987. The maximum credit is increased from $550 to $800. The credit benefits only low-income workers with dependents. *Id.* § 111.

65. 1 TREASURY PROPOSAL, *supra* note 20, at 66; WAYS AND MEANS PLAN, *supra* note 56, at 55; SENATE PLAN, *supra* note 56, at 714. In recommending increases in the personal exemption and zero bracket amounts, the *Treasury Proposal* states, "These proposed changes are designed to reflect differences in ability-to-pay taxes that result from differences in family size and composition. The increase in the personal exemption recognizes the greater financial responsibilities and lesser ability-to-pay of those taking care of dependents." 1 TREASURY PROPOSAL, *supra* note 20, at 66.

66. The top individual rate under the 1986 Act is actually 33% when the phase out of the lower 15% rate above certain income levels is taken into account. *See infra* text accompanying notes 68-70.

67. Tax Reform Act of 1986 § 601. Although the 1986 Act reduced corporate tax rates, corporations suffer an increase in their tax bill where their lobbyists were unsuccessful because of structural improvements in the Code that move toward a more comprehensive definition of income. The overall reduction of individual tax rates is financed in large part by increased corporate tax liabilities. The 1986 Act contemplates a $120 billion tax increase on corporations over five years, $25 billion in 1987, $24 billion in 1988, $23 billion in 1989, $23 billion in 1990, and $25 billion in 1991. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-884, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075 [hereinafter CONFERENCE REPORT].

ture of 15% and 28%.[68] A third bracket is created with a 5% surtax on married individuals filing jointly with taxable incomes between $71,900 and $149,250, on single individuals with taxable incomes between $43,150 and $89,560, and on heads of households between $61,650 and $123,790.[69] The 5% surtax effectively phases out the 15% bracket for high income earners. After the 15% bracket is eliminated, the 5% surtax continues to apply until personal and dependents exemptions are also phased out. Thus, income levels subject to the 5% surtax vary by the number of dependents — the more dependents the more income that is subject to the 33% marginal rate.[70] After the 15% bracket and personal exemptions are phased out, the tax returns to a flat 28%. This creates an anomaly: marginal income above the surtax threshold is taxed at a lower rate than income below the threshold.

A shift of relative tax burdens from upper to middle income taxpayers is an inevitable result of these modified flat tax schedules with sharply reduced top marginal tax rates.[71] Under the

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68. Tax Reform Act of 1986 § 101. *See also* CONFERENCE REPORT, *supra* note 67 at II-4 to -5. The 28% bracket begins for married individuals filing jointly with taxable income of $29,750 and $17,850 for single individuals. The threshold income levels for the higher bracket were slightly lower in the *Senate Plan*, $29,300 for marrieds filing jointly, and $17,600 for single individuals. SENATE PLAN, *supra* note 56, at 38.

69. Tax Reform Act of 1986 § 101(a) (adding I.R.C. § 1(g)). The 1986 Act lowers the thresholds for imposition of this surtax from those provided in the original *Senate Plan*, to between $75,000 and $145,320 of taxable income on a joint return and between $45,000 and $87,240 of taxable income for single individuals. SENATE PLAN, *supra* note 56, at 39.

70. In the case of married individuals filing joint returns in 1988 the phase out of exemptions begins with taxable income of $149,250. Each exemption is fully phased out with $10,920 of additional income in 1988, and $11,200 in 1989 (the difference being due to higher exemptions in 1989). In the case of a married couple filing jointly who claim two dependents, the four $1,950 personal exemptions are fully phased out at taxable income of $192,930. *See also* CONFERENCE REPORT, *supra* note 67, at II-9.

71. This shift is obvious under flat tax proposals because adoption of a flat rate increases the marginal rate for the bottom taxable income brackets. *See* Pechman, *An Overview of Current Tax Reform Plans*, 27 TAX NOTES 311, 313 (1985). An example of this shift is documented for the Hall/Rabushka flat tax. By their own figures, Hall and Rabushka indicate that their flat tax proposal would increase tax liability at the lowest income levels by 78.1% and 84.5% respectively. Tax liability declines for all income levels above $58,753. For incomes of $1,792,476 the tax reduction would be 41.1%. R. HALL & A. RABUSHKA, *supra* note 37, app. C at 124-25. *See also* Simmons, Book Review, 17 U.C. DAVIS L. REV. 1009, 1017 (1984) (reviewing R. HALL & A. RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX (1983)).

The *Reagan Plan* and *Treasury Proposal* would have reduced the top marginal rate from 50% to 35% with a smaller reduction of marginal rates for lower- and middle-income levels in the proposed three bracket tax rate schedule of 15%, 25% and 35%. Tax rate reductions for middle-income groups were not accompanied by a reduction in

Ways and Means five bracket proposal with its top rate of 38%, individuals with less than $75,000 of income would have received 72% of the tax reductions for individuals.[72] The Committee report indicated that this group represents more than 95% of all income tax filers.[73] This means that a disproportionate 28% of the individual tax reductions would have been distributed to the top 5% of filers by income level.[74] The Senate's initial two bracket plan was justified with a similar distributional impact. The Finance Committee report allocated 27% of the overall individual tax saving to the top 5% of taxpayers by income.[75] Sixteen percent of the reduction would have gone to taxpayers with incomes in excess of $200,000.[76] The distribution of tax savings under the 1986 Act reflects a similar pattern because of its similar rate structure. The shift away from upper-income taxpayers is mitigated somewhat under the 1986 Act as finally passed, however, by the 1% rate increase for the upper brackets. In ad-

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actual tax liabilities commensurate with reductions provided to the lowest and highest income groups. Overall progressivity would have been increased by reductions in tax burden at the lower income levels. But, at least with respect to the *Reagan Plan*, the second largest tax reduction was provided to the $200,000 and above income group. Below the top income levels the smallest tax reduction, and therefore, an increase in relative tax burden, fell to what the *Wall Street Journal* referred to as the "political middle class," the group with incomes between $50,000 and $200,000. Murray, *Reagan's Tax-Overhaul Plan Faces Criticism From Upscale, Politically Active Middle Class*, Wall St. J., July 12, 1985, at 46, col. 1 (Western ed.). This occurred because proposals for the elimination of deductions such as that for state and local taxes, and the increased taxation of certain forms of income under the *Reagan Plan* and *Treasury Proposal* were more than offset for the very top income goups by the 15% reduction in marginal rates, but not offset by the lesser reductions in marginal rates for this "middle income" group. *Id.*

The same phenomenon occurred with the 1981 tax reductions where the tax burden in the top income decile was reduced because rate reductions and other structural changes, particularly the reduction in the long-term capital gains rate and increased individual retirement account contribution limits, more than offset the effect of income increases attributable to restrictions on certain deductions. J. PECHMAN, *supra* note 35, at 69.

72. WAYS AND MEANS PLAN, *supra* note 56, at 85.

73. *Id.*

74. Twenty-one percent of the tax reductions are allocated to families with income below $20,000. *Id.* at 86 (table 3). Families at this income level represent approximately 39% of all families by economic income. *See* 1 TREASURY PROPOSAL, *supra* note 20, at 54 (extrapolated from table 4-4). The remaining 51% of the tax reductions are distributed to the 56% of families in the $20,000 to $75,000 income range. Although the percentage figures derived from the different tables in the *Treasury Proposal* and *Ways and Means Plan* may not accurately reflect the same groups, there is a strong possibility from these numbers that the latter plan enhances the decline in progressivity noted by Pechman *See* J. PECHMAN, *supra* note 35.

75. SENATE PLAN, *supra* note 56, at 35.

76. *Id.*

dition, the individual tax reductions are financed in large part with an increased tax burden on corporations. To the extent this tax increase is passed through to individual shareholders rather than consumers or workers, the corporate tax increase will fall on upper-income taxpayers, thereby enhancing progressivity.[77] Nonetheless, in terms of vertical equity based on ability-to-pay, the flat rate schedule exacerbates the regressive trend of the last twenty years by taxing upper-income individuals at relatively lower rates.[78]

### D. *Ability-to-Pay Versus Increased Productive Activity*

Advocates of lower marginal rates do not focus on vertical equity issues. They justify the reduction of tax burdens for upper-income levels on the basis of economic incentive and efficiency.[79] Each of the major reform proposals asserted that rate reductions would increase incentives for "work, saving, investment, risk-taking, and innovation."[80] In more direct terms productive activity increases when the rate of return on investment is enhanced by lower taxation. Hall and Rabushka explain that

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77. *See supra* note 51.

78. *See* J. PECHMAN, *supra* note 35, at 8, and *supra* text accompanying note 35.

79. Hall and Rabushka recognize, for example, that their flat tax proposal would result in a shift of tax burden from wealthier to lower- and middle-income households. They argue that reducing the tax burden of the most economically active and alert segment of the economy will free them to invest the saved capital in activities that will provide benefits to the economy as a whole. R. HALL & A. RABUSHKA, *supra* note 37, at 59-60. In other words, the direct benefit of a low rate flat tax realized by the big earners will be passed on to those whose tax burden is increased.

The *Reagan Plan* echoes this sentiment where it states that, "Changes in the tax system for individuals—*reducing rates* and *increasing the perception of fairness*—should increase incentives for work, saving, investment, risk-taking and innovation." REAGAN PLAN, *supra* note 32, at 5 (emphasis in original).

In terms of efficiency, lower marginal rates reduce the federal subsidy and thereby the value of deductions. Hall and Rabushka, advocating a 19% flat tax, colorfully explain that:

> When you take a potential business client to lunch and deduct the cost as a normal business expense, the savings in taxes is only 19 cents on the dollar, compared with the current 46 cents. Stockholders will find a steady return at 81 cents for each earned dollar a strong incentive to curtail wasteful business practices. We would expect business managers to watch their expenses more closely in a 19 percent world.

R. HALL & A. RABUSHKA, *supra* note 37, at 114. *See also* SENATE PLAN, *supra* note 56, at 7.

80. REAGAN PLAN, *supra* note 32, at 5. *See* 1 TREASURY PROPOSAL, *supra* note 20, at 64; WAYS AND MEANS PLAN, *supra* note 56, at 4; SENATE PLAN, *supra* note 56, at 7. Under all three plans the reduction in individual tax rates is financed largely by increased taxation of corporate income. *See supra* note 67.

it is necessary to provide the bulk of such tax reductions to high-income groups to stimulate increased productive economic behavior:

> Heavy taxation of successful people yields quite a bit of revenue, as well as pushing them out of their most productive undertakings and diverting their attention to tax avoidance. Until a response to improved incentives takes place, it is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on average people. If tax reform is a zero-sum process, giving relief to a minority by raising taxes on the majority, it is a political impossibility. Revitalization of the economy, with more income to divide between the big earners and the rest, is the point of tax reform. The 4 to 6% cut in income in the lower brackets brought about immediately by tax reform will soon be repaid by faster growth and higher incomes.[81]

Henry Simons put the same point in slightly different terms: "Increasing progression means augmenting income where savings is impossible and diminishing incomes too large to be used entirely for consumption."[82]

Tax reduction benefiting lower- and moderate-income taxpayers is directed to consumption and an improved standard of living. The wealthy, whose needs for consumption are more likely to be satisfied, are in a position to direct extra capital derived from tax reductions into saving and investment.[83] Hall and Rabushka assert that the increased economic activity following from reduced tax burdens at high-income levels will cause an increase in real incomes at all levels.[84] Each of the contemporary proposals appears to base its vision of economic improvement on this reasoning.

The theory supporting flat and modified flat taxes with lowered marginal rates thus deviates from ability-to-pay as a stan-

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81. R. HALL & A. RABUSHKA, *supra* note 37, at 58. Note that using Hall and Rabushka's figures the 4% to 6% tax increase represents an increase in actual tax liability of as much as 84.5% in the lowest income brackets. *Id.* app. C at 125.

82. H. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 22 (1938).

83. *Id.*

84. R. HALL & A. RABUSHKA, *supra* note 37, at 59-60. However, "[s]ince capital is concentrated in the hands of the wealthiest taxpayers, the use of the tax system to increase aggregate levels of capital formation by uncompensated reductions in the effective rates of tax on capital income will make the income tax less progressive." Gann, *Neutral Taxation of Capital Income: An Achievable Goal?*, LAW & CONTEMP. PROB. 77, 94 (Autumn 1985).

dard for vertical allocations of the tax burden. Rather than constructing a rate structure on the theory that enhanced ability-to-pay should result in a progressively greater tax burden, the proposals leading to the 1986 Act reduce the marginal tax burden of upper income groups in order to provide additional capital for productive savings and investment. Formulated in these terms, policy makers have moved toward a new philosophy for allocating government costs. The 1986 Act is an imposition of the burden of tax on middle income earners who direct economic gains to consumption of goods and services, including governmental services, for the benefit of those who accumulate and invest capital. This is essentially the choice rejected at the turn of the century when the income tax was originally enacted.[85]

If the goal is to increase individual savings and investment with tax reform, the central issue in evaluating reform is not the marginal tax rate, but the effective rate of tax applied to total income within various economic groups. Under this measure, the 1986 Act retains, to some extent, distributions in effect in 1981. In terms of the availability of after-tax capital for productive investment by upper-income taxpayers, it should make no difference whether a high marginal rate is applied to a small tax base that excludes portions of discretionary economic income (as was the case under the pre-1986 tax law),[86] or whether a low marginal rate is applied to an expanded tax base. Under either approach, capital is freed for investment when actual tax liability is reduced. Savings and investment arise from capital left after consumption and taxes. The major problem with the tax structure before 1986 was that the narrow base riddled with incentives tended to direct investment into particular governmentally selected tax-favored activities. The result was both complexity and distorted investment decision making. While it still

85. *See supra* text accompanying notes 15-19.

86. The tax burden of upper-income taxpayers is reduced by provisions of the code that reduce adjusted gross income below economic income, no less than the tax burden is reduced by marginal tax rates. Both the *Treasury Proposal* and the *Reagan Plan* point to this fact asserting high rates are attributable to preferences that shrink the tax base. 1 TREASURY PROPOSAL, *supra* note 20, at 1; REAGAN PLAN, *supra* note 32, at 1. For this reason assertions that recent tax reductions have increased productivity based on the findings that taxpayers with increased adjusted gross income are paying higher taxes are questionable. *See, e.g.*, Vedder & Gallaway, *The Changing Burden of the Federal Individual Income Tax, 1981-1983*, 26 TAX NOTES 1271 (1985). Since adjusted gross income is determined after the major incentives of the 1981 Act have been subtracted, the inquiry should focus on tax burdens relative to economic income.

exacerbates the increased tax burdens of the middle income earner, the 1986 Act eliminates many incentives, compensates the upper-income investor with reduced rates, and, to a lesser extent, reduces the rates of other individuals.

Relative burdens of taxation between upper- and middle-income groups can be altered either by adjusting the tax base incentives, or by altering the progressive rate structure with lower rates applied to a broader base, or both.[87] The Reagan proposal attempted both. It altered the tax burden of upper- and lower-income groups with substantial rate reductions and continued incentives for favored economic activity.[88] Although not to the same degree as the *Reagan Plan*, the *Ways and Means Plan* retained some investment incentives and lowered rates. It paid for some of these provisions by increasing the threshold level of taxation (personal exemptions) in a fashion that applied differently to different taxpayers.[89] Both plans paid for lower individual rates with a major shift of tax burdens to corporate taxpayers.

These plans would have expanded the tax base while retaining at least two of the principal tax preferences of upper-income groups, preferential treatment of capital gain and tax-exempt interest on governmental obligations. The lowered marginal rates of both plans shifted relative tax burdens away from upper-income levels.

The 1986 Act adopted the bold proposals of the *Senate Plan* to eliminate the capital gain deduction for individuals and provide low marginal rates while retaining a number of significant investment incentives. Economic growth is thus encouraged by continued incentives and reduced taxation of upper-income earners to free capital for investment. These provisions might be justifiable encouragements to capital investment. However, when measured in terms of vertical equity as a function of ability-to-

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87. It is possible to maintain a progressive rate schedule with lower marginal rates without a shift in tax burdens. *See* Pechman, *supra* note 71, at 313 (stating that progressivity approximately the same as present law is possible with nine brackets from 9% to 28%, using a zero bracket amount of $4,000 per person and personal exemptions of $1,750, on a comprehensive income base.

88. The *Reagan Plan* retained preferential treatment of capital gains and incentives for capital investment in the form of accelerated capital recovery provisions. REAGAN PLAN, *supra* note 32, at 138, 166-68. The *Treasury Proposal* replaced the capital gains preference with an inflation adjustment to basis and restricted capital recovery deductions to economic depreciation of a basis indexed for inflation. TREASURY PROPOSAL, *supra* note 20, at 98-109.

89. The proposal reduced itemized deductions by $500 for each dependent exemption claimed. WAYS AND MEANS PLAN, *supra* note 56, at 91.

pay, the revisions continue the shift of relative tax burdens to middle-income individuals.

## II. Defining the Tax Base to Reflect Ability-to-pay

### A. *Realized Gains and the Measure of Ability-to-Pay and Taxation of Capital*

The structure of the tax base exerts as great an influence on allocations of the tax burden and vertical equity as the rate schedule. The tax base may be structured to prefer certain forms of economic gains or wealth with exclusions, lower tax rates for certain forms of income, or preferences to certain costs of producing income. Persons who take advantage of the preferences are subject to lower tax than persons with the same economic ability-to-pay who do not. The alert taxpayer will naturally direct capital into a tax favored activity to reduce his or her tax burden. This shifts relative tax burdens to taxpayers who are not in a position to take advantage of the preferred activity — generally taxpayers with insufficient discretionary income or taxpayers in brackets too low for the benefit of the preference to outweigh the direct cost of its acquisition.

To be effective, preferences must be aimed at taxpayers with sufficient capital remaining after consumption to invest in the preferred activity. Tax incentives thus benefit upper-income taxpayers relatively more than lower- and middle-income taxpayers, thereby causing a regressive shift of the tax burden. At the same time, preferences can distort horizontal equity as taxpayers with similar economic incomes make varying use of tax incentives. These distortions are controllable only if policy makers are able to agree upon a comprehensive definition of the measure by which tax burdens are ascertained.

Many advocates of a broad-based income tax assert that ability-to-pay should be measured by Henry Simons' definition of economic income—the sum of amounts expended in consumption plus net accretions to wealth.[90] The tax base before and after the 1986 Act purposely ignores the full measure of this economic income.

The income tax base begins with "gross income" which is simply and elegantly defined in section 61 of the Code as "all income from whatever source derived." The United States Su-

90. H. Simons, *supra* note 82, at 49-50.

preme Court has described gross income as including all "gains" not specifically exempted.[91] However, taxable gains must be "derived" from the capital or labor that produced the gain.[92] Hence, appreciation that has accrued to the taxpayer's capital, but has not been severed from the capital, is excluded from the tax base under the so-called "realization" requirement.[93] Thus, property appreciation, the "accretion to net worth" part of Simons' definition of income, is not included in the tax base until there is a disposition of the property when gain may be said to be "realized" by the taxpayer.

Critics of the income tax point out that deferred taxation of unrealized gain provides an incentive for investment in assets that produce long-term appreciation.[94] While appreciation of capital investment is excluded from tax, periodic gain derived from capital investment, such as interest and dividends, is subject to tax. This result creates inequities between forms of investment by providing a tax preference for long-term capital appreciation.[95] The taxpayer who accumulates wealth in the form of appreciated property is taxed on a smaller share of his real wealth than the taxpayer solely dependent on wages or investments that produce current income.

The major reform plans did not question the use of realized gain as a starting point for defining the tax base, perhaps because the standard has much to commend it as a measure of ability-to-pay. Realized gain as a measure of ability-to-pay contains two parts. First, ability-to-pay depends on gains derived by the taxpayer. Responsibility for contribution to government arises as realized gain increases. Economic improvement thus carries with it increased responsibility to contribute to the cost of government. The taxpayer contributes not only to the degree he or she removes goods from society's store of goods and services (consumption), but also to the degree that unconsumed realized wealth obtains the protection of organized government.

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91. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955). The Court refined the concept a little further by describing the taxpayers' gains as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have dominion and control." *Id.* at 431.

92. Eisner v. Macomber, 252 U.S. 189, 207 (1920).

93. *Id.* at 214-15.

94. *See, e.g.*, Andrews, *supra* note 63, at 1115-16.

95. For example, undistributed earnings on corporate stock may increase the value of the investment without taxation, but declared dividends reinvested in the same stock result in current taxation. *Id.*

Second, the measure of ability-to-pay depends upon the degree to which the taxpayer has obtained control over gain by extracting income or converting an investment to a different form. Hence, ability-to-pay includes both the consumption of income and the exercise of control over income, but not income or gains represented by unrealized accretions to net worth.

Examination of the broad based consumption tax as an alternative to a tax based on realized income is instructive in assessing ability-to-pay out of realized gain as a theoretical measure of vertical equity. The consumption tax uses cash flow as a measure of taxable consumption. Basically it is a tax measured by income with a deduction for additions to savings and investment.[96] Thus, the tax falls only on gains expended in consumption by excluding gains devoted to further income production (investment). The consumption tax base must also include withdrawals from savings or investment that are used for current consumption, plus all borrowing for the purpose of personal consumption, but not borrowing for investment.[97] Gifts and transfers at death may also be treated as a form of consumption.[98]

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96. *Id.*

97. The fact that borrowings and withdrawals from saving will increase tax liability where these transactions are not taxable events under an income tax represents one of the major political liabilities of the consumption tax concept.

98. *See* H. AARON & H. GALPER, *supra* note 63, at 68. Gifts and death-time transfers may be included in the tax base of the transferor recognizing that these transfers represent current consumption through enjoyment of the satisfactions of wealth in the form of economic benefit conferred upon the objects of the donor's affections. *See, e.g.*, Helvering v. Horst, 311 U.S. 112, 116 (1940) (The realization of income may occur when one "has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth."). Given the recent history of transfer taxation in this country, however, this option is not likely to appeal to policy makers. Brannon, *The Value Added Tax is a Good Utility Infielder*, 37 NAT'L TAX J. 303, 317 (1984) (citing the collapse of the carryover basis rule for death-time transfers under I.R.C. § 1023 which was enacted by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(2), 90 Stat. 1520, 1872, and repealed by the Crude Oil Windfall Profit Tax of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299, as evidence of the absence of any Congressional commitment to taxing inter-generational wealth transfers). *See also* Heller, *Tax Reform and Revenue: An Overview*, 26 TAX NOTES 917, 921 (1985).

The alternative is to ignore the transferor's consumption of wealth transferred by gift until it is consumed by the donee. Gifts and inheritances would be included in the tax base only when transferred capital is withdrawn for consumption by the donee. This possibility allows for indefinite tax-free accumulations of wealth across generations. Break, *Avenues to Tax Reform: Perils and Possibilities*, 37 NAT'L TAX J. 1, 3 (1984). *See also* 1 TREASURY PROPOSAL, *supra* note 20, at 193. Professor Andrews argues that the solution to this potential lies in the gift tax. Andrews, *supra* note 63, at 1162-63. Recent legislative actions with respect to estate and gift transfer taxes do not suggest an inclination in this direction. *See* Heller, *supra*, at 921. *See also* Dobris, *A Brief for the Aboli-*

Although tax reform has not yet moved towards a consumption tax base, continued need for revenue in the face of the federal deficits keeps alive its potential as a revenue source.

Proponents of the consumption tax base claim that it is a superior measure of ability-to-pay because consumption more accurately reflects the taxpayer's standard of living.[99] The consumption tax would allocate the burden of federal finance in accord with the Hobbsian notion that one should contribute to society in proportion to what one withdraws from it.[100] Thus the wealthy miser who accumulates his or her resources will pay the same tax as the wage earner who maintains the equivalent standard of living through current consumption of all of his or her wages. A consumption tax achieves horizontal equity between persons measured by their standard of living. Vertical equities are adjustable by taxing maintenance of a higher standard of living at progressively higher rates. Under such a system, however, there is no recognition of the protection society provides to the wealthy miser when it makes accumulation and investment of his wealth possible. Actual consumption, not ability to consume, measures the tax base.

A progressive tax rate schedule applied to consumption would impose progressively higher tax burdens only at the time accumulations are actually converted to personal consumption — the greater the taxpayer's current consumption, the higher his or her tax liability.[101] Hence, the consumption tax arguably would encourage saving and discourage consumption.[102] How-

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*tion of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215 (1984).

99. Andrews, *supra* note 63, at 1165-66. An extensive list of the proponents of the consumption tax base can be found in Stephen, *Federal Income Taxation of Human Capital*, 70 VA. L. REV. 1357, 1366 n.16 (1984).

100. Musgrave, *supra* note 11, at 46; T. HOBBES, LEVIATHAN 181 (A. Lindsay rev. ed. 1914) (1st ed. 1651).

101. Henderson, *Alternatives to the Income Tax*, in OPTIONS FOR TAX REFORM, *supra* note 19, at 78, 89; Andrews, *supra* note 63, at 1167.

102. The income tax encourages current consumption over saving because the imputed economic benefit from consumed durables escapes taxation while the return on savings and investment is reduced by current income tax liability. Henderson, *supra* note 101, at 81. In addition, accretion taxes make saving difficult because money is taxed once before it can be saved and then the earnings on savings are themselves taxed again. *See* H. AARON & H. GALPER, *supra* note 63, at 26; DEPARTMENT OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 50 (1977) [hereinafter DEPARTMENT OF TREASURY]. One wonders whether a consumption tax would really make saving easier, however. If the burden of tax is to be allocated throughout economic income levels in the same proportion as under the existing income tax, the capital available to a particular individual for savings or investment after taxes are paid may not be vastly different. Perhaps the real incentive to

ever, measured by an ability-to-pay standard, deferral of tax liability to periods of actual consumption, and away from periods of accumulation, would result in significant shifts in relative tax burdens. A proportionately greater share of the tax burden would fall on young and old families who borrow or use accumulated wealth to finance consumption.[103] Families headed by persons in their high-income years, who are typically in a better position to save and invest, would obtain a reduction in their relative tax burden.[104] The consumption tax also shifts the burden of taxation to wage earners as it principally is a tax on wages.[105] The *Treasury Proposal* recognized that capital income is in effect exempt from the tax:

> Although individuals would have to pay tax on capital income when it was used for consumption the deduction for saving (out of wages) and the tax exemption of interest income results in a present value of the tax liability which, under certain circumstances, is the same as if the individual had been taxed only on total wages when paid.[106]

The *Treasury Proposal* also noted that because of the effective exclusion of capital income from a consumed income tax base, a higher rate of tax would be necessary to raise the same amount of revenue.[107]

The net result of a consumption tax would be a shift of the relative burden of tax away from taxpayers who are in a position to accumulate at the expense of lower- and middle-income taxpayers who are forced to utilize larger portions of current earn-

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saving under a consumption tax is the fact that any unnecessary consumption will bear a greater cost at the individual's marginal tax rate. There is a major negative economic potential in this for industry producing high-cost consumer durables such as automobiles, where each expenditure would be accompanied by a substantial increase in tax liability. Not all commentators agree that the magnitude of any potential increase in savings from adoption of a consumption tax would justify the switch. McLure, *supra* note 36, at 142.

The assertion that a consumption tax is superior because it encourages saving over consumption raises the more basic question whether the tax system should be designed to provide either incentives or disincentives to certain forms of economic behavior. Although not inherently incompatible, perhaps the guiding rationale should focus primarily upon whether the chosen system provides an equitable allocation of tax burdens throughout the economy.

103. Pechman, *supra* note 71, at 314.

104. *Id.*

105. *Id.*

106. 1 TREASURY PROPOSAL, *supra* note 20, at 193-94.

107. *Id.* at 194.

ings for consumption.[108] This shift is questionable when analyzed in terms of ability-to-pay. The realized gain model of the income tax taxes economic gain at the time the taxpayer exercises control or choice over that gain. A consumption tax base draws a distinction between the taxpayer who achieves a higher standard of living through current consumption and the taxpayer who derives economic satisfaction from income by exercising the choice to save or invest that income. It is not evident that the latter use of income is any less of an economic benefit in the sense of satisfaction from wealth than current consumption.[109] Mere possession of wealth carries with it a degree of power and prestige not necessarily conferred on the less well-to-do. In addition, protection of wealth by organized society in the form of protection of property interests represents consumption of the benefits of society even though not directly tied to material consumption.[110]

As with the movement to modified flat taxes, the choice between a tax base measured by consumption and one measured by realized gain is a choice between competing views of vertical equity. Should tax liability be predicated only on the tangible material benefits derived from the society in the form of current consumption? Or is taxation to be based on the taxpayer's capacity to contribute to the cost of society?[111] The latter basis was selected at the turn of this century by adoption of an in-

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108. Graetz, *supra* note 19, at 64. Andrews characterizes this shift as an issue of deferral. Andrews, *supra* note 63, at 1167. Under a consumption tax deferred consumption is subject to deferred tax liability. The issue is one of deferral as opposed to complete tax avoidance only if accumulations are treated as taxable consumption on death, however. *See supra* note 98.

109. "If X and Y both receive an income of $10,000, they may both choose between consuming or saving $10,000 as they wish. While their choices may differ, this does not void the equality of their pre-choice position and hence their ability-to-pay taxes." Musgrave, *supra* note 11, at 46 n.4. Andrews counters this argument by saying that:

> [I]nvestment is not a final use of economic resources; it is an intermediate use by which more is ultimately to be produced for future consumption, private or public, or for further investment. A tax on investment as such means an additional burden on those products and processes that require substantial investment as compared with others that do not.

Andrews, *supra* note 63, at 1166.

110. By this I refer to the protection of organized society that allows a degree of safety for wealth accumulations ranging from the overall defense of the nation to the regulation of financial markets that provides the means for capital investment. The list may also include the protections given to accumulations by the police power which prevent the less fortunate from seizing accumulations of the wealthy for their own consumption. *See* H. AARON & H. GALPER, *supra* note 63, at 20-21.

111. *Id.* at 46.

come tax base as opposed to excises on consumer items. The 1986 Act moves in the opposite direction with its emphasis on tax reduction at upper-income levels to enhance investment potential.

### *B. Horizontal Equity and Realized Gains from Capital*

#### *1. Unrealized appreciation*

The consumption tax debate identifies a principal horizontal defect of the income tax base. Consumption tax advocates have convincingly demonstrated that excluding unrealized accretions to wealth from the tax base creates a major distortion between different forms of investment.[112] Taxpayers may invest in assets producing long-term appreciation and defer tax liability until accretions to the invested capital are realized on disposition. This favors investment in long-term appreciating property over investments producing a current income flow subject to current taxation.[113] A principal attraction of the consumption tax is the avoidance of this disparity by excluding all gains from savings and investment activity, plus all other current income that is saved or invested. As a consequence, the tax base shrinks substantially under a consumption tax because of the removal of all unconsumed economic income.[114] The consumption base would, however, treat all gains devoted to saving and investment the same — the gains are excluded from taxation until consumed.[115] Thus consumption tax advocates complain not that the realized gain concept requires deferral of taxes on unrealized gain, but that some investment gain is taxed earlier than unrealized appreciation on long-term assets. The solution to that difficulty is not the total exclusion of all unconsumed investment income.

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112. Commentators describe this as one of the principal distortions of the present system. *See, e.g.* Andrews, *supra* note 63, at 1115 (stating that the worst inequity and distortion of the existing income tax arises out of the failure to properly deal with unrealized accretion). *See also* Aaron & Galper, *A Tax on Consumption, Gifts and Bequests and Other Strategies for Reform*, in OPTIONS FOR TAX REFORM, *supra* note 19, at 119.

113. This includes interest from a savings account or rent from property. *See* Andrews, *supra* note 63, at 1115. As discussed below, this disparity may be minimized with a tax exemption for accumulated income from certain investments until the income is actually withdrawn from the underlying investment. *See infra* text accompanying note 116.

114. The shrinkage is mitigated by the fact that all borrowing for consumption and all withdrawals from saving for consumption are included in the tax base.

115. *See* Andrews, *supra* note 63, at 1149.

Harmonizing the tax treatment of all forms of saving and investment using a realized gain standard to identify the exercise of control over gains is a better approach.

The deferral advantage of long-term gain can be mitigated by putting all return from investments producing current income on a similar footing. The realized gain concept measures ability-to-pay with economic gain that is subject to an exercise of discretionary control by the taxpayer. The concept would not be harmed if interest on savings retained in an account with the principal and dividends reinvested in the corporate payor, were not subject to tax until withdrawn from the underlying investment.[116] Economic gains in the form of interest and dividends should thus be taxed, like appreciation, when actually removed from the underlying investment and made subject to consumption or reinvestment.[117] Withdrawals from qualified savings accounts and gains on disposition of stock would be treated first as a return of the reinvested current income and taxed accordingly.[118] Ability-to-pay would then be measured by economic gains controlled by the taxpayer with no advantage to unrealized gains on appreciated property. Deferred taxation of interest and dividend income would equalize the treatment of investments in appreciating property with investments producing a current income stream. Deferred taxation of interest and reinvested dividend income would serve as an inducement to savings and investment. This incentive might be sufficient to justify eliminating the present cumbersome scheme for encouraging retirement saving, resulting in less complexity and perhaps more revenue.[119]

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116. This proposal would also harmonize the treatment of dividends and savings interest with the treatment of inside interest buildup of whole life insurance policies. *See* 2 TREASURY PROPOSAL, *supra* note 20, at 258-61.

117. This was done to a limited extent with respect to dividend reinvestment plans of public utilities, but the provision expired at the end of 1985. I.R.C. § 305(e) (1982).

118. The current tax treatment of amounts received from an annuity or life insurance contract that do not represent annuity payments under I.R.C. § 72(e) is identical to this proposal.

If interest not actually withdrawn and reinvested dividends are removed from the tax base, a concurrent provision should disallow any deduction for interest incurred to carry such investments, at least until such time as the interest or dividends are actually recognized in gross income by the taxpayer. *See, e.g.*, I.R.C. § 265 (1982). In addition, disallowing any deduction by the payor of interest until the recipient takes the interest into income would mitigate the revenue loss. *See, e.g.*, I.R.C. § 461(h).

119. This would include Individual Retirement Accounts (IRA's) and other voluntary contribution plans such as I.R.C. §§ 401(k) and 403(b). Qualified pension and profit sharing plans for employed and self-employed individuals could also be substantially

### 2. *Preference for Long-Term Capital Gains*

The preference for long-term appreciation has not been limited to deferral. Long-term capital gains have also been subject to substantially reduced tax rates.[120] Before the 1986 Act, the capital gains preference allowed individuals to claim a deduction for 60% of gain recognized on the sale or exchange of a capital asset held for longer than six months.[121] The maximum tax rate on long-term capital gains derived by non-corporate taxpayers was 20%, 40% of the maximum rate on other forms of income.[122] Corporate taxpayers paid tax on long-term capital gains at a maximum rate of 28%.[123] Not only did this preference provide a major advantage to a form of realized gain, it was perhaps the greatest single contributor to complexity in the Internal Revenue Code. Elimination of the capital gains preference may be one of the most significant features of the 1986 Act.

The *Treasury Proposal* described the preference as a "very rough way of allowing for the effects of inflation."[124] The Trea-

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restricted.

In a small fashion the 1986 Act has such an impact. For individuals subject to qualified retirement plans, the benefits of IRA's are limited to tax deferral on accrued earnings. Earnings on nondeductible contributions to an Individual Retirement Account will not be taxed currently. Tax Reform Act of 1986 § 1102 (amending I.R.C. § 408).

120. The preference for capital gains created distortions in both horizontal and vertical equities. Horizontal equity was disturbed because the recipient of this favored form of economic income paid taxes at a lower rate than the recipient of other forms of income notwithstanding similar ability to pay. Vertical equity was disturbed because the capital gains preference was utilized more by upper-income taxpayers than at lower income levels. The capital gains preference was one of the two most significant tax preferences for upper-income taxpayers. Musgrave, *supra* note 11, at 51.

121. I.R.C. §§ 1201, 1222 (1982 & Supp. II 1984). A capital asset is defined in § 1221 as all property excluding certain items such as inventory, property held primarily for sale to customers in the course of a trade or business, and depreciable property and real property used in a trade or business. I.R.C. § 1221 (1982). Gains on depreciable and real property used in a trade or business are nonetheless given capital gain treatment by I.R.C. § 1231 (1982).

122. The *Ways and Means Plan* would have reduced the capital gains preference to 42% of long-term capital gain. WAYS AND MEANS PLAN, *supra* note 56, at 196. The *Reagan Plan* would have reduced it to 50%. REAGAN PLAN, *supra* note 32, at 168. Both plans retained the present law treatment of the capital gains deduction as a preference item included in the alternative minimum tax base. WAYS AND MEANS PLAN, *supra* note 56, at 315; REAGAN PLAN, *supra* note 32, at 331. In the *Ways and Means Plan* where the alternative minimum tax is higher than the maximum rate on capital gains under the regular tax, the preference is reduced by 3/25 of the gain in order to limit the tax on capital gains to the preference level provided in the regular tax. WAYS AND MEANS PLAN, *supra* note 56, at 315.

123. I.R.C. § 1201 (1982).

124. 1 TREASURY PROPOSAL, *supra* note 20, at 101. The *Ways and Means Plan* also

sury analysis indicated that during the high-inflation years of the 1970s, the effective tax rate on capital gains exceeded 100% in spite of the 50% capital gains deduction then in effect. The *Treasury Proposal* stated that an inflation adjustment of approximately 4%, the current rate of inflation, would produce an effective tax rate equivalent to the pre-1986 maximum rate on long-term capital gains.[125] More importantly, as the *Treasury Proposal* pointed out:

> The preferential tax rate for capital gains also distorts investment decisions by providing a potentially lower effective rate of tax on assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Along with other provisions that establish special tax treatment for particular sources and uses of income, the preferential tax rate for capital gains is one of an elaborate series of tax incentives for particular businesses and investments. These incentives impede the efficiency of an economy based on free market principles. This undeclared government industrial policy largely escapes public scrutiny, yet it increasingly controls the form and content of business and investment activity.[126]

In addition, the *Treasury Proposal* described the distinction in tax rates between capital gains and ordinary income as a source of substantial complexity.[127] It pointed out that characterization principles "are complicated in concept and application, typically requiring careful scrutiny of the facts of each case."[128] The *Treasury Proposal* added:

> [S]ignificant simplification would result from eliminating the distinction between capital gains and ordinary income, including repeal of recapture rules as well as the extremely complicated collapsible partnership and corporation provisions. Real gains from the sale of most assets will simply be taxed in the same ways as all other income. Many elaborate schemes designed to obtain capital gains treatment for ordinary income will lose much of their attraction; as a result, fewer resources

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cites inflation as one of the principal justifications for the capital gains preference. WAYS AND MEANS PLAN, *supra* note 56, at 196.

125. 1 TREASURY PROPOSAL, *supra* note 20, at 102. With a deduction of 60% and a maximum statutory rate of 50%, the maximum regular tax rate on nominal long-term capital gains was 20%. I.R.C. § 1202 (1982).

126. 2 TREASURY PROPOSAL, *supra* note 20, at 180-81.

127. *Id.* at 181.

128. *Id.*

will be wasted in tax planning activities as well as in auditing returns with questionable conversion schemes.[129]

The 1986 Act taxes long-term capital gain at the regular rates for individuals and corporations, thus eliminating the capital gains preference.[130] However, deductible capital losses of individuals remain limited to capital gains plus $3,000.[131] As a precursor to the next round of tax legislation, the statutory structure for capital gains is retained in the Code "to facilitate reinstatement of a capital gain rate differential if there is a future tax rate increase."[132]

If an incentive is desirable to encourage capital investment, reduced tax rates on gains removed from the investment pool is not the best approach. Capital gains reform should provide rollover relief allowing a taxpayer, within a defined period of time, to reinvest the proceeds from a disposition of property without

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129. 1 *id.* at 105. In lieu of preferential treatment the *Treasury Proposal* would have indexed the basis of capital assets for inflation. In effect, this proposal would change the measure of ability-to-pay from realized gain in United States dollars to realized gain in terms of market ability to acquire goods and services determined with reference to the Bureau of Labor Statistics' Consumer Price Index for Urban Households. 1 *id.* at 181-83. The original cost basis of property would be adjusted by an inflation factor determined from tables published by the Internal Revenue Service. The tables would specify a single inflation adjustment factor based on calendar quarters that an asset was held. *Id.* This approach was justified on the theory that taxation should be based on real, that is inflation adjusted, economic gains. *Id.* at 99. *See also* The 1982-83 Federal Tax Committee of the American Accounting Association, *Indexing the Tax Law to Adjust for Inflation*, 62 TAXES 125 (1984). The *Treasury Proposal* recognized that the inflation adjustment would add complexity to the Code as taxpayers would be required to compute the increase to basis resulting from inflation, but pointed out that this complexity is not nearly as severe as the complexity injected into the Code by the capital gains preference. 1 TREASURY PROPOSAL, *supra* note 20, at 105. The *Treasury Proposal* also called for adjustments to interest income and interest payments to reflect the inflation element of interest. *Id.* at 77.

The *Reagan Plan* attempted to provide the best of both worlds. The existing preferential treatment would have been retained with the preference reduced from 60% to 50% so that the effective rate on nominal gains under the lowered top marginal rate of the proposal would have been 17.5%. REAGAN PLAN, *supra* note 32, at 168. Beginning in 1991, the *Reagan Plan* would have allowed taxpayers an election to adjust basis for inflation occurring after that date rather than claim the 50% preference. *Id.* at 169.

The *Ways and Mean Plan* had none of this. The plan continued the existing preference but at a reduction to 42%. WAYS AND MEANS PLAN, *supra* note 56, at 196.

130. The capital gains preference is important through 1987 where the top tax bracket is 38.5% for individuals. Tax Reform Act of 1986 § 101(a)(adding I.R.C. § 1(h)). The rate of tax on an individual's long-term capital gain is limited in 1987 to 28%. I.R.C. § 1(j) (as amended by the Tax Reform Act of 1986 § 302(a)).

131. I.R.C. § 1211(b) (1982). *See also* CONFERENCE REPORT, *supra* note 67, at II-105 to -106.

132. CONFERENCE REPORT, *supra* note 67, at II-106.

recognizing gain or loss.[133] The basis of the old property would be carried over to the new so that gain would be recognized when the investment is finally terminated. The current Code virtually allows this treatment with respect to real estate investment under the like-kind exchange provisions.[134] Such a provision would encourage continued investment in lieu of consumption.[135]

Roll-over relief for reinvestment coupled with deferred taxation of accrued interest and reinvested dividends would create a hybrid consumption tax system without the extreme advantage provided to earnings transferred to investment and the accompanying shift in relative tax burdens that would result from a cash-flow consumption tax.[136] First, realized and unrealized investment earnings would be placed on the same footing — recognition at regular rates when the investment is terminated. Second, earned income would be subject to tax when initially derived, regardless of its disposition in consumption or investment. Like the consumption tax theory, however, this approach excludes investment gains from the tax base until the gains are diverted to consumption. It thus provides a substantial incentive for saving and investment without providing undue tax preference to the taxpayer in a position to direct income to investment. Furthermore, it eliminates the current system's disincentive to saving.

If taxation of investment gain is deferred, the tax base must also address donative transfers to avoid tax free accumulations

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133. *See* Andrews, *supra* note 63, at 1179. A detailed analysis of this possibility may be found in Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 TAX L. REV. 383 (1986). The capital gains preference has been justified in part as a way to mitigate the so-called "lock-in effect," the idea that high tax rates discourage investors from disposing of long-term appreciated property because of potential tax liability. *See* WAYS AND MEANS PLAN, *supra* note 56, at 196. Rollover relief would end this problem.

134. I.R.C. § 1031 (1982).

135. A third reason cited for the capital gains preference is the impact of long-term gains on the taxpayer's bracket under the progressive rate structure. A large gain arising over a period of years can create a bulge in taxable income in the year recognized putting the taxpayer in a higher tax bracket. This problem is easily solved with an averaging convention that would divide gain from property held for more than a prescribed period by the number of years the property is held by the taxpayer and include only that proportion in income for purposes of determining the marginal rate of tax applicable to the gain. The holding period requirement should be lengthy, two years or longer, in order to avoid application of this rule to inventory or property held for sale to customers. The 1954 Code used this kind of averaging technique in §§ 1301-1304. The 1986 Act repealed these sections. Tax Reform Act of 1986 § 141(a).

136. *See, e.g.*, Andrews, *supra* note 63, at 1179.

of wealth across generations.[137] It remains possible under the 1986 Act to completely avoid tax by transferring appreciated property as a gift or at death. In the case of gifts, no gain is recognized by the donor, but the donor's basis (recoverable cost) carries over to the donee.[138] Although the gain is ultimately fully taxed, taxation is deferred to the date of the donee's disposition. Further, the gain is taxed at the marginal tax bracket of the donee.[139] The donee's tax bracket may be lower than the donor's bracket.

In the case of a transfer at death, pre-death appreciation is removed from the tax base entirely. The transferee's basis in the property is "stepped-up" to fair market value at the date of death.[140] In both situations the transferor enjoys the economic benefit of appreciation by transferring that value to the objects of his or her bounty. In effect, the transferor exercises control over the gain by directing it to another, but by doing so either shifts or avoids the tax entirely.

To maintain horizontal and vertical equity the tax system should recognize that ability-to-pay includes the ability to direct accumulations of wealth in the form of appreciated property to family and other recipients of donative transfers. Thus, gain should be recognized on all donative transfers of appreciated property including gifts, death-time transfers, and charitable contributions.[141] As is the case under current law, gain would not be recognized on any transfer to a spouse.[142] The transferor's basis would carry over to the spouse so that appreciation would be

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137. *See supra* note 98.

138. I.R.C. § 1015 (1982).

139. With respect to a related problem, the 1986 Act provides that unearned income of a child under age 14 will be taxed to the child at the parents' marginal rate. Tax Reform Act of 1986 § 1411 (adding I.R.C. § 1(i)).

140. I.R.C. § 1014 (1982). There is an alternative valuation date, six months after the date of death, if elected by the decedent's estate. I.R.C. § 2032 (1982).

141. The 1986 Act takes a small step in this direction by including the portion of the regular charitable contribution deduction attributable to appreciation of property contributed to charity in the alternative tax base. Tax Reform Act of 1986 § 701(a) (adding I.R.C. § 57(a)(6)). *See* WAYS AND MEANS PLAN, *supra* note 56, at 313. Subject to certain limitations, many of which refer to the elusive distinctions between capital gains and ordinary income property, a taxpayer receives a deduction from regular taxable income for the full fair market value of long-term capital gain property contributed to charity. I.R.C. § 170 (1982). The 1986 Act adds the portion of this deduction attributable to untaxed appreciation to the minimum tax base. *See also* H. AARON & H. GALPER, *supra* note 63, at 68 (advocating a cash flow income tax that would include the full amount of gifts and death-time transfers in the tax base as current consumption).

142. I.R.C. § 1041(a) (Supp. II 1984).

taxed on disposition by the transferee spouse.[143] Further, to avoid undue complexity for small estates, a de minimis exception could exclude the first $100,000 (or some other appropriate amount) of appreciation at death.

These proposals demonstrate that harmonization of the tax treatment of capital gains with other forms of income is possible under the realized gain concept of income in a manner that will provide horizontal equity and at the same time encourage saving and investment. Although deferral of taxes on earnings from investment and capital gains would primarily benefit upper-income individuals, progressive rates can be used to achieve appropriate vertical equity.

## III. Defining the Tax Base With Adjustments to Realized Gains

Realized gains alone do not fully define the appropriate tax base. An allocation of tax burdens based on ability-to-pay requires adjustments to account for individual circumstances. These adjustments are accomplished in the Code by a series of exclusions and deductions from gross income.[144] The greatest challenge in tax reform is to devise a tax base that encompasses appropriate adjustments without providing undue benefit to diverse classes of incomes or taxpayers. Equitable and understandable taxation must be based on a consistently applied measure of the tax base constructed without major deviations for taxpayers in similar circumstances. The 1986 Act makes substantial improvements in the tax base that enhance horizontal equity. Unfortunately, the 1986 Act is marred by its lack of a guiding theory other than a "winners and losers" approach to tax reform that has left the tax base seriously flawed.

Most of the appropriate exclusions and deductions from realized gains can be analyzed within three broad categories. Two groups have an impact on ability-to-pay: (i) adjustments to ac-

143. I.R.C. § 1041(b) (Supp. II 1984).

144. Technically the Code begins by defining gross income as gains from whatever source derived. I.R.C. § 61(a) (1982). That definition is followed by a series of provisions, known as "exclusions," that exclude certain realized economic gains from gross income. I.R.C. §§ 72(b), 79, 101-133 (1982). Gifts and inheritances are an example. I.R.C. § 102 (1982). Next the Code provides deductions from gross income to compute the taxable income upon which tax is calculated. These deductions include the ordinary and necessary expenses of a trade or business, I.R.C. § 162 (1982), provisions for most of the incentives provided by Congress, and the reductions of the tax base for a number of non-income producing items such as interest and taxes, I.R.C. §§ 163-164 (1982).

count for the cost of producing realized gains, and (ii) adjustments to account for varied family circumstances such as family size and the number of income earners within the family economic unit. A third level of adjustment reduces the tax base to provide governmental incentives for preferred economic and social behavior. This last category represents governmental expenditures in the form of revenue foregone to accomplish a policy objective.[145] It operates through the first two, as incentives are often justified as accelerated costs of income production or as special provisions to account for diverse family circumstances.

There are some exclusions from gross income representing items historically not considered as income that do not fit within the three categories just mentioned. Gifts and inheritances, for example, have been excluded from the gross income of the recipient since the inception of federal income taxation.[146] These economic gains are treated as a division of the transferor's income rather than as additional taxable income to the recipient.[147] The statutory exclusions for scholarships and fellowships,[148] and for awards for meritorious achievement,[149] arose from the gift exclusion because of difficulty encountered distinguishing excludable

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145. This category broadly includes what the late Professor Stanley Surrey described as "tax expenditures." *See* S. SURREY, PATHWAYS TO TAX REFORM 3 (1973). The tax expenditure concept is based on the assumption that there are accepted concepts of what properly constitutes net income and that preferences enacted to induce specific behavior are equivalent to governmental subsidies, expenditures, on behalf of the favored activity. The Congressional Budget and Impoundment Act of 1974, Pub. L. No. 93-344, § 3(a)(3), 88 Stat. 297, 299, defines tax expenditures as "those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability . . . ." Ascertaining which exclusions and deductions are proper in determining net income and which represent tax expenditures is a matter of some debate. *See, e.g.*, McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79 (1980). For a history of the tax expenditure budget see Forman, *Origins of the Tax Expenditure Budget*, 30 TAX NOTES 537 (1986).

146. I.R.C. § 102 (1982).

147. *See* R. GOODE, *supra* note 19, at 97. Henry Simons would have included gifts and inheritances in income, however. H. SIMONS, *supra* note 82, at 135.

148. I.R.C. § 117 (1982).

149. I.R.C. § 74(b) (1982). The exclusion was limited to prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. The exclusion was available only if the recipient was selected without any action on his part to enter the contest or proceeding and was not required to render substantial services as a condition of the award. The Treasury Regulations provide that awards to employees in recognition of some achievement in connection with employment are not excludable. Treas. Reg. § 1.74-1(b) (1985). *But see* Jones v. Commissioner, 743 F.2d 1429 (9th Cir. 1984) (award from employer (NASA) for scientific achievement excluded from income).

gifts from scholarships and awards presented as compensation for services.[150] The 1986 Act repeals the exclusion for prizes and awards[151] and limits the exclusion for scholarships and fellowships to amounts given to degree candidates for tuition and equipment required for courses of instruction.[152] The 1986 Act also repeals the exclusion for unemployment compensation benefits.[153]

Employer provided fringe benefits were left essentially undisturbed.[154] Fringe benefits represent a major element of realized gain not included in the tax base. The *Treasury Proposal* and the *Reagan Plan* both asserted that existing tax preferences allowed to fringe benefits as a form of employee compensation increase consumption of such benefits, thereby shrinking the tax base.[155] The *Treasury Proposal* contained far-reaching recommendations to repeal exclusions for employer-provided group life insurance, death benefits, dependent-care services, housing and housing allowances for ministers, and certain military cash compensation.[156] The *Treasury Proposal* would have also per-

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150. *See* J. Sneed, The Configurations of Gross Income 157 (1967).

151. Tax Reform Act of 1986 § 122(a)(1) (amending I.R.C. § 74). In repealing the exclusion, each of the proposals recognized that the receipt of a prize or award increases an individual's economic well-being and thus enhances ability-to-pay. 2 Treasury Proposal, *supra* note 20, at 60; Reagan Plan, *supra* note 32, at 59; Ways and Means Plan, *supra* note 56, at 104; Senate Plan, *supra* note 56, at 48.

152. Tax Reform Act of 1986 § 123 (amending I.R.C. § 117). Portions of scholarships awarded for living expenses are included in the tax base.

153. *Id.* § 121 (amending I.R.C. § 85). A number of government transfer payments are excluded from gross income on the theory that it represents a rough equalization for the omission of numerous other governmental benefits such as police and fire protection. *See* Bittker, *A Comprehensive Tax Base as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 938 (1967); Schenk, *The Effect of a Broad-Based Flat-Rate Income Tax on the Average Taxpayer*, 23 Tax Notes 423, 425 (1984). The *Treasury Proposal* and *Reagan Plan* would have repealed the exclusion for workers compensation and related payments except for payments for medical services. 2 Treasury Proposal, *supra* note 20, at 52-54; Reagan Plan, *supra* note 32, at 52. The proposals asserted that increased tax thresholds, including an expanded credit for the elderly, blind, and disabled would allow low income taxpayers to effectively exclude these amounts from tax while persons with more substantial incomes should be required to measure their ability-to-pay by including these items. 2 Treasury Proposal, *supra* note 20, 54; Reagan Plan, *supra* note 32, at 52.

154. I.R.C. § 132 excludes from gross income employee fringe benefits that are provided to employees at no additional cost to the employer, are an employee discount not in excess of the employer's profit margin, are provided as a working condition, or are of such low value that accounting for their cost would be unreasonable.

155. 2 Treasury Proposal, *supra* note 20, at 73-74; Reagan Plan, *supra* note 32, at 23. The major target of this fringe benefit language is the exclusion for employee health plans, the most significant of the excluded fringe benefits. This topic is discussed *infra*, beginning in the text accompanying note 306.

156. 1 Treasury Proposal, *supra* note 20, at 73.

mitted exclusions for educational assistance plans and group legal services to expire.[157] The *Reagan Plan* would have retained exclusions for all of these items except for the $5,000 employee death benefit and the exclusion for employer-provided commuting services (van pools).[158] In drafting the 1986 Act the Ways and Means and Senate Finance Committees retained all of the exclusions. They recommended instead a broad nondiscrimination rule to insure that fringe benefits were not restricted to owners and highly compensated employees.[159]

The early reform plans thus advocated some expansion of the tax base to include realized gains previously exempt from tax. But as the process progressed from the initial *Treasury Proposal* to the bills passed by the House of Representatives and the Senate, the scope of the base expansion in these areas was progressively narrowed. This pattern is evident in each of the areas described below.

### A. *The Costs of Income Production*

The first and most significant adjustments to realized gain reflect the expense of income production. The Federal income tax is based on the concept of gain.[160] Realization of gain first requires a return of capital investment.[161] This means that amounts realized from the disposition of property, including inventory, are reduced by the taxpayer's costs of acquiring the property.[162] In addition, the computation of gain or profit requires that the tax base be limited to the excess of receipts over the cost of producing those receipts. The Code thus allows deduction of the ordinary and necessary expenses incurred in the taxpayer's trade or business,[163] or in the production of income,[164] plus deductions for the recovery of previous capital invest-

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157. *Id.*

158. REAGAN PLAN, *supra* note 32, at 31-32; *see also id.* at Summary 26-27 (comparison table).

159. WAYS AND MEANS PLAN, *supra* note 56, at 769-70; SENATE PLAN, *supra* note 56, at 650-51.

160. Jackson v. Commissioner, 708 F.2d 1402, 1404 (9th Cir. 1983).

161. Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918).

162. *See* J. SNEED, *supra* note 150, at 13. Gain or loss on disposition of property is computed by subtracting adjusted basis from amount realized (the amount of money and fair market value of property received). I.R.C. § 1001 (1982). Basis represents the taxpayer's recoverable cost (I.R.C. § 1012) that is returnable without additional tax.

163. I.R.C. § 162(a) (1982).

164. I.R.C. § 212 (1982).

ment.[165] Horizontal equity requires a consistently applied measure of income, receipts less cost, as the basis for measuring ability-to-pay.[166] Identifying allowable costs and allocating those costs to appropriate periods of income production is a complex undertaking.[167]

A comment about complexity is appropriate here. Simplicity in the tax system was the stated goal of each of the reform plans. Yet simplicity in the tax system is not achievable. A system of laws designed to measure flows of income and capital throughout the United States economy, and at the same time to cope with international transactions that are also subject to taxation by other nations, will be complex by virtue of the nature and breadth of its subject matter. In addition, the Code affects numerous non-monetary issues such as family organization and dissolution, economic and social relations between family members, transfer payments to the poor and not-so-poor, and criminal behavior. The tax statute thus encompasses virtually every area regulated by law.[168] No other body of law is as comprehensive in touching virtually every aspect of organized society within the United States. The impact of the Internal Revenue Code is far-reaching and the degree of required complexity is commensurate with its reach.

The complexity could be made manageable, however, if the tax system were systematically built upon a coherent understanding of the goal to be achieved. But this is not the kind of simplification envisioned by the framers of the 1986 Act which is based on the idea that restricting deductions and adopting fewer

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165. *See, e.g.*, I.R.C. §§ 167, 168 (1982).

166. To this end the 1986 Act contains significant accounting method adjustments affecting inventories, long term construction contracts, construction costs, installment sales by dealers, pledges of installment obligations and bad debt reserves. Tax Reform Act of 1986 §§ 801-824; CONFERENCE REPORT, *supra* note 67, at II-290 to -316. The 1986 Act also limits the use of the cash method accounting system by corporations and tax shelters with an exception for personal service corporations owned by employees who perform the services and entities with annual gross receipts of $5 million or less. Tax Reform Act of 1986 § 801 (amending I.R.C. § 448). *See* CONFERENCE REPORT, *supra* note 67, at II-285 to -289. In very broad terms, most of these provisions will have the effect of accelerating recognition of income into earlier years.

167. Although defining this base is not without major difficulty, Congress has been able to identify the scope of appropriate adjustments in at least two parts of the existing Code, the list of tax preferences for alternative minimum tax purposes (I.R.C. § 57) and the adjustments to taxable income for purposes of ascertaining corporate earnings and profits for dividend purposes (I.R.C. § 312(k) & (n)).

168. The Code even specifically deals with skateboards, massage facilities, and hot-tubs. I.R.C. § 144(a)(8)(B) (1982).

rate brackets makes the taxpayer's lot simpler because he or she need not account for specific items or be concerned with marginal rate changes as income fluctuates.[169] The undue complexity of the Code arises from the myriad of special incentives and preferences coupled with their complex restrictions, recapture rules, and treatment as tax preferences in the alternative tax base.[170] This complexity is compounded by the type of decision-making reflected in the 1986 Act, which attempted to distribute the burden of tax by targeting deductions used by identified income groups rather than allocating tax burdens with a progressive rate structure. Complexity is compounded by the 1986 Act's lack of overall theory in the application of many of the Code's specific rules.

Progress towards a manageable tax system depends on adoption of a uniform measure for the tax base and consistent application of that measure. Deviations should be tolerated only for defined policy goals that are consistent with the measure itself. For this reason the gain or profit included in the tax base "should correspond to commonly accepted business measures of net income consistently followed."[171] Simplification can be achieved only if policy makers forebear using a complex system of incentives and restrictions to achieve their goals.[172] The 1986 Act offers some comfort by reducing the existing system of preferences and punishments for over-use of the preferences. Nonetheless, the 1986 Act retains the complex scheme of preferences for the recovery of invested capital that has generated most of the complexity.

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169. *See* WAYS AND MEANS PLAN, *supra* note 56, at 87-88. Simplification is said to be achieved because fewer taxpayers will itemize deductions and because of the four bracket rate structure. *See also* 1 TREASURY PROPOSAL, *supra* note 20, at 63, 87. But taxpayers must still determine if they are qualified to itemize by performing the same computations. The rate structure change will have little direct impact on filers who consult tables to find their precise dollar tax liability.

The *Senate Plan* goes a little further with its restrictions on passive investment losses, SENATE PLAN, *supra* note 56, at 713, that reduce potential return from uneconomic losses thereby directing taxpayers into less complex and more productive forms of investment. *Id.* at 4.

170. Heller, *supra* note 98, at 919.

171. Bittker, *supra* note 153, at 929.

172. Aaron and Galper add, "Such forbearance could be encouraged by the knowledge that beyond a certain point piecemeal incentives tend to become self-defeating. Incentives result from relative advantages; if tax concessions are pervasive, the relative advantage of favored activities declines." H. AARON & H. GALPER, *supra* note 63, at 118.

### 1. *Capital recovery*

Capital recovery provisions represent one of the major sources of complexity and investment distortion. These provisions are the policy makers' primary tool to favor some income production activities over others. An overview of the capital recovery rule in effect before the 1986 Act provides a striking illustration of the interplay between complexity and economic distortion that disturbs both horizontal and vertical equities. This complexity and distortion was condemned in all of the reform proposals. Yet the scheme remains in the Code under the 1986 Act.

Originally the deduction for depreciation was viewed as a method to allocate the cost of income-producing property, to the periods in which property is used in the production of income.[173] Indeed, the courts had gone so far as to reject the currently popular notion that depreciation is intended to create a fund for the replacement of income-producing property, expressly stating that "[d]epreciation reflects the cost of an existing capital asset, not the cost of its future replacement."[174] In 1981, however, the Senate Finance Committee concluded that "present rules for determining depreciation allowances and the investment tax credit need to be replaced because they do not provide the investment stimulus that is essential for economic expansion."[175] The Accelerated Capital Recovery System (ACRS), which was one of the centerpieces of the 1981 tax reduction, plus the ten percent investment tax credit, provided major tax reductions to capital intensive business.[176] ACRS was the culmination of a trend begin-

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173. Commissioner v. Idaho Power Co., 418 U.S. 1, 10-11. (1974); Massey Motors, Inc. v. United States, 364 U.S. 92, 104 (1960). *See also* H.R. REP No. 1337, 83d Cong., 2d Sess. 22 (1954).

174. Commissioner v. Idaho Power Co., 418 U.S. at 12; United States v. Chicago, B. & Q. R.R. 412 U.S. 401, 415 (1973). The Senate Finance Committee indicated in its report of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, that depreciation to that date had been based on the concept "that the cost of an asset should be allocated over the period it is used to produce income." S. REP. No. 144, *supra* note 43, at 39.

175. S. REP. No. 144, *supra* note 43, at 47. The use of accelerated capital recovery provisions as an incentive to investment follows a trend that began in 1954 when Congress first enacted double declining balance depreciation to accelerate recovery of capital investment.

176. Using a 12% discount rate, one commentator demonstrated that the present value of ACRS deductions plus the investment tax credit on a $1 investment was greater than $1 producing a negative effective tax rate. Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C.L. REV. 1327, 1346-48 (1982) (tables 5 & 6).

ning in 1954 that increasingly accelerated capital recovery deductions to the early years of income production from an asset. In addition, the Code contained incentives for particular capital investment in the form of rapid amortization of the costs of acquiring and developing trademarks and tradenames,[177] the cost of certain pollution control facilities,[178] rehabilitation expenses for low income housing,[179] expenses for the removal of architectural barriers to the handicapped,[180] and the cost of railroad rolling stock[181] among others.[182] Certain other expenditures creating income producing value for future years were deductible as an incentive in the year the expense was incurred. These included such things as research and development expenditures[183] and intangible drilling and development costs incurred with respect to oil, gas or geothermal wells.[184] Most of these provisions are retained by the 1986 Act but with some modification.[185]

Depreciation expenditures and several of the rapid amortization provisions require the taxpayer to reduce basis in the affected assets to reflect the taxpayer's recovery of a portion of invested capital in the form of tax deductions.[186] This reduced basis will result in recognition of taxable gain on disposition of

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The 1981 tax reductions were so significant that Congress recognized that not all business would be in a position to fully utilize the benefits. To compensate, Congress enacted broadened leasing standards designed to allow one taxpayer to transfer the benefits of ACRS and the investment tax credit to a taxpayer with sufficient taxable income to absorb the investment incentives. *See* S. Rep. No. 144, *supra* note 43, at 61-63. These benefits proved too much, however, and were cut back in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 208, 209, 96 Stat. 324, 433-42; S. Rep. No. 494, 97th Cong., 2d Sess. 138 (1982).

177. I.R.C. § 177 (1982).

178. I.R.C. § 169 (1982).

179. I.R.C. § 167(k) (1982).

180. I.R.C. § 190 (1982).

181. I.R.C. § 184 (1982).

182. Congress has recognized that this shopping list of incentives results in a deviation from economic income and required corporate taxpayers to add back a number of these items to compute earnings and profits for dividend purposes. I.R.C. § 312(k), (n) (1982).

183. I.R.C. § 174 (1982).

184. I.R.C. § 263(c) (1982).

185. The research credit is extended for three years reduced from 25% to 20%. Conference Report, *supra* note 67, at II-70 to -71. Trademark and tradename expenditures, and the costs of railroad grading and tunnel bores must be capitalized. *Id.* at 78, 80. A new credit is provided for residential rental projects providing low-income housing. Tax Reform Act of 1986 § 252; Conference Report, *supra* note 67, at II-85 to -103.

186. I.R.C. § 1016(a) (1982).

the asset whenever economic depreciation is less than the tax allowance.[187] Although deductible depreciation and amortization reduced income at higher ordinary income tax rates, the Code formerly treated gain on the sale or exchange of depreciable property used in a trade or business as capital gain subject to lower capital gains rates.[188] To prevent taxpayers from receiving too much advantage from the incentive of accelerated deductions, the Code restricted the capital gains allowance with lengthy and complex provisions for the recapture of prior depreciation deductions on disposition of property for more than its adjusted basis.[189] Although the preference for capital gains is eliminated by the 1986 Act, the recapture provisions remain in the Code patiently awaiting return of the preference.[190]

Another set of rules is designed to prevent taxpayers from financing investments that produce depreciation deductions and other artificial accounting losses in excess of income with debt for which there is no personal liability.[191] Originally applicable to investment in personalty, the "at-risk rules" are expanded by the 1986 Act to include real estate other than real estate financed by a third party lender.[192] Artificial accounting losses financed with debt are available to offset income from other sources only when the taxpayer is personally liable for the debt.[193] Often taxpayers were faced with difficult conceptual decisions in identifying investments to which these limitations apply.[194]

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187. I.R.C. § 1001 (1982). Gain is defined as the difference between the amount realized on disposition (the amount of money plus the fair market value of property received) and the adjusted basis of the property.

188. I.R.C. § 1231 (1982). Individuals were allowed to deduct 60% of long term capital gains. *Id.* § 1202(a). Corporate capital gain was taxed at a maximum rate of 28%. *Id.* § 1201(a).

189. I.R.C. §§ 1245, 1250 (1982). This recapture has difficult collateral consequences in a number of transactions. *See, e.g.*, I.R.C. §§ 338, 751(c) (1982). Also note that although the tax preference for capital gains is repealed by the 1986 Act, the characterizations of income under sections 1245, 1250 and other recapture provisions remain important for some purposes such as determining the extent of allowable capital loss under section 1211. The distinction also affects use of installment reporting under section 453 which is restricted in the case of section 1245 gain.

190. CONFERENCE REPORT, *supra* note 67, at II-107.

191. I.R.C. § 465 (1982).

192. Tax Reform Act of 1986 § 503 (amending I.R.C. § 465(b)); CONFERENCE REPORT, *supra* note 67, at II-134.

193. The author has criticized the approach of these "at-risk" rules. *See* Simmons, *Nonrecourse Debt and Basis: Mrs. Crane Where Are You Now?*, 53 S. CAL. L. REV. 1, 58-73 (1979).

194. *See, e.g.*, Pritchitt v. Commissioner, 85 T.C. 580 (1985).

Finally, there is the separate alternative minimum tax that seeks to add incentives back to a minimum tax base. The alternative minimum tax is basically a flat rate tax imposed on a broader tax base that includes many of the incentives eliminated from the regular income tax base. Alternative minimum taxable income is subject to lower tax rates than regular taxable income. When the Senate Finance Committee approved increases in capital recovery provisions with the 1981 Act, it strengthened the minimum tax provisions, saying that its amendments serve "one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."[195] The alternative minimum tax thus attempts to sweep up those taxpayers who have taken too much advantage of the very incentives designed to induce taxpayers to act in Congressionally approved ways.

Thus, before 1987 a long list of special provisions, each with its own set of complex requirements and limitations on qualification, provided an incentive to different forms of investment. These complex rules and limitations were followed by additional complex rules limiting the degree to which certain kinds of investors and financial arrangements could take advantage of the incentives, and another set of rules attempting to recapture a portion of the prior incentive on disposition of the affected assets. Finally the alternative minimum tax punished those who took too much advantage of deductions. The resources required to find a path through this maze are enormous. It is no wonder that business and individual taxpayers have complained about the complexity of the Code. Unfortunately, the situation after January 1, 1987, is not much different.

Proponents of the major tax reform plans recognized that the pre-1987 situation was less than ideal. The *Treasury Proposal* asserted that the pre-1986 Act depreciation scheme "favor[ed] industries that invest heavily in depreciable assets . . . over others such as high technology industries, service industries, and the trade sector that invest more heavily in inventories."[196] The Treasury noted further that "[a]t current rates of

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195. S. REP. No. 144, *supra* note 43, at 108. The report adds that, "Although these provisions provide incentives for worthy goals, they become counter-productive when individuals are allowed to use them to avoid virtually all tax liability." *Id.* Identical language is contained in the *Ways and Means Plan* (WAYS AND MEANS PLAN, *supra* note 56, at 305-06) and the *Senate Plan* (SENATE PLAN, *supra* note 56, at 518).

196. 1 TREASURY PROPOSAL, *supra* note 20, at xiii. The *Treasury Proposal* advocated

inflation the ITC [investment tax credit] and ACRS generally provide capital recovery allowances that exceed the present value of the real economic depreciation which is required for the accurate measurement of income."[197] The *Reagan Plan* agreed that the existing system resulted in significant distortions in effective tax rates on various forms of income.[198] The *Reagan Plan* added that:

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a system designed to provide an accurate measurement of real economic income based on economic depreciation with realistic recovery periods and rates accompanied by an adjustment to basis for inflation. 2 *id.* at 99. The proposal contained recovery rates and periods intended to minimize deviations in effective tax rates for different asset classes on the basis of economic depreciation measured by replacement value. Under the proposal assets would be assigned to seven classes with depreciation rates from 3% to 31% applied to the inflation adjusted unrecovered basis of the asset. *Id.* at 158-62. The proposal indicates that the rates were based on Treasury Department studies showing "that a geometric pattern of constant-dollar economic depreciation is generally an appropriate method to apply to all classes of business assets, even though the geometric pattern may not accurately characterize all items within the class." *Id.* at 160. The Treasury cites Hulten & Wykoff, *The Measurement of Economic Depreciation*, in DEPRECIATION, INFLATION, AND THE TAXATION OF INCOME FROM CAPITAL 81 (C. Hulten ed. 1981), as a source for its studies. The proposal abandoned the idea that depreciation represents an allocation of historic cost to periods of income production, and proposed a system to compensate for the economic loss from a decline in the "real value of an asset over the year, which is equal to the cost of replacing lost productive value." 2 TREASURY PROPOSAL, *supra* note 20, at 155. As such, the proposal sought to compensate for economic changes in value attributable to changes in the consumer price index, in addition to allocating original cost. Note that this scheme would not create perfect neutrality among various long term assets as the true economic value of a particular piece of depreciable property will not always fluctuate in tandem with the price index.

197. 1 TREASURY PROPOSAL, *supra* note 20, at 98.

198. REAGAN PLAN, *supra* note 32, at 135-37. The *Reagan Plan* would have repealed ACRS and the investment tax credit and adopted a "Capital Cost Recovery System" (CCRS) that utilized shorter recovery periods than the *Treasury Proposal.* CCRS used six classes with recovery periods of 4, 5, 6, 7, 10 and 28 years. REAGAN PLAN, *supra* note 32, at 145. Depreciation rates were stated as a percentage of the inflation adjusted basis of depreciable properties. The rates were the equivalent of 220% declining balance for classes 1 and 2, 198% declining balance for class 3, 154% for class 4, 170% for class 5, and 114% declining balance for class 6. The declining balance method would switch to straight line in the year that straight-line recovery yields a higher allowance. *Id.* at 138. First year depreciation would be prorated based on the month an asset is placed in service. *Id.* The recovery periods of the *Reagan Plan* were not intended to reflect economic useful lives or depreciation rates. *Id.* On the contrary, the proposal was designed to provide a replacement for lost value consumed in the income producing process, as opposed to a recovery of the historical cost of producing that income. Thus the plan provided for annual increases to the unrecovered basis of depreciable property to account for inflation as measured by "an appropriate government price index." *Id.* at 139. The recovery percentages were designed to impose an 18% effective tax rate on all types of equipment and machinery. *Id.* at 149. The tax rate on income from capital investment was thus to be substantially below the maximum statutory rates set out in the plan of 33% on corporate income and 35% on individual income. *Id.* at 1, 119. The depreciation scheme thus envisioned capital recovery in excess of actual economic depreciation. The result would

> Investment distortions created by ACRS, investment tax credits and other capital cost recovery provisions hamper economic efficiency. The tax code guides the allocation of capital, overriding private market forces and the individually expressed consumer preferences they represent. Paradoxically, these distortions do not reflect stated government policy to favor particular assets or industries. As a result, ACRS operates as an undeclared government industrial policy which largely escapes public scrutiny and systematic review.[199]

Similarly, the *Ways and Means Plan* would have eliminated many of the accelerated capital recovery provisions.[200] The Committee indicated that it was

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be a smaller tax burden on income produced by investment in equipment and machinery than is imposed on other forms of income. *See* Hulten & Robertson, *The Taxation of High Technology Industries*, 37 NAT'L TAX J. 327, 332 (1984).

199. REAGAN PLAN, *supra* note 32, at 137. It is interesting to recall that this statement comes from the Administration that proposed ACRS initially.

200. The *Ways and Means Plan* included repeal of the investment tax credit and enactment of a new depreciation scheme called the "Incentive Depreciation System" which was intended to provide for longer depreciation periods more systematically related to economic useful lives. WAYS AND MEANS PLAN, *supra* note 56, at 145. The *Ways and Means Plan* utilized ten classes with recovery periods of 3, 5, 7, 10, 13, 16, 20, 25 and 30 years. *Id.* at 147-53. Depreciation was based on the 200% declining balance method switching to straight line except for class 10 property (real property that is not low income housing). *Id.* The Committee proposal allowed 200% declining balance recovery rates in the belief that the "intermediate degree of acceleration that was available prior to 1981 under the ADR system is generally the right target." *Id.* at 146. Yet, after denouncing the negative impact of preferences that direct capital to preferred investment, and praising its own effort to "provide more equal taxation of diverse economic activity," the Ways and Means Committee described its Incentive Depreciation System as "retaining incentives for investment in productive plant and equipment." *Id.* at 59.

The *Ways and Means Plan* also would have continued preferential treatment for investment in particular activities. Credits for research and development and rehabilitation of old and historic structures were to be continued. *Id.* at 60. Rapid amortization for rehabilitation of low income housing was to be made permanent, and removal of architectural barriers to the handicapped was to be extended. *Id.* at 173, 175. The current expense deduction for intangible drilling costs in the case of oil and gas wells was to be modified and continued because the Committee believed "that more preferential tax treatment was warranted because of the large amount of risk associated with exploratory drilling and the national security interest in encouraging the discovery of new hydrocarbon deposits." *Id.* at 201. Percentage depletion for minerals used as or in fertilizer or animal feed was continued at existing rates "to avoid a further squeeze on farm income." *Id.* at 212. Current percentage depletion rates were retained for ornamental stone because of the depressed state of the industry attributable to foreign competition. *Id.* In addition, although the Committee stated that income derived in the ordinary course of a business should be taxed as ordinary income, timber growing by individuals on non-Federal lands was an activity where a particular need for an incentive was identified so gain from the sale of such timber was to continue to be taxed at reduced capital gains rates. *Id.* at 646; *see also infra* note 320.

Although preferential treatment was condemned by both the House and Senate tax

> very concerned about the significant inequities that result from the amount and concentration of these tax benefits. Individuals and corporations who have considerable amounts of economic income are permitted to pay little or no tax by using the credit and ACRS, while others with equal or lesser incomes are left fully exposed to high tax rates.[201]

The Ways and Means Committee also determined that these incentives do not accomplish their intended purpose. It stated, "Proponents of massive tax benefits for depreciable property have theorized that these benefits would stimulate investment in such property, which in turn would pull the entire economy into more rapid growth. The committee perceives that nothing of this kind has happened."[202]

Taking a different view, the Senate Finance Committee report did not question accelerated capital recovery. Instead, the Committee noted that "an efficient capital cost recovery system is essential to maintaining U.S. economic growth."[203] The Committee thus proposed an enhanced capital recovery scheme.[204]

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writing committees because it distorts investment decision making and causes inequities, preferences appear to be acceptable if the activity is one which Congress prefers. This approach maintains the open door for advocates to press in the future for preferential treatment of particular interests for the good of the economy (savings, investment, jobs and the like).

201. WAYS AND MEANS PLAN, *supra* note 56, at 145.

202. *Id.* at 145-46. The Committee cites several factors in support of this conclusion.

> First, the average annual compound rate of real growth in equipment spending since 1980 has been close to the historical trend dating from the early 1960's and the rate of overall economic growth has been smaller. Second, the growth which has occurred in equipment spending has been heavily concentrated in computers and automobiles, assets which . . . received no boost from the 1981 Act. Third the benefits of [ACRS] and the tax credit provide little expansionary stimulus to new or rebuilding enterprises that lack the taxable income to turn credits and deductions into tax savings . . . . Fourth, the investment tax credit and ACRS deductions provide little expansionary stimulus to the service, small business, high technology and other important sectors of the economy that do not make extensive use of depreciable assets but do contribute to economic growth and will benefit from lower tax rates.

*Id.* at 146.

203. SENATE PLAN, *supra* note 56, at 96.

204. *Id.* The *Senate Plan* recommended increased acceleration of the rate of capital recovery to "compensate partly for the repeal of the investment tax credit." *Id.* With respect to personal property, the Plan would have retained the basic 3, 5, 10 and 15 year recovery periods of the pre-1986 ACRS system (I.R.C. § 168 (1982)) but would have replaced the fixed recovery rates of that scheme with depreciation rates for different classes of property ranging from the 200% declining balance method to straight line. *Id.* The greatest benefit was to have been provided for assets classified as 5 and 10 year property under ACRS where the recovery rate would have been increased from 150% declining balance to 200%. A 150% declining balance rate would have been applied to 3

The Committee did recognize, however, that variations in the rate of capital recovery for different assets result in distorted resource allocations.[205]

In addition to injecting substantial complexity into the tax system, the capital recovery provisions have resulted in a significant reduction of effective corporate tax rates. Congress has reduced the effective corporate tax burden by shortening write-off periods for depreciation and by subsidizing selected assets with the investment tax credit rather than reducing the statutory rate of taxation.[206] This course of action has resulted in wide dispar-

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and 15 year property. A special category of three year property including automobiles, light general purpose trucks and property used to manufacture semiconductors would have been allowed straight line recovery only. *Id.* at 99. Capital recovery for real estate would have been substantially lengthened by using the straight line method over 27.5 years for residential property, and 31.5 years for nonresidential property. *Id.* at 100. The *Senate Plan* would have retained incentives for income from timber operations which included capital gains treatment for income from cutting timber or holding a timber royalty interest (I.R.C. § 631 (1982)) and seven-year amortization for certain reforestation expenditures (I.R.C. § 194 (1982)). Reforestation expenditures would have lost the benefit of the repealed 10% investment tax credit. SENATE PLAN, *supra* note 56, at 106. Incentives for domestic oil and gas operations were generally unchanged. SENATE PLAN, *supra* note 56, at 282. The report indicates that, "Domestic production of oil, gas, and other minerals is currently depressed and subject to serious international competition. The committee believes that the tax incentives provided for IDCs and mining expenses are appropriate only with respect to domestic exploration." The *Senate Plan* would have provided that these expenditures could be amortized over 10 years or added to basis for cost depletion purposes. *Id.* The *Senate Plan* would have repealed the five year amortization provision for trademarks and trade names (*Id.* at 256), but left a number of other rapid amortization and incentive programs unchanged including five year amortization of pollution control facilities (I.R.C. § 169), five year amortization for railroad rolling stock (I.R.C. § 184), and immediate expensing of the removal of architectural barriers to the handicapped (I.R.C. § 190). This provision expired in 1985 but was to have been reinstated on a permanent basis by the *Senate Plan*. SENATE PLAN, *supra* note 56, at 882. The Targeted Jobs Credit (I.R.C. § 51) was to be extended for three years with some restrictions. SENATE PLAN, *supra* note 56, at 881. Current expensing for research and experimental expenditures (I.R.C. § 174) was to have been retained without revision and the incremental research tax credit (I.R.C. § 30) would be extended for four years. Senate Plan, *supra* note 56, at 695. The tax credit for rehabilitation of historic structures was to be retained at a reduced level to account for lower tax rates (*Id.* at 754-55) and a new credit enacted for low income housing in lieu of the five-year rapid amortization provision (I.R.C. § 167(k)) which would have been allowed to expire. SENATE PLAN, *supra* note 56, at 759-68.

205. SENATE PLAN, *supra* note 56, at 96.

206. Hulten & Robertson, *supra* note 198, at 332. The authors indicate that the first significant reduction in corporate effective tax rates took place in 1954 with the introduction of accelerated depreciation. The marginal effective rate on new plant and equipment fell from the 60% level to 52% between 1953 and 1961. Additionally, that "the marginal effective rate was thus brought into line with the statutory rate suggests that the adoption of accelerated depreciation in 1954 brought depreciation practices more in line with economic depreciation." *Id.* at 330. The 1981 tax cuts lowered effective rates for the

ity in the effective tax rates on various forms of investment.[207] The Ways and Means Committee used this disparity to justify significant increases in corporate Tax liability.

> Between 1950 and 1985, the corporate income tax as a percentage of total budget receipts has declined from 27 percent to only 8 percent. Over the same period, the corporate income tax as a percentage of total income tax receipts has declined from 40 percent to only 16 percent, despite a slower decline in the relative share of the income earned by corporations. To restore the traditional balance of the income tax between individuals and corporations, the committee has greatly restricted the ability of corporations to eliminate their tax liability.[208]

The same incentives and reduced effective tax rates were available to upper-income taxpayers—those in the higher marginal brackets with sufficient income to invest in preferred activities. The accelerated capital recovery provisions are an example of adjustments to the tax base that shift the relative burden of taxation away from favored taxpayers. As a result, the preferences distort both horizontal and vertical equity among individual taxpayers.

The clear recognition by leading governmental decision makers that tax preferences inject unfairness and complexity into the Code is music to the ears of tax reformers. Unfortunately, the 1986 Act continues the system of incentives counterbalanced by disincentives. Although the 1986 Act reduces the scope and number of incentives, retained preferences will continue to cause divergent taxation of some forms of income. As a result, the 1986 Act does little to relieve the burden of complexity.

The 1986 Act adopts the Senate Finance Committee position that a tax preference in the form of accelerated capital recovery is required to maintain economic growth.[209] The invest-

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nonresidential business sector to 5%. *Id.* at 331. The adoption of the basis stepdown provision of the Tax Equity and Fiscal Responsibility Act of 1982 increased the effective rate to 16%. *Id.*

207. Effective rates for different categories of investment activity in 1981 ranged from 91.2% to -21.5%. M. KING & D. FULLERTON, THE TAXATION OF INCOME FROM CAPITAL: A COMPARATIVE STUDY OF THE UNITED STATES, THE UNITED KINGDOM, SWEDEN, AND WEST GERMANY 244 (1984). The Economic Recovery and Tax Act of 1981 would have widened this disparity even further. H. AARON & H. GALPER, *supra* note 63, at 3 n.2.

208. WAYS AND MEANS PLAN, *supra* note 56, at 55.

209. SENATE PLAN, *supra* note 56, at 96.

ment tax credit is repealed, however.[210] The 1986 Act modifies ACRS to increase depreciation allowances—allowing slower recovery than was suggested in the *Senate Plan* but substantially more recovery than that provided by the *Ways and Means Plan.* Before the 1986 Act, ACRS recovery for personal property was determined under percentage tables based on the 150% declining balance method.[211] The 1986 Act increases the rate of recovery for personal property with class lives of ten years or less to 200% declining balance.[212] The acceleration of recovery is reduced for some property because the 1986 Act adds a seven year and a twenty year class to the pre-1986 three, five, ten and fifteen year classes applicable to personal property.[213] The seven year class will require longer recovery periods for property formerly in the five year class.[214] The twenty year class extends recovery periods for property formerly in the fifteen year class.[215]

Recovery periods for real property are lengthened substantially. Capital invested in residential rental property is recoverable over 27.5 years instead of the 19-year recovery available before 1987. Nonresidential real property is moved to a 31.5-year class. In addition, the recovery rate for real property in the 27.5- and 31.5-year classes is limited to the straight line method.[216]

Accelerated capital recovery is a device to reduce taxation of capital. It induces taxpayers with excess capital available for investment to direct that capital into the type of assets favored by the capital recovery scheme, *i.e.*, shorter-lived tangible personal

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210. Tax Reform Act of 1986 § 211 (adding I.R.C. § 49).

211. I.R.C. §168 (1982 & Supp. II 1984). A 150% declining balance means that the recovery allowance is computed as 150% of the amount that would result by dividing the recoverable basis by the number of years in the recovery period. In other words, 150% of the straight line recovery rate. In each succeeding year, the same rate is applied to the declining balance of the depreciation base determined by subtracting prior years' recovery deductions from basis.

212. Tax Reform Act of 1986 § 201 (amending I.R.C. § 168).

213. CONFERENCE REPORT, *supra* note 67, at II-39.

214. Seven year property includes property with an ADR midpoint life of more than 10 and less than 16 years. *Id.* at II-39. Like the pre-1986 Act rules, three year property includes assets with an ADR midpoint life of four years or less. However, automobiles and light duty trucks are moved to the five year class. The five-year class includes assets with an ADR midpoint life of more than four years and less than 10 years. Ten-years assets are those with midpoint lives between 16 and 20 years, narrowed from the pre-1986 10-year class range of 18.5 to 25 years. Fifteen year recovery is provided for assets with ADR midpoint lives between 20 and 25 years.

215. Twenty-year assets are personal property with an ADR midpoint life in excess of 25 years. *Id.* at II-40.

216. *Id.* at II-39.

property. The 1986 Act reflects the policy-makers' judgment that economic incentives justify lower taxation of certain invested capital. In terms of ability-to-pay, an appropriate concept of "income" does not require that depreciation be measured by changes in economic value or replacement cost.[217] Ability to contribute to the cost of government depends upon what is left to the taxpayer after incoming revenue is offset with outflows necessary to produce the income. Where income is produced over several periods by an asset acquired in a single period, the income available for taxes in each of those periods is diminished by some portion of the cost of the long-term asset.[218] In pure ability-to-pay terms, what is necessary, therefore, is a device to allocate the cost incurred in the year of acquisition to periods of income production. Fair capital recovery requires a neutral system that does not favor one investment over another with an excessively accelerated allocation of costs incurred in the year of acquisition to periods of future production.[219]

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217. Indeed, it is not entirely clear that annual increases in replacement costs are a proper measure of economic depreciation. An alternative would measure the true value of taxable income from depreciable property as the yearly decline of the present value of the income stream anticipated from the taxpayer's investment—sinking fund depreciation. *See* M. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 6.07, at 133-35 (4th ed. 1985). This approach would result in an apportionment method that starts low and provides for progressively larger deductions because the difference between the present value of the asset's projected future income stream at the beginning of the year and the end of the year increases as the asset approaches the end of its useful life. Determining present values with a discount rate that reflects expectations regarding inflation adjusts for the economic impact of inflation. Under this view of depreciation, even straight line depreciation provides a subsidy to investment in depreciable property. *But see infra* note 219.

218. Commissioner v. Idaho Power Co., 418 U.S. 1, 11-12 (1974).

219. Professor Kahn has argued that accelerated recovery rates can be designed to appropriately allocate the present value of the anticipated future income stream of an asset to each of the periods of income production measured as of the date of acquisition. Kahn, *Accelerated Depreciation—Tax Expenditure of Proper Allowance for Measuring Net Income*, 78 MICH. L. REV. 1, 39 (1979) [hereinafter *Measuring Net Income*]; *see also* Kahn, *Accelerated Depreciation Revisited—A Reply to Professor Blum*, 78 MICH. L. REV. 1185 (1980). *But see* Blum, *Accelerated Depreciation: A Proper Allowance for Measuring Net Income?!!*, 78 MICH. L. REV. 1172 (1980). Kahn asserts that the

> cost of a depreciable item should be allocated to each year of the asset's use according to the amount paid for that year's use: the amount of income that the taxpayer initially expected the property to produce in that year, discounted to present value as of the date that the taxpayer acquired the property.

Kahn, *Measuring Net Income*, *supra* at 35. In present value terms, the portion of cost allocated to the years closest to the date of acquisition is greater than the present value of cost allocated to later years. Professor Kahn thus concludes that "an accelerated rate of depreciation provides a more accurate measurement of net income than does a straight line method," and therefore "does not constitute a preference." *Id.* at 40

Since the 1986 Act retains investment incentives for various activities, the 1986 Act relies on the alternative minimum tax to reduce the impact of these preferences.[220] The Senate Finance

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Accuracy of the rate of recovery under this scheme depends upon the discount rate used to ascertain present values. Applying a discount rate that reflects anticipated inflation in the year an asset is placed in service will allocate the annual decline in the present value of the future income stream from depreciable property in a manner that measures the effect of inflation on the cost of producing income in future periods that is based on the cost incurred at the time of acquisition. The depreciation allocation would thus reflect the investor's expected return estimated at the time of the investment. Varying the discount rate based on length of useful lives to reflect differences in short and long term interest rates would produce a relatively neutral investment choice among competing alternatives at the time the investment is made. Although varying rates of inflation or deflation would affect the actual economic accuracy of the allowed deductions, thereby preventing complete economic neutrality, varying inflation and deflation rates on different assets would also vary the accuracy and neutrality of a depreciation scheme indexed for inflation using the consumer price index or some other broad measure. *See* Gann, *supra* note 84, at 113.

220. The minimum tax for individuals is imposed at a 21% rate on the minimum tax base reduced by the same threshold exemptions applicable before 1987, $40,000 on a joint return and $30,000 for singles. Tax Reform Act of 1986 § 701 (amending I.R.C. § 55); CONFERENCE REPORT, *supra* note 67, at II-250 to 251. The corporate minimum tax rate is 20% with a $40,000 exemption. *Id.* at II-264 to 265. The exemption levels for both individual and corporate taxpayers are reduced 25 cents for each $1 by which alternative minimum taxable income exceeds $150,000. *Id.* at II-251, II-265. The breadth of tax preference items is expanded to more accurately reflect economic income including a provision applicable through 1989 that classifies as a preference item 50% of the excess of corporate book income over corporate minimum taxable income computed without the addition of book income. *Id.* at II-272 to 274. After 1989 the preference is 75% of the amount by which current earnings and profits exceed alternative minimum taxable income computed without the adjustment. *Id.* at II-274 to 279.

Because each of the reform proposals, except the *Treasury Proposal*, contained investment incentives, each plan would have continued the alternative minimum tax. The minimum tax under the *Reagan Plan* contained a 20% rate on the minimum tax base with threshold exemptions of $15,000 on joint returns and $10,000 for single persons. REAGAN PLAN, *supra* note 32, at 330. The corporate minimum tax rate was 15% of the minimum tax base in excess of an exemption level of $10,000. *Id.* at 333.

The *Ways and Means Plan* adopted a 20% minimum tax rate for individuals with a $20,000 exemption for single taxpayers and $40,000 on a joint return. The minimum tax rate for corporations was 25% with a $40,000 exemption. WAYS AND MEANS PLAN, *supra* note 56, at 308-09.

The *Senate Plan* contained a 20% alternative minimum tax rate for both individuals and corporations. SENATE PLAN, *supra* note 56, at 521-22. The *Senate Plan* would have continued present law exemption levels for individuals. *Id.*

In contrast, the *Treasury Proposal* called for elimination of both the individual alternative minimum tax and the corporate add-on minimum tax. 2 TREASURY PROPOSAL, *supra* note 20, at 112-14.

> Minimum taxes reflect an attempt to maintain the equity and neutrality of a tax system that is riddled with special preferences. The corporate minimum tax would be necessary only if the underlying special preferences were retained. Because the Treasury Department comprehensive tax reform package repeals almost all special preferences directly, eventual repeal of the corporate

Committee report explains that although preferences "may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liabilities."[221] The *Ways and Means Plan* indicates that an "effective minimum tax is necessary to allow the committee to substantially reduce the marginal tax rates applicable to high-income taxpayers without causing an overall percentage tax reduction for this group larger than for the average taxpayer."[222] This justification admits two critical points. First, the Committee recognized that its revised rate structure, with a statutory rate for upper income taxpayers lowered to 38 percent, would in fact provide greater relative benefits to upper income taxpayers. Second, the tax base remained so riddled with preferences that an alternative flat tax was necessary to insure taxation of the economic income of taxpayers seduced into specific economic behavior by the preferences.[223] The *Reagan Plan* justified the minimum tax for the latter reason:

> Since the Administration proposals contain incentive provisions that depart from the measurement of economic income, some high-income individuals would be able to eliminate their tax liabilities or substantially reduce their effective tax rates by heavy utilization of such provisions. As under current law, the prospect of high-income individuals paying little or no tax threatens public confidence in the system. Consequently, a minimum tax designed to limit the number of high-income low-tax returns should be retained.[224]

Thus, while taxation of economic income is the goal, policy makers were not willing to forego preferences for certain economic activity. Because the policy makers believed that every person should pay some taxes, however, economic income is taxed at a flat rate that is lower than the statutory rate. The 1986 Act's alternative minimum tax imposes a statutory rate on preferred income that is less than the statutory rate imposed on

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minimum tax would be possible.

1 *id.* at 118.

221. SENATE PLAN, *supra* note 56, at 518.

222. WAYS AND MEANS PLAN, *supra* note 56, at 306.

223. Note that the Committee used language identical to that of the Senate Finance Committee in 1981 to indicate that the minimum taxes serve "one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits." *Compare* WAYS AND MEANS PLAN, *supra* note 56, at 305-06 *with* SENATE PLAN, *supra* note 56, at 515.

224. REAGAN PLAN, *supra* note 32, at 330.

a single wage earner with taxable income in excess of $17,850, or a joint return with taxable income in excess of $29,750.[225] In addition, because of exemptions, the minimum tax does not become applicable until minimum taxable income exceeds income levels that would subject non-preferred taxpayers to higher statutory rates.[226] Because of these lower rates on preferred activity, the upper income taxpayer with capital available for investment remains in a preferred position.

Unquestionably the minimum tax concept is a sound device to impose some level of taxation in a system riddled with preferences. The growing importance of the alternative minimum tax as a device to ensure fairness may be an indication that Congress is moving towards substitution of the alternative minimum tax as the primary tax base.[227] However, in terms of vertical equity (the idea that tax burdens should vary in accord with ability-to-pay), the system fails to equitably allocate burdens between the economic income of a wage earner, or other non-preferred taxpayer, and the economic income of the taxpayer who derives gains from preferred investments.

Recognizing that the alternative minimum tax alone is an insufficient disincentive, the 1986 Act adopts a new weapon in the battle against taxpayers who make too much use of the Congress's incentives. The 1986 Act contains a substantial restriction on the use of tax incentives by passive investors. Section 469 is added to the Code to limit the deduction of losses from passive investment activities to the income produced by the activity.[228] This limitation will severely curtail an individual's ability to shelter either earned income or portfolio investment income with tax shelter losses. The passive loss limitation not only limits the use of tax preferences, it also restricts the loss deductions representing an expenditure of actual invested capital. The limitation applies to any activity where the taxpayer does not

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225. These figures represent the threshold taxable income levels for the 28% bracket. CONFERENCE REPORT, *supra* note 67, at II-4.

226. The minimum tax levels must exceed $40,000 on a joint return and $30,000 for singles. *See supra* note 220.

227. *See* Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a "Flat-Rate" Tax*, 56 S. CAL. L. REV. 527 (1983).

228. Tax Reform Act of 1986 § 501 (adding I.R.C. § 469); CONFERENCE REPORT, *supra* note 67, at II-137 to 150. The passive loss limitation rule originated in the House bill, but only as a preference item for alternative minimum tax purposes. WAYS AND MEANS PLAN, *supra* note 56, at 320-23. It was extended to regular tax liability by the Senate Finance Committee. SENATE PLAN, *supra* note 56, at 718-19.

materially participate in the "operations of the activity on a regular, continuous, and substantial basis."[229] Losses derived from a working interest in oil and gas property are not subject to the limitation.[230] All rental activities are considered passive activities subject to the limitation, even though the taxpayer materially participates. [231] An exception is provided for rental real estate when the taxpayer owns ten percent of the property and actively participates, in which case up to $25,000 of losses are allowed against other income in the taxable year.[232] One consequence of this limitation is that individual taxpayers will be required to separately compute income and loss from an active trade or business, portfolio investments, and passive investment—a major enhancement to complexity.

Due in large part to the passive loss limitation, the 1986 Act makes substantial progress towards limiting the scope of tax preferences in the Code. To the degree it is successful, the tax base represents a better measure of ability-to-pay. Yet, taxpayers with similar economic income are not treated the same under the Act because of its retention of preferences for certain activities and forms of income. Although the use of preferences is more restricted than before 1987, the Code continues to retain its flavor of bargained for benefits for preferred economic activity at the expense of the middle-income taxpayer who lacks the ability to engage in the favored transactions. The average taxpayer may legitimately question whether the tax reform effort has fulfilled its promise of fairness. The retention of incentives and the complex systems restricting the benefits of those incentives also means that reform has failed to meet the promise of simplicity.

### 2. *Other costs of income production*

*a. Employee expenses.* Historically, the income tax has relied on a concept of profit which allows deductions for the cost of income production.[233] However, each of the reform proposals

229. SENATE PLAN, *supra* note 56, at 719-20.

230. *Id.* at 720.

231. *Id.*

232. *Id.* at 721.

233. I.R.C. § 162 provides deductions for the ordinary and necessary expenses incurred in a trade or business. I.R.C. § 212 allows a deduction for the ordinary and necessary expenses "incurred for the production or collection of income [or] . . . for the management, conservation or maintenance of property held for the production of income

that preceded the 1986 Act suggested simplifying the Code by limiting miscellaneous itemized deductions to the excess over 1% of adjusted gross income in order to reduce record keeping.[234] Under both the House and Senate versions of the reform bill, miscellaneous itemized deductions included the ordinary and necessary business expenses of an employee, including travel away from home, and investment expenses.[235] As a revenue raising measure, the 1986 Act increased the threshold for miscellaneous itemized deductions to the excess over two percent of the taxpayer's adjusted gross income.[236]

Under the 1986 Act, miscellaneous itemized deductions, including employee business expenses, are deductible only by employees who itemize deductions, and then only to the extent these expenses exceed two percent of adjusted gross income.[237] Employee expenses that are reimbursed by the employer, however, are fully deductible whether or not the employee itemizes deductions.[238] Furthermore, the employee's business expenses are fully deductible if the employee is an actor or artist with

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234. The *Treasury Proposal* indicated that the need for simplification was one of the most frequently repeated themes in hearings held in seven cities during 1984. 1 TREASURY PROPOSAL, *supra* note 20, at 15. The Treasury translated this need into a desire for reduced record keeping and documentation requirements to support claimed tax deductions. *Id.* at 15-16. The *Treasury Proposal* and *Reagan Plan* would have combined employee business expenses with allowable deductions for state and local taxes (taxes incurred in an income-producing activity other than income taxes) and allowed deduction of these items by an employee only to the extent that the combined expenses exceeded one percent of the employee's adjusted gross income computed without the deductions. 2 *id.* at 116; REAGAN PLAN, *supra* note 32, at 105.

The *Ways and Means Plan*, and the *Senate Plan* would have allowed deductions of employee business expenses as itemized deductions only to extent that these expenses plus investment expenses exceeded one percent of adjusted gross income. WAYS AND MEANS PLAN, *supra* note 56, at 110; SENATE PLAN, *supra* note 56, at 79.

235. WAYS AND MEANS PLAN, *supra* note 56, at 107-10; SENATE PLAN, *supra* note 56, at 77-79.

236. Tax Reform Act of 1986 § 132, (adding I.R.C. § 67); CONFERENCE REPORT, *supra* note 67, II-33 to 34.

237. Tax Reform Act of 1986 § 132(b); CONFERENCE REPORT, *supra* note 67, II-33 to 34. Before 1987, employee incurred business expenses for travel away from home, for transportation in connection with performance of services as an employee, and all ordinary and necessary expenses incurred as an employee outside salesperson, were deductible from adjusted gross income. I.R.C. § 62(2) (1954). This meant that the employee was permitted to deduct these expenses and use the zero bracket amount or standard deduction at the same time. Under the 1986 Act, all unreimbursed employee business expenses are considered itemized deductions allowable only to the taxpayer who itemizes rather than claim the standard deduction.

238. Tax Reform Act of 1986 § 132(b); CONFERENCE REPORT, *supra* note 67, II-34.

more than one employer, has incurred expenses in excess of ten percent of adjusted gross income, and has income not in excess of $16,000 before the expenses are taken into account.[239]

While eliminating some complexity in the form of record keeping requirements for those employees whose business expenses are clearly below the two percent threshold, these proposals add complexity to the tax calculation process with the injection of an additional set of computations to determine allowable deductions. However, the limitation on employee business expenses is wrong from a more fundamental standpoint. Ordinary and necessary expenses incurred by an employee in the pursuit of the employee's trade or business are a legitimate cost of earning income. As a measure of ability-to-pay, the employee's cost of income production reduces money available for taxes. Expenses incurred in production of investment income also reduce "income" as a cost of its production. The limitation on these costs as a deduction in computing taxable income is a major departure from the concept of income as the tax base.[240]

In addition, as policy makers clearly recognize, taxpayer morale depends upon perceptions that taxes are fair.[241] Lasting impressions of fairness are not likely when an employee realizes that his or her self-employed neighbor with similar economic income is able to reduce taxable income with the full cost of the income's production unhampered by the two percent limitation while the employee cannot. There is a similar discrimination between the employee whose employer reimburses employee expenses and the less fortunate employee whose employer does not.

There is no justification for distinguishing between these costs. Administrative convenience does not justify restricting deduction of true costs in the computation of taxable income. Aside from the need to document claimed deductions, the principal difficulty in this area is distinguishing allowable business expenses from personal expenses, a problem for both employed and self-employed taxpayers. The abuses caused by taxpayer's claiming personal expenses can and should be dealt with in a more direct fashion.[242]

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239. Tax Reform Act of 1986 § 132(b); CONFERENCE REPORT, *supra* note 67, II-34.

240. Query the reaction to a proposal to limit the deduction of corporate business expenses to those in excess of 2% of gross income.

241. *See, e.g.*, 1 TREASURY PROPOSAL, *supra* note 20, at 9.

242. For example, the Tax Reform Act of 1984 imposed limitations on the personal

*b. State and local taxes.* Controversy regarding deductibility of state and local taxes is also partly resolved by examining whether adjustments for costs of income production are appropriate to the measure of ability-to-pay. The *Treasury Proposal* and *Reagan Plan* would have disallowed itemized deductions for state and local property, sales and income taxes except to the extent such taxes were incurred in a trade or business.[243] The *Treasury Proposal* asserted that a deduction for state and local taxes is not required for the accurate measurement of income and further that the deduction is an inefficient subsidy for spending by State and local governments.[244] The *Reagan Plan*

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use of automobiles and computers with the listed property rules of I.R.C. § 280F. The reform proposals continued additional limitations on personal use expenditures some of which survived to be included in the 1986 Act. The *Treasury Proposal* would have disallowed deductions for all entertainment expenses including club dues and tickets to public events. The deduction for business meals in a clear business setting would have been retained subject to limits of $10, $15 and $25 per person for breakfast, lunch and dinner respectively. 2 *id.* at 83. The *Treasury Proposal* limited deduction of meals and lodging while away from home to 200% of the federal per diem allowance for the city involved and would have denied any deduction for travel involving cruise ships or travel as a form of education. *Id.* at 88-89. The *Reagan Plan* would also have denied deductions for entertainment. The deduction for business meals would have been limited to $25 per person plus 50% of the excess. REAGAN PLAN, *supra* note 32, at 77-78. The *Reagan Plan* would also have eliminated deductions for travel by cruise ship and travel as a form of education. *Id.* at 81. The *Ways and Means Plan* and the *Senate Plan* would have restricted deductions for meals and entertainment by allowing a deduction of only 80% of the cost. *See, e.g.,* SENATE PLAN, *supra* note 56, at 71. This 80% limitation was retained in the 1986 Act. Tax Reform Act of 1986 § 142(a) (amending I.R.C. § 274(n)). Following the lead of the House and Senate proposals with some modifications, the 1986 Act also provides that deductible meals must be directly related to the conduct of business. Tax Reform Act of 1986 § 142(a) (amending I.R.C. § 274(k)); *see* WAYS AND MEANS PLAN, *supra* note 56, at 124-27; SENATE PLAN, *supra* note 56, at 70-76. The 1986 Act also limits deductions for tickets to entertainment activities to the face value of the tickets (except for charitable events), allows deduction of only 80% of otherwise deductible entertainment expenses, disallows deductions for travel as a form of education, and limits deductions for the costs of travel on cruise ships. I.R.C. § 142(m) (West Supp. 1987); *see* WAYS AND MEANS PLAN, *supra* note 56, at 128, 129-30; SENATE PLAN, *supra* note 56, at 74-76. The 1986 Act contains additional restrictions on luxury sporting event seating rentals (sky boxes), which are limited to single events and the cost of regular box seating. I.R.C. § 142(m) (West Supp. 1987); *see* WAYS AND MEANS PLAN, *supra* note 56, at 127-28.

243. 1 TREASURY PROPOSAL, *supra* note 20, at 78-81; REAGAN PLAN, *supra* note 32, at 64-65.

244. 1 TREASURY PROPOSAL, *supra* note 20, at 78.

> The present system with full deductions encourages people to get some of their economic services through state and local governments, rather than in the private marketplace. A town is better off financing its trash collection through deductible taxes on businesses and families than through nondeductible payments from families to private trash collection services. Elimination of deductions makes the town neutral in the choice, as it should be.

R. HALL & A. RABUSHKA, *supra* note 37, at 39.

added that the deduction "disproportionately benefits high-income taxpayers residing in high tax states".[245] Both proposals pointed out that elimination of the deduction would have raised over $30 billion in tax revenues.[246] This provision was, therefore, one of the major funding sources for the lower tax rates in the two plans. The *Ways and Means Plan* retained deductions for all state and local taxes. The *Senate Plan* would have retained deductions for state and local income and property taxes while limiting deductions for sales taxes to sixty percent of the excess of such taxes over the state and local income taxes paid or accrued by the taxpayer during the taxable year.[247] The 1986 Act fully repeals the itemized deduction for state and local sales taxes but leaves intact the deduction for other state and local taxes.[248]

The *Treasury Proposal* and *Reagan Plan's* advocacy of a repeal of the deduction for state and local income taxes as an inefficient subsidy focused on the issue from the wrong perspective. State and local income taxes represent a direct cost of earning income subject to the tax. They are a levy exacted on each dollar earned. In ability-to-pay terms, the taxpayer's controllable income is reduced by state income tax liabilities. Thus the taxpayer subject to higher state or local income taxes has less income to direct into consumption or investment. More importantly, the impact of state income taxation on ability-to-pay varies as a function of income for differently situated taxpayers. If the federal tax base is measured by realized gains subject to the taxpayer's control, horizontal equity requires that state and local income taxes be taken into account as a diminution of income available for federal taxation. State and local income tax liability is a cost of the income, just as ordinary and necessary business expenses are a cost of business income.

The *Reagan Plan* condemns the deduction, asserting that it improperly prefers taxpayers in higher marginal brackets.[249] But, in a progressive income tax system, this phenomenon is common to all deductions including those representing ordinary business expenses. It is true that any deduction lowers the amount of taxable income at the taxpayer's highest rate bracket,

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245. REAGAN PLAN *supra* note 32, at 62.
246. 1 TREASURY PROPOSAL, *supra* note 20, at 78; REAGAN PLAN, *supra* note 32, at 63.
247. SENATE PLAN, *supra* note 56, at 57.
248. Tax Reform Act of 1986 § 134 (amending I.R.C. § 164).
249. REAGAN PLAN, *supra* note 32, at 65.

and therefore provides a greater tax savings to taxpayers at higher income levels. However, condemnation of a deduction on this basis overlooks the converse point that every dollar of additional taxable income is subject to higher tax for the high-bracket taxpayer. Higher marginal rates of tax are imposed on taxpayers with greater realized gains. Higher rates are justified on the philosophy that greater ability-to-pay demands a greater contribution to government. Fairness requires that this greater contribution be based on a consistent measure of ability-to-pay. If ability-to-pay depends upon realized gains left over after an allowance for the cost of their production, the progressive tax system is distorted, where adjustments to the tax base necessary to ascertain ability-to-pay are denied, with the argument that the adjustment benefits taxpayers at the highest marginal rates. Higher rates are imposed because the higher-bracket taxpayer has a larger store of realized gain. The progressivity of the tax system is not a justification for refusing to reduce the tax base for costs incurred in producing income.

The same arguments cannot be made with respect to property and sales taxes. Unlike an income tax, which is an excise on producing income, property and sales taxes are incurred as part of the consumption of income. Property and sales taxes on consumer items, including personal-use real estate, do not fluctuate with the ability to control realized gains, but with the taxpayer's personal consumption of those gains. Where property and sales taxes are incurred with respect to property used in the production of income, they are appropriately deductible as a cost of income production.[250] When these taxes are incurred as an incident of personal consumption, however, they are not proper adjustments to the measure of ability-to-pay. In addition, as sales and property taxes represent expenditures for personal consumption, the amount of tax imposed on any one individual, and therefore the amount of federal subsidy to consumption, increases as consumption increases. Since these taxes represent a cost of consumption rather than a cost of income production, it is appropriate to recognize that the subsidy to consumption pro-

250. The *Treasury Proposal* and *Reagan Plan* recognized this proposition where they continued a deduction for state and local taxes incurred in an income producing activity. 2 TREASURY PROPOSAL, *supra* note 20, at 63-64; REAGAN PLAN, *supra* note 32, at 64.

vides a greater benefit to higher income, higher bracket taxpayers.[251]

The tax base should allow for consistently applied adjustments to realized gains in order to define ability-to-pay in terms of what is left to the taxpayer for consumption or reinvestment. As the Treasury concluded in both of its recent analyses of tax reform, the inquiry must focus on adjustments that reflect the costs of income production in a neutral fashion. [252] Adjustments which either favor or discriminate against particular income producing activity place the recipient of income from the activity in a skewed position with respect to horizontal equity and result in distorted economic decision making.

### B. *Adjustments for Family Size and Personal Circumstance*

A second set of adjustments to ability-to-pay is necessary to reflect personal circumstances. These adjustments account for the availability of less discretionary monies in diverse family circumstances after the necessities of life are acquired. Here ability-to-pay reflects some factors that have nothing to do with concepts of economic income. Rather, notions of social equity require an adjustment to the tax system in recognition of the diverse economic position of persons in different family or personal circumstances. Relevant circumstances may include family size, old age and disabilities. However, adjustments for items that are common to all taxpayers do not serve any purpose in this regard. For example, allowing a personal exemption to the taxpayer does not distinguish between individuals with different abilities to pay because every individual taxpayer uses a personal exemption. The taxpayer's personal exemption serves another purpose with respect to family circumstance, however, by measuring the level of income which any individual may receive tax-free.

The initial question raised by adjusting the tax system for family circumstances is treatment of married versus unmarried

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251. Retaining deductions for one form of state taxation but not others is opposed in part with the assertion that states would be motivated to increase reliance on the deductible source of revenue. *See* REAGAN PLAN, *supra* note 32, at 65. This is undoubtedly correct. Overall, however, motivating states to adopt progressive forms of taxation using income as a base, as opposed to more regressive excise and sales taxes, would be consistent with federal theories of appropriate taxation.

252. 1 TREASURY PROPOSAL, *supra* note 20, at 13; DEPARTMENT OF TREASURY, *supra* note 102, at 53.

taxpayers. The response of the tax system to income splitting between husband and wife requires a choice between different concepts of marital relations. In its argument before the United States Supreme Court in *Poe v. Seaborn*,[253] the Treasury attempted to require that every income earner separately return earned and investment income regardless of marital status.[254] The marital partnership was ignored for tax purposes and each spouse was viewed as an independent taxpayer. The Supreme Court held in *Seaborn* that in a community property state each spouse's gross income includes only the spouse's one-half share of the community income.[255] As a result, a married income earner in a community property state was allowed to split income between two taxpayers,[256] substantially reducing the marginal tax bracket at which the income was taxed. Since *Seaborn* applied only in community property states, a number of states enacted community property laws in an attempt to provide their citizens with tax savings made possible by the decision.[257]

Congress responded in 1948 by adopting the joint return with a rate schedule that allowed married couples in all states to divide income in half.[258] The rate schedule treated each individual member of the marital community as a separate taxpayer for one-half of the community's combined income. With these revisions the Code adopted the community property notion that marriage was a partnership requiring equal allocation of all income items regardless of source.

The 1948 joint return eliminated the need for income-splitting devices between husband and wife along with the distinction between community property and common-law states.[259] An important advantage of this system was that all married couples were taxed the same regardless of the source or character of their combined income.[260] In addition, horizontal equity was en-

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253. 282 U.S. 101 (1930).

254. *See, e.g.*, Lucas v. Earl, 281 U.S. 111, 114 (1930).

255. 282 U.S. at 113-14.

256. *Id.* at 118.

257. These included Oklahoma, Oregon, Michigan, Nebraska and Pennsylvania. *See* Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1104 (1948).

258. Revenue Act of 1948, Pub. L. No. 80-471, §§ 301, 303, 62 Stat. 110, 114-16.

259. Treating husband and wife as two separate taxpayers would allow them to transfer property and thereby allocate investment income to the lower bracket taxpayer.

260. Splitting income on separate returns would have produced different tax results for couples whose income came in part from sources that were separate to each spouse, such as income from a spouse's separate property in a community property state.

hanced by focusing on the income of the family.[261] A married person was compared with individual taxpayers as if the marriage were a partnership with a 50% allocation of income items to each spouse.

Compared to a single individual, the 1948 rate structure created an advantage for the married person who was the sole source of family income. For tax purposes it divided a married couple's income between the marital partners. Hence, they were subject to the same marginal tax rate as a single taxpayer with only half as much income. A single person faced tax rates as much as 41% higher than a married income earner with a nonearner spouse.[262] Notwithstanding the fact that the income of a married earner was supporting two persons, single taxpayers viewed themselves as unfairly bearing higher taxes than their married counterparts. Congress responded in the Tax Reform Act of 1969 by reducing rates for single taxpayers to a level that was 17% to 20% greater than rates for joint returns filed by married couples.[263] The Senate Finance Committee indicated that while some difference between the rate of tax paid by single persons and married couples is appropriate to reflect the additional living expenses of married taxpayers, the large disparity that resulted from statutory income-splitting was too exaggerated.[264] The variable rate schedule thus changed from a device to split income equally between husband and wife, to a reduction in tax liability of married couples accounting for increased living costs arising from the obligation to support a spouse.[265]

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261. In a different context the 1986 Act adopts the idea that taxation of the family should be based on income of the family unit. Unearned income of a child is to be taxed at the parents' marginal tax rate to the extent that the child's unearned income exceeds the sum of $500 and the greater of (1) $500 of the standard deduction or $500 of itemized deductions or (2) the allowable deductions that are directly connected with the production of the unearned income. Tax Reform Act of 1986 § 1411 (adding I.R.C. § 1(i)); CONFERENCE REPORT, *supra* note 67, II-767 to 69. The *Treasury Proposal* justified this provision, saying that the availability of income shifting devices violates the principle that families with equal incomes should pay equal taxes. 1 TREASURY PROPOSAL, *supra* note 20, at 85.

262. S. REP. No. 552, 91st Cong., 1st Sess. 260 (1969).

263. *Id.* at 260-61.

264. *Id.* at 260.

265. The 1969 Act also provided a new rate schedule for heads of households (unmarried taxpayers with a dependent) that was halfway between the rates for single taxpayers and the joint return. S. REP. No. 552, *supra* note 262, at 261. Married individuals filing separate returns were subjected to higher rates than a single individual which effectively prevented income splitting devices between husband and wife from having beneficial impact.

This change provided an adjustment in ability-to-pay terms for the added costs of a spouse, but brought with it a substantial negative side effect, the so-called "marriage penalty".

The 1969 revisions to the rate tables created a penalty for two married individuals with separate incomes. The marriage of two single individuals with equivalent incomes increased the cumulative tax burden on their combined income. For example, under the tax rate schedules in effect for 1985, a single taxpayer with $15,000 of taxable income would pay $1,961 at a top marginal rate of 20%. The combined tax liability of two single individuals each with $15,000 of taxable income would be $3,921. If these two persons were married with the same $30,000 of combined taxable income, they would pay tax of $4,706 on their joint return with a top marginal rate of 25%.[266] Thus the federal tax cost of marriage would be $785, a 20% increase in tax liability.[267]

Although the tax system penalizes the marriage of two single individuals in the same tax bracket, a single taxpayer who marries a lower-income or non-working spouse obtains a tax reduction. For example, the 1985 tax on $30,000 of taxable income for a single taxpayer was $5,947 based on a top marginal rate of 34%. If that individual were to marry a spouse with no income, the tax on the couple's $30,000 of taxable income would be $1,241 less. Thus, not all marriage is penalized by the tax system. Here is the dilemma. If marriage is treated as an equal partnership of two individuals with an equal division of the income of the marital community, as was the case between 1948 and 1969, there is a disparity between the individual married income earner and a single income earner. Alternatively, under the post-1969 approach, two single taxpayers with similar income levels face a tax penalty on marriage. The tax code will either contain a marriage penalty, or a disparity between tax rates of single and married income earners.

In the Economic Recovery and Tax Act of 1981, Congress attempted to mitigate the marriage penalty by enacting a deduc-

266. *See* I.R.C. §§ 1(a), (c) (West Supp. 1986). These tax liabilities reflect the zero bracket amount (ZBA) which compounds the marriage penalty. The ZBA in 1985 for a married couple filing a joint return was $3,540 while that for an unmarried individual was $2,390. *Id.* Thus, two unmarried income earners in the same household would have the advantage of $4,780 of standard deductions, $1,240 more than they would get if married.

267. This figure does not take account of the two earner deduction. *See infra* text accompanying note 268.

tion for two-earner married couples in the amount of 10% of earned income of the lower earner.[268] This provision created its own disparity. A two-earner married couple paid less tax on the same earned income than the single earner married couple.[269] Congress justified the disparity by arguing that large penalties on marriage undermined respect for families.[270] In ability-to-pay terms, however, the disparity makes no sense. The two earner couple represents the same number of dependents as the single earner married couple.[271]

The 1986 Act repeals the two-earner deduction[272] and adopts a compromise position slightly reducing the level of the marriage penalty. The *Treasury Proposal* and *Reagan Plan* asserted that the two-earner deduction did not effectively eliminate the marriage penalty for many couples and provided a benefit in excess of the increased tax liability of marriage for others.[273] These proposals concluded that reduced marginal rates are a better response to the problem.[274] The existence of wider brackets in the rate schedules reduces the penalty in many situations because the tax rates applicable to combined incomes

268. I.R.C. §221(a) (1982). Thus, the maximum deduction is $3,000. The combined tax under 1985 rate tables on two single individuals each earning $30,000 of taxable income would be $11,894. The tax on $60,000 of income on a joint return reduced by the $3,000 deduction to $57,000 is $13,717. This results in a marriage penalty of $1,823, 18% of the combined tax liability of singles.

269. *See* STAFF OF THE JT. COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY AND TAX ACT OF 1981 33 (Jt. Comm. Print 1981).

270. *Id.*

271. There is one difference. If they have children, the two earner couple will incur dependent care costs in order to enable both spouses to work. These expenditures should be recognized, not as an adjustment for family circumstances, but as a cost of income production—an expense directly required for income production that reduces the realized gains available for taxation. *See* Bittker, *Reflections on Tax Reform*, 47 CINN. L. REV. 185, 195-201 (1978). Current law allows a restricted credit for household or dependent care services to enable both spouses to work. I.R.C. § 21 (1982). The *Treasury Proposal* and *Reagan Plan* would have replaced the credit with a deduction limited to $2,400 per year for households with a single dependent and $4,800 for two or more dependents. 2 TREASURY PROPOSAL, *supra* note 20, at 18; REAGAN PLAN, *supra* note 32, at 20.

272. Tax Reform Act of 1986 § 131 (repealing I.R.C. § 221).

273. 2 TREASURY PROPOSAL, *supra* note 20, at 13; REAGAN PLAN, *supra* note 32, at 15. In almost identical language, both proposals state that abandonment of the joint return system would eliminate the marriage penalty but would create problems regarding allocation of income and income splitting between spouses. The proposals also reject treating a married couple as two single taxpayers with equivalent combined incomes because "married couples frequently pool their incomes and may benefit from shared living expenses."

274. 2 TREASURY PROPOSAL, *supra* note 20, at 13; REAGAN PLAN, *supra* note 32, at 15.

on a joint return are more likely to be the same as rates applicable to one-half of the same income for a single taxpayer.[275] Under the 1986 Act, the marriage of two individuals, each of whom earns $14,875 or less of taxable income, will not create a marriage penalty in the form of higher marginal rates because of the flat 15 percent tax rate on single taxpayers below $17,850 of taxable income and married couples below $29,750. There remains a spread in the rate brackets between married and single individuals, however. The marriage of two individual income earners with incomes in excess of $17,850 each will cause a rate induced marriage penalty of up to $774.[276] The increase is due to the fact that the threshold level for the 28 percent bracket with respect to married individuals, $29,750, is 83 percent of the combined threshold level for two single individuals of $35,700 ($17,850 X 2).

The marriage penalty is exacerbated for higher income mar-

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275. Rate induced marriage penalties remain significant for individuals whose combined taxable incomes move them to a higher bracket on a joint return. Under the *Treasury Proposal* a single taxpayer would pay tax of $1,830 on $15,000 of taxable income. Two single taxpayers would pay $3,660. A joint return with $30,000 of taxable income would pay tax of $3,930, a marriage penalty of $270. 2 TREASURY PROPOSAL, *supra* note 20, at 1-3. Under the *Reagan Plan* the tax on a single taxpayer's $15,000 of taxable income would be $1,815 or $3,630 on two combined incomes of $15,000. The tax on a joint return with $30,000 of taxable income would be $4,000. The marriage penalty is $370. The *Ways and Means Plan* would produce a marriage penalty of $250; each single individual would pay $2,500 on $15,000 of taxable income, a combined tax liability of $5,000, while a couple with $30,000 of taxable income on a joint return would pay $5,250. Under the *Senate Plan* a single individual with $15,000 of taxable income would pay $2,250, and two single individuals would pay $4,500 on their combined incomes. A married couple with $30,000 of taxable income on a joint return would incur tax liability of $4,584, a marriage penalty of $84. SENATE PLAN, *supra* note 56, at 38. The marriage penalty under each plan would be somewhat different if comparisons were made taking the standard deductions and personal exemptions into account. Although differences in the standard deduction would increase the marriage penalty in some cases, in the examples above, if calculations were based on $15,000 and $30,000 of adjusted gross income, the taxpayers would remain in the same marginal bracket so the marriage penalty would be limited to differences in standard deductions. *See infra* note 285.

276. Tax Reform Act of 1986 § 101 (amending I.R.C. § 1). For example, a single individual with $18,000 of taxable income pays tax of $2,719,50 [($17,850 X 15%) + ($150 X 28%)]. Two single individuals each with $18,000 of taxable income would pay combined taxes of $5,439.00. If these two persons were to marry, their combined tax liability on $36,000 of taxable income, ignoring changes caused by the standard deduction, would be $6,212.50 [$4,463 + ($6,250 X 28%)], an increase of $773 which is a penalty of 14% of their combined tax as two single individuals. The penalty occurs because, as single individuals, only $300 of the taxpayers' combined income is subject to the 28% bracket while as married taxpayers, $6,250 of their combined incomes is subject to the 28% bracket. The penalty here is the maximum penalty imposed by the different thresholds for the 28% rate [[($17,850 X 2) - 29,750] X 13% = $773.50].

ried individuals subject to the 5% surtax (the 33% tax bracket).[277] Two single individuals, each with taxable incomes of $43,150, face a maximum rate-induced marriage penalty of $1,494.[278] The penalty disappears, however, for taxpayers with sufficient income to be subjected to a flat 28% rate. [279]

At the low end of the income spectrum the marriage penalty issue is related to the question of tax thresholds. The Ways and Means Committee asserted that the marriage penalty could be mitigated with an adjustment to the relative tax thresholds of married and single taxpayers.[280] Prior to 1987, the zero bracket amount for single taxpayers ($2,390) was 67 percent of the zero bracket amount for joint returns ($3,540).[281] The Ways and Means Committee proposed reducing this ratio to 61 percent. [282] The Committee claimed that this proposal would allow "single individuals who marry [to] retain more of the total standard deduction for two single individuals than under present law."[283] When fully effective in 1988, the 1986 Act will provide a $3,000 standard deduction for single taxpayers, which is 60 percent of the $5,000 standard deduction provided for joint returns.[284] Thus, marriage will cost the loss of $1,000 of combined standard deductions, a $150 penalty in the 15 percent bracket, a $280 penalty in the 28 percent bracket, or a $330 penalty in the 33 percent bracket.[285] This is the most progressive part of the 1986

277. The 5% add-on begins for married couples with taxable income of $71,900. A single individual is subject to the 5% surcharge with taxable income of $43,150. Two single individuals together could thus receive $86,300 of taxable income before being subject to the 5% surcharge. The difference is a potential marriage penalty of $720.00 [(($43,150 X 2) - $71,900) X 5%]. Tax Reform Act of 1986 § 101(a) (amending I.R.C. § 1(g)).

278. *See supra* notes 276, 277.

279. The 5% add-on terminates for married couples with $149,250 of taxable income and single taxpayers with $89,560. The $720 marriage penalty attributable to the 5% add-on tax begins to phase out when the married couple reaches $149,250 and disappears completely at taxable income levels above $179,300 (2 X $89,560). CONFERENCE REPORT, *supra* note 67, at II-4.

280. WAYS AND MEANS PLAN, *supra* note 56, at 88, 92.

281. I.R.C. § 1(a), (c) (West Supp. 1986).

282. The proposal adopted a standard deduction for single individuals of $2,950, and $4,800 for joint returns. WAYS AND MEANS PLAN, *supra* note 56, at 91.

283. *Id.* at 88. Under the proposal the marriage of two taxpayers cost $1,100 of lost standard deduction compared to a loss of $1,240 worth of deduction under pre-1986 law.

284. Tax Reform Act of 1986 § 102(a) (amending I.R.C. § 63).

285. Figures contained in the *Ways and Means Plan* and *Senate Plan* indicate that both proposals contemplated a substantial marriage penalty for couples with similar incomes. WAYS AND MEANS PLAN, *supra* note 56, at 89; SENATE PLAN, *supra* note 56, at 37. *See also* O'Neil & Ostrowski, *Tax Reform Proposals and the Marriage Penalty*, 31 TAX

Code, as income increases the marriage penalty gets stiffer, at least until the 5 percent surtax is fully phased out at income levels above $149,250 for a married couple.[286]

Family circumstance also affects decisions regarding tax thresholds. The standard deduction, higher personal exemptions, and an increased earned income credit were used by all of the reform proposals to adjust the threshold level of taxation.[287] The tax threshold in each plan was based on estimates of the poverty level. The Ways and Means Committee's estimate of the 1987 poverty level was $5,962 for single individuals and $7,637 for married couples without dependents.[288] Using the poverty level to set the tax threshold creates a marriage penalty because the combined poverty level figure for two single individuals is greater than the poverty level for a married couple.

Historically, personal exemptions have represented an amount high enough to cover basic cost-of-living requirements, although in recent years this has not been the case.[289] A single exemption against earned income equivalent to minimum costs of living for a single individual is the ideal tax threshold. The poverty level represents a minimum amount of tax-free income an individual should be allowed to retain. As an alternative, one commentator has recommended using minimum wage for full-time employment as representing a minimum amount of income that should be allowed to each taxpayer without tax liability.[290]

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NOTES 1017, 1020 (1986) (calculated the marriage penalty under the *Ways and Means Plan* and the *Senate Plan* for combined incomes of $30,000, $50,000 and $100,000, and found a substantial marriage penalty borne primarily by couples whose second income exceeds approximately 14% of their combined income).

The *Treasury Proposal* and *Reagan Plan* would have enhanced the penalty attributable to differences in the zero bracket amount (ZBA) by increasing the ratio of the ZBA for single taxpayers to over the ZBA for joint returns. The *Treasury Proposal* set the ZBA for single taxpayers at $2,800 and for joint returns at $3,800. 2 TREASURY PROPOSAL, *supra* note 20, at 7. The ZBA for single taxpayers is 74% of the joint return amount. The *Reagan Plan* put the ZBA for single taxpayers at $2,900 for single returns and $4,000 for joint returns. REAGAN PLAN, *supra* note 32, at 7. The single return amount is 73% of that for joint returns.

286. CONFERENCE REPORT, *supra* note 67, at II-4. The 5% tax isn't finished at this income level. The add-on continues until the taxpayer's personal and dependency exemptions are eliminated. Tax Reform Act of 1986 (amending § 101(a)); CONFERENCE REPORT, *supra* note 67, at II-9. This phase-out does not discriminate between unmarried and married taxpayers.

287. *See supra* note 56.

288. WAYS AND MEANS PLAN, *supra* note 56, at 84.

289. *See* R. LINDHOLM, A NEW FEDERAL TAX SYSTEM 90 (1984).

290. O'Kelley, Jr., *Tax Policy for Post-Liberal Society: A Flat-Tax-Inspired Redefinition of the Purpose and Ideal Structure of a Progressive Income Tax*, 58 S. CAL. L.

Rather than dividing this exemption among three different provisions—a standard deduction, personal exemption, and low income credit—simplicity dictates that each income earner receive the first $6,000 of earned income (to use a round number close to the poverty level and slightly below minimum wage for a full year's work) without tax.[291] A couple with two income earners would be allowed a full $12,000 as an offset against earned income. A single earner married couple would receive only $6,000 of exemption. This would result in a different tax treatment for married couples depending on the number of income earners. At the same time, however, the imputed income of a non-income-earning spouse would not be taxed. The increased exemption allowance for the two earner family balances, to some extent, the tax-free benefit of this imputed income.[292] Under this system each income earning taxpayer is entitled to a minimum level of earned income before tax is imposed. There is no penalty in the form of lost exemptions on the marriage of two single income earners. There is also an incentive to the second spouse to work as that spouse can contribute an additional $6,000 to the family income at any income level without tax.

The reduced ability-to-pay of the married couple should be recognized, not in a dependency exemption for the non-income-earning spouse, but by treating marriage as a partnership where the economic income of the marital community is divided between two persons.[293] In a single-earner marriage, the absence of a dependency exemption for a non-earner spouse would be offset both by the receipt of the tax free imputed income of the non-earner spouse, and by the benefits of income-splitting. Horizontal equity based on a comparison of individuals would be accomplished by recognition of the fact that income of a married couple is shared by the two spouses.[294] The ability-to-pay of

REV. 727, 744-51 (1985).

291. Earned income for this purpose should include governmental and other payments that are received as substitutes for earned income and included in the tax base.

292. O'Kelley, *supra* note 290, at 759-69 (suggesting that an exemption for income based on minimum wages and allowed against earned income would adjust for the imputed income of the nonincome-earning spouse by valuing the imputed income at the minimum wage rate).

293. A single earner married couple would have one $6,000 exemption, the same as a single person. This system may work some hardship on a single-earner couple below the poverty level. In a deviation from simplicity, the Code may provide this couple with an extra $1,500 dependency exemption for the nonwage-earning spouse to create a tax threshold nearer the poverty level for married couples.

294. McIntyre, *Fairness to Family Members under Current Tax Reform Proposals,*

each marital partner would be a function of that spouse's share of family income. A married couple should be taxed at the same rate as a single person with the same per capita income level. In other words, the rate schedule should impose rate increases for joint returns at two times the income level as for single returns so that the married couple would pay the same tax as two single persons with the same combined incomes.[295] In terms of the ability of each individual taxpayer to bear the cost of government, equity and simplicity are best achieved by treating the married couple as two single taxpayers each with half of the community income. The added benefit of this regime is a tax system that encourages rather than penalizes marriage.

Adjustments for family circumstance must also include a dependency exemption for persons other than a non-earner spouse who are dependent upon the taxpayer. The reform proposals uniformly focused on the poverty level for a family of four as the measure of the tax threshold. A dependent's exemption of $2,500 would put the family of four with a non-working spouse at a tax threshold of $11,000. The family of four with two working spouses would be exempt on the first $17,000 of income.[296] The $2,500 figure is undoubtedly inadequate as a measure of the additional cost of raising a child, at least at middle- and upper-income levels. To that degree, $2,500 is not a perfectly accurate adjustment for variations in ability-to-pay attributable to family size. On the other hand, defining the exemption to correspond to the poverty level exempts a greater proportion of income for lower income taxpayers. The greater impact of the exemption at low income levels enhances the progressivity of the tax system as a whole.[297]

Reductions to the tax base for varied family circumstance provide relief for costs of personal consumption of basic necessi-

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31 TAX NOTES 713, 714 (1986).

295. *See* Bittker, *supra* note 153, at 974-75. "If married couples think of themselves as equally entitled to their combined income, how do the tax rates applicable to joint returns 'erode' the tax base?" *Id.*

296. This includes a $6,000 personal exemption for each spouse and a $2,500 dependency exemption for each child.

297. Under current law the exemption for old age and blindness recognizes reduced ability-to-pay. However, there is little logic in limiting the extra exemption to only one debilitating disability. Equity requires that the list be expanded to include other equally serious disabilities, or the exemption be eliminated entirely. The 1986 Act provides an additional standard deduction for an elderly or blind person who is married, or $750 for such a person who is unmarried. The $750 addition is also available to an elderly or blind head of household. CONFERENCE REPORT, *supra* note 67, at II-7.

ties. Before 1987 the Code provided additional allowances for some personal consumption in the form of deductions for consumer interest, sales and property taxes, and interest on a home mortgage. The 1986 Act broadens the tax base by eliminating deductions for consumer interest and state and local sales taxes.[298]

To the extent that the remaining deductions for personal consumption must be retained in the Code out of political necessity, it is appropriate to reduce allowable deductions by the adjustments that are allowed for personal consumption. The standard deduction was originally enacted in 1944 as a substitute for individual itemized deductions.[299] The revenue loss caused by deductible consumer interest and taxes could be mitigated by allowing deductions for these items only to the extent that they exceed personal exemptions, dependents exemptions and the standard deduction.[300] The *Ways and Means Plan* took a step in this direction with a proposal to reduce allowable itemized deductions by $500 for each dependent's exemption claimed by the taxpayer.[301] This approach was criticized, however, because it measured the loss of deductions strictly by family size, a factor that decreases rather than increases ability-to-pay.[302]

Increasing the tax threshold with personal and dependent exemptions is expensive in terms of lost revenue. The approach is also condemned because it increases the tax savings of high bracket taxpayers. Some of the revenue loss could be offset with a limitation on personal consumption deductions to the excess over personal and dependents allowances—a limitation with greater impact on high income taxpayers. The remaining reve-

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298. Tax Reform Act of 1986 §§ 102(a), 134, 511(b).

299. S. REP. No. 552, *supra* note 262, at 255.

300. This suggestion may also ease at least one dilemma faced by policy makers in eliminating deductions for home mortgage interest and taxes. Outright elimination of these items will undoubtedly lower home prices as the cost of home ownership would increase by the value of the deduction. Retaining the deduction but decreasing its relative value through elimination of other itemized deductions, or moving some of those deductions above the line, while also increasing the standard deduction available to nonitemizers, provides a method to phase out the home interest and property tax deductions without a precipitous impact.

Hall & Rabushka assert that lower interest rates resulting from elimination of interest deductions entirely would enhance the demand for housing because of lowered carrying costs and thereby cancel out the loss to householders to a "reasonable approximation". R. HALL & A. RABUSHKA, *supra* note 37, at 64.

301. WAYS AND MEANS PLAN, *supra* note 56, at 88.

302. McIntyre, *supra* note 294, at 719 & n.20.

nue loss could be recovered with adjustments to tax rates on income above the exemption levels. Although this approach results in higher marginal rates, the end result is a more progressive tax system with less complexity. Higher threshold levels have a progressive impact by removing taxpayers with the least ability-to-pay from the tax system and providing a tax free income floor having proportionately greater impact on effective tax rates at lower income levels.[303] Adopting a direct approach to allocating relative tax burdens through the rate schedule rather than relying on variable credits and deductions limited to particular groups allows for more specifically targeted allocations because of the need to manipulate only a single variable—relative marginal rates.

### C. *Governmental Incentives*

The third category of adjustments that reduce the tax base includes incentives for Congressionally preferred activity. Policy makers recognize that tax deductions for an activity in excess of the cost of the income it produces is a government subsidy in the amount of revenue lost from the reduced tax base. They also recognize that a tax subsidy to one taxpayer increases the relative tax burden of others. The question is how to identify activities that are appropriate recipients of subsidies through tax savings.

A governmental subsidy through tax relief has some advantages over direct benefits. There is no application process to qualify. The taxpayer seeking the benefit bears initial responsibility for establishing qualification for the benefit and, if challenged, bears the burden of proof. The Internal Revenue Service provides an efficient enforcement mechanism. The cost of administration is therefore substantially less than a direct payment program. More importantly, the degree of central government planning and control is reduced. This allows the marketplace some additional freedom in applying the subsidy. However, this freedom also makes specific targeting of the subsidy nearly impossible.

The Treasury concluded that an "ideal tax system would . . . interfere with private decisions as little as possible" al-

303. *See* R. Hall & A. Rabushka, *supra* note 37, at 24-26. A flat tax with a $10,000 exemption is a progressive tax in the sense that "rich people pay a higher fraction of their income in taxes than poor people." *Id.*

lowing the market place to determine economic choices.[304] This sentiment is expressed in the other reform proposals, although each of the proposals found it easy to depart from this goal for favored commercial ventures. The final enactment is no exception.

The Treasury justified its advocacy of a neutral tax system by saying in part that a "consistent definition of taxable income would allow market forces, rather than the tax system, to determine the allocation of the nation's scarce economic resources."[305] This philosophy is appropriate, however, only where the market offers monetary return as an attraction to competing investments. The philosophy also suggests that governmental subsidy through tax incentives should be strictly limited to activities in the commercial market place that government has an interest in encouraging, but which do not offer monetary returns as an inducement. To go further burdens the tax act with the complexities and inefficiencies that the reform has only begun to eliminate.

A second standard should focus on the specific activity to be subsidized. Expenditure of governmental resources in terms of foregone revenue should be limited to items which reduce or mitigate governmental costs. Thus tax expenditures might be limited to activities that benefit the common good, as opposed to enhancing return on private investment, in those areas that are unable to independently attract capital because of the absence of profit potential.

The government's interest in insuring adequate health care for the population provides an example that allows exploration of these concepts.[306] Absent private resources, government's costs for health care would increase. There is little profit potential to attract business investment in a health care system for employees. Thus the existing exclusion from income of the value of employer provided health care plans subsidizes a governmentally preferred activity that would not otherwise attract private expenditures of capital.[307]

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304. 1 TREASURY PROPOSAL, *supra* note 20, at 1.

305. *Id.* at 42.

306. SENATE PLAN, *supra* note 56, at 650.

307. Pollution control, subsidized with a five year rapid amortization provision (I.R.C. § 169), is another example of a commercial expenditure not resulting in added profit but which is necessary to the common good.

Deductions for charitable contributions (I.R.C. § 170) may also be cited as an example of a provision of subsidizing an activity that does not offer profit potential to attract

Critics argue that tax favored fringe benefits such as health plans cause a distortion in compensation.[308] Their argument is based on the assumption, which may or may not be true, that absent the tax preference the value of one dollar of health care coverage is worth less to employees than a dollar of cash.[309] If this is the case, an employee would prefer cash for purchase of other goods and services of higher value to the employee. This argument proves the validity of the tax expenditure as a government subsidy. If the employee finds cash compensation more valuable for consumption of goods and services than participation in a health plan, the employee will forego the health-care coverage. Reduction in the scope of health-care coverage would increase the number of people seeking governmental assistance when major health problems prevent them from earning sufficient income to maintain health care for themselves and their families. Reduced costs in the form of tax savings is the very thing that induces widespread health care coverage at a saving to the government in transfer payments. Whatever the inefficiencies inherent in encouraging the maintenance of health care plans for employees in the private market place, the system is bound to be more efficient and less expensive than a government-financed universal health care program.

The *Treasury Proposal* argued that a governmental incentive program such as the health insurance exclusion can result in too much of a good thing. The Treasury noted that tax incen-

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capital and which reduces the costs of government by funding activities that fulfill governmental type functions. Some studies have demonstrated that the deduction for contributions to charity works as an efficient tax subsidy only for high-income contributors. *See* Rudney, *Charitable Deductions and Tax Reform: New Evidence on Giving Behavior*, 26 TAX NOTES 367, 368 (1985). Hall and Rabushka argue that elimination of the deduction would not adversely affect churches, but that only "institutions serving the absolute economic and social elite" such as universities, symphonies, opera companies, ballets or museums, would be harmed by loss of the subsidies. R. HALL & A. RABUSHKA, *supra* note 37, at 66.

The *Treasury Proposal* said that charitable deductions were justified only when contributions of a high percentage of income reduce ability-to-pay, and would therefore allow deductions only to the extent that contributions exceed 2% of adjusted gross income. 1 TREASURY PROPOSAL, *supra* note 20, at 81. The *Reagan Plan* leaves the charitable deduction for itemizers untouched, but would accelerate the expiration date of the 1981 enacted deduction for nonitemizers. REAGAN PLAN, *supra* note 32, at 70-71. The *Ways and Means Plan* would have made the nonitemizer's deduction permanent but would have allowed only deduction of contributions in excess of $100. WAYS AND MEANS PLAN, *supra* note 56, at 112. The 1986 Act allows the charitable deduction for nonitemizers to expire. CONFERENCE REPORT, *supra* note 67, at II-21.

308. *See, e.g.*, H. AARON & H. GALPER, *supra* note 63, at 4.

309. *Id.*

tives cause more of the favored benefit to be consumed than would be the case absent the subsidy. The proposal added that "[h]ealth-care is made more expensive for all because it is effectively subsidized through the tax system for some."[310] The Treasury did not propose to eliminate the program which it recognized as "an appropriate part of the national policy to encourage essential health care services."[311] Instead, in order to reduce overuse of medical services,[312] the Treasury recommended that the exclusion from income be limited to $70 per month for individual employee coverage and $175 per month for family coverage.[313] The proposal would have thus continued to serve a governmental purpose with an inducement to expenditures that would not otherwise be provided in the marketplace through profit incentives. However, the Treasury would strictly limit the subsidy to the perceived need.

The *Reagan Plan* turned the *Treasury Proposal* on its head. Rather than cap the amount of excludable health care benefits, the *Reagan Plan* recommended taxing the first $10 per month of an employer's contribution to a health plan for individual coverage, and the first $25 per month for an employer's contribution to a family plan that includes coverage for a spouse or dependent of the taxpayer.[314] This proposal has some advantage in terms of simplicity because it eliminates the need to ascertain the cost of each employee's health care as would be required under the *Treasury Proposal*.[315] It suffers from the defect condemned in the *Treasury Proposal*, however, in that it would subsidize unlimited expenditure for health care. This would continue to encourage overuse of health plans. At the same time, the *Reagan Plan* would have discouraged the use of health plans by increasing their relative costs for lower-compensated individuals. The *Reagan Plan* thus would have worked against the purpose of the tax incentive to encourage wide spread health care.[316]

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310. 1 TREASURY PROPOSAL, *supra* note 20, at 73.

311. *Id.* at 23.

312. "Because many employer-provided plans are so generous that the employees pay very little, if anything, out-of-pocket for health services, the employees are more likely to overuse doctor and hospital services and medical tests." *Id.*

313. *Id.* at 25.

314. REAGAN PLAN, *supra* note 32, at 26.

315. *Id.* at 27.

316. The *Reagan Plan* would also impose nondiscrimination rules on excludable health plans. *Id.* at 39. The *Ways and Means Plan* and the *Senate Plan* would have retained the existing exclusion but subjected it to nondiscrimination rules. WAYS AND

The 1986 Act does not adopt any of these restrictions on excludable health care coverage. It merely extends nondiscrimination rules to employer-provided health plans along with other employee benefits.[317] The 1986 Act also expands the Code's incentives for health plans by allowing a self-employed individual to deduct 25 percent of amounts paid for health insurance.[318] Employees not covered by a health plan receive no deduction. The 1986 Act does, however, negatively affect noninsured employees by increasing the threshold for deductible medical expenses from 5 percent to 7 1/2 percent.[319]

The exclusion for health care demonstrates that governmental incentives in the form of tax savings can be crafted to induce particular forms of behavior by business enterprise without the distortions condemned by the Treasury and other tax proposals. Overuse of an incentive that accomplishes a governmental function is in one sense a mark of its success. That overuse is preventable, however, with the sort of cap on benefits proposed by the Treasury for the health-care exclusion.

## IV. Conclusion: Is it Reform?

This article suggests four basic principles for analyzing a tax base using ability-to-pay as a standard. First, the base should include all realized economic gains—accessions to wealth over which the taxpayer exercises control. Second, the tax base should be reduced by costs incurred in producing realized gains. Third, to insure that the tax is based on ability-to-pay standards, diverse family circumstances must be accounted for with adjustments to reflect reduced resources available to diverse family groups. Fourth, the tax base may be reduced to allow tax subsidies for private expenditures that decrease governmental costs by subsidizing activities benefiting the common good that would not otherwise be profitable.

Measured by these standards the 1986 Act accomplishes a great deal. Realized gains continue to represent the backbone of the income tax system. Elimination of the capital gains prefer-

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Means Plan, *supra* note 56, at 771; Senate Plan, *supra* note 56, at 650-51.

317. Tax Reform Act of 1986 § 1151(a) (amending I.R.C. § 89); Conference Report, *supra* note 67, at II-498.

318. Tax Reform Act of 1986 § 1161(a) (amending I.R.C. § 162(m)); Conference Report, *supra* note 67, at II-538 to 539.

319. Tax Reform Act of 1986 § 133 (amending I.R.C. § 213); Conference Report, *supra* note 67, at II-22.

ence enhances neutrality towards different forms of income although unrealized capital appreciation continues to occupy a preferred position over other forms of return on invested capital.

With respect to the costs of income production, repeal of the investment tax credit, reduction or repeal of other subsidies, and the limitation on passive losses move the income tax base toward a cost recovery system that improves the measure of income in terms of receipts less the cost of income production. Incentives in the form of accelerated capital recovery for shorter-lived capital investment, however, continue to provide a preference to this form of investment. The presence of significant preferences continues to require an alternative tax scheme to prevent overuse. In addition, the concept of income as receipts less cost is damaged by discriminatory limitations on legitimate employee expenses.

Taxation of the family unit is neither helped nor harmed by the 1986 Act, which does nothing other than increase tax thresholds through the old combination of personal and dependents exemptions, the standard deduction, and the earned income credit. The marriage penalty continues as a substantial disincentive to marriage by working individuals. However, the increased tax threshold that removes large numbers of the very lowest level of taxpayers from the tax rolls is one of the most important impacts of the 1986 Act. From top to bottom, the federal income tax is undoubtedly more progressive because of the higher tax threshold.

Nonetheless, progressive income taxation based on ability-to-pay, the hallmark of United States income taxation since its inception, is undermined by the movement towards flat-tax and modified flat-tax plans that is based on a philosophy of lower rates to shift burdens of tax away from upper-income groups. The 1986 Act does little to reverse the overall trend of the last twenty years towards a more regressive tax structure.

The income tax system has lost credibility because of the not wholly inaccurate perception of the taxpaying public that the income tax discriminates against the lower- and middle-income wage earner through an extensive list of incentives available only to upper-income taxpayers. This has not been a function of the marginal rate schedule or high marginal rates. It is a result of a tax code riddled with preferences to induce favored activity. The preferences in the 1954 Code became so extensive that the tax net caught only those lacking the wealth to slip

through. Congress will devise a tool that equitably raises revenue on an ability-to-pay basis only if it mends the tax net by adopting a strict and comprehensive definition of ability-to-pay in terms of realized gains less the cost of income production. The 1986 Act makes significant progress in this direction by substantially broadening the tax base. However, gaps in the tax base continue to evidence the philosophy that pervaded adjustments to the 1954 Code through the last two decades allowing preferential treatment to activities whose proponents convinced Congress that tax subsidies were necessary.

The legislative process leading to the 1986 Act was marked by intense competition to protect the interests of different groups.[320] The participants in this national debate, including members of Congress, the Treasury Department, and the President, viewed tax reform as a question of how to lower rates and allocate the resulting burden of raising compensating revenue to different sectors of the tax paying public.[321] A sharp focus on winners and losers, rather than on any comprehensive theory of income taxation, lead policy makers to define issues in terms of the impact of various provisions on incentives and disincentives to economic growth.[322] The focus on the economic benefits and

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320. As an example, on July 10, 1985, Senator Robert Packwood, Chairman of the Senate Finance Committee, promised to do his best to kill the Reagan Administration's tax reform plan if several provisions that he said would be devastating to the lumber industry in the State of Oregon were not removed. 133 Daily Tax Report (BNA) G2-4 (July 11, 1985). He withdrew the threat after conversations with Secretary of the Treasury James Baker and House Ways and Means Committee Chairman Daniel Rostenkowski. 134 Daily Tax Report (BNA) G-1 (July 12, 1985).

Another example occurred on September 23, 1985, when Congressman Rostenkowski was presented petitions bearing 750,000 signatures by a group calling itself Citizens Organized to Restore an Effective Corporate Tax demanding repeal of special interest loopholes and restoration of corporate tax. At the same time, however, the group criticized President Reagan's proposals to tax portions of employer provided health plans and repeal state and local tax deductions. 185 Daily Tax Report (BNA) G-1 (Sept. 24, 1985). As Senator Russell Long once said, "Don't tax you, don't tax me, tax that fellow behind the tree."

321. Perhaps one of the major deterrents to tax reform is the fact that there are more burdens than benefits to allocate. Although some may argue that the urgent need for revenue is an important propellant to reform, "when there are no net tax cuts to compensate the losers in tax reform, it seems hard to believe that the pressing need for revenue will make the road to reform easier." Heller, *supra* note 98, at 918.

322. *See* Break, *Avenues to Tax Reform: Perils and Possibilities*, 37 NAT'L TAX J. 1, 6 (1984), who points out that "prospective gains from a better-performing economy are an attractive possibility, but citing them as a major objective of tax reform is likely to raise more questions than it answers." One commentator has described this phenomenon as a swing in tax policy from "Surrey to Ture". *See* Wetzler, *Tax Reform A La the Bradley-Gephardt Bill*, 37 NAT'L TAX J. 265, 265 (1984).

burdens of tax reform left an open door to claims for preferential treatment.[323] As long as benefits and burdens are allocated to enhance the productivity of winners and shift burdens to the losers, various sectors of the economy can legitimately cite the economy's need for their particular production to justify claims for preferential treatment. The open door constricts the way to broad conceptual reform.

Reform in the shape of comprehensive taxation of a uniform base will come only from a restructuring of the tax base even broader than that accomplished by the 1986 Act. That will occur only if policymakers first agree on fundamental principles to define the tax base, and on guidelines for deviating from the tax base to further governmental interests. A piecemeal focus on specific characteristics of households or enterprises without the guidance of general principles for structuring the tax base is doomed to create an uneven tax base with substantial complexity.[324] The absence of cohesive guidelines in this past year's effort will lead to tax revisions in the near future when advocates of preferential treatment convince Congress that their vital interests are injured by a burdensome tax system, and when the reduced rate structure becomes too expensive in light of continued federal budget deficits.

When the tax net is fully mended with a fairly determined tax base, the allocation of the tax burden may be made by adoption of a rate schedule reflecting the desired degree of progressivity. Indeed, Congress has evidenced its continued capacity to do so with the 1987 transition rate schedule of five brackets and a top marginal rate of 38.5%.[325] The retention of this rate schedule, perhaps with a restructured personal exemption for wage earners, would be a significant step forward. The step may be necessary when Congress faces the substantial revenue losses projected under the 1986 Act for 1988 and 1989.[326]

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323. This phenomenon threatened to derail the tax reform process entirely when, on April 18, 1986, Senator Packwood cancelled the Senate Finance Committee markup sessions after a series of Committee votes accepting revenue-losing amendments to the plan without any offsetting tax increases. Sheppard, *Revenue Losses Force Packwood to Postpone Markup*, 31 TAX NOTES 205 (1986).

324. Musgrave, *supra* note 11, at 50.

325. CONFERENCE REPORT, *supra* note 67, at II-5.

326. *Id.* at II-885. The 1986 Act is projected to increase revenue in 1987 by approximately $11 billion, but the 1986 Act will lose $17 billion in 1988, and $15 billion in 1989. The revenue losses are to be made up by projected revenue gains of $8 billion and $12 billion in 1990 and 1991.

Without a comprehensive definition of income that accurately measures ability-to-pay, allocating burdens with any rate schedule is pure guesswork. If the great band of middle-income taxpayers awakens to discover that tax reform has increased or maintained their current tax burden while giving substantial relief to other groups, the tax system may find itself in greater compliance difficulties than those perceived under the system before 1987.