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THE DEFINITION OF "INCOME" UNDER A NEGATIVE INCOME TAX

WILLIAM A. KLEIN*

I. INTRODUCTION

A. Two Brief Prefatory Remarks

This article will review problems that arise when one begins to prescribe, for purposes of an income-maintenance program like the negative income tax,¹ those individual economic resources that are to be included to determine the appropriate level of benefits. Before proceeding, however, two brief prefatory remarks seem appropriate.

First, the discursive nature of the discussion here is dictated by my objective to review and to record for future use the most significant considerations that molded a series of decisions on particular issues. The ideas are not just my own but also those of the many intelligent, experienced and dedicated people I have worked with in devising rules for several negative income tax experiments. My objective in recording these ideas is neither narcissistic nor wholly academic; the ideas are some that others dealing with related issues arising in other contexts will want to take into account. And the issues will inevitably arise—if not in the context of an income-maintenance proposal, then in the context of some other program, such as public housing or medical care for the indigent, in which benefits are based on need.

Secondly, I ask the reader's indulgence for a compromise: the discussion may seem too detailed for the reader with only a general interest and insufficiently detailed (perhaps even superficial) to specialists interested in particular points.

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1. This article assumes the reader's familiarity with the basic features of the negative income tax. Descriptions may be found in Klein, *Some Basic Problems of Negative Income Taxation*, 1966 WIS. L. REV. 776 [hereinafter cited as Klein, *Basic Problems*]; Tobin, Pechman & Mieszkowski, *Is a Negative Income Tax Practical?*, 77 YALE L.J. 1 (1967) [hereinafter cited as Tobin]; Comment, *A Model Negative Income Tax Statute*, 78 YALE L.J. 269 (1968) [hereinafter cited as *Yale Statute*]. See also Asimow & Klein, *The Negative Income Tax: Accounting Problems and a Proposed Solution*, 8 HARV. J. LEGIS. 1 (1970) [hereinafter cited as Asimow & Klein]; Klein, *Familial Relationships and Economic Well-Being: Family Unit Rules for a Negative Income Tax*, 8 HARV. J. LEGIS. 361 (1971) [hereinafter cited as Klein, *Family Unit*].

B. Positive and Negative Tax—Compared and Contrasted

The problems that will be examined in this article correspond to those that arise under the positive income tax system when one tries to define "income" or, more broadly, the proper base for raising general revenues through personal taxation. It would be glossing over some fundamental issues of income-maintenance theory and policy, however, if one assumed a perfect parallel between the negative and the positive tax systems and referred to the problem presently to be considered as one of defining "income" or as one of defining the proper "tax" base. Whether income is the proper base for measuring individual economic resources for the negative income tax—even if it is granted that income is the proper base for positive tax purposes—is a very serious and perplexing question. Similarly, use of the concept of "taxation" when one refers to the reduction of benefit payments as a consequence of individual resources may obscure a fundamental sociological-philosophical question about the function and nature of income-maintenance programs in present-day society. Although the very phrase "negative income tax" is misleading, it will be used throughout this article for convenience. For the same reason there will sometimes be talk of defining "income," although the concept referred to is much broader than income.

A principal distinction between the positive and the negative income tax bases—a distinction that reveals the profound differences between the two—lies in the fact that benefits under the negative income tax² reflect not only a person's income but also his wealth or

2. There is, in fact, no such thing as "the" negative income tax. The appendix to this article, pp. 488-90 *infra*, contains relevant portions of a model statute that the author drafted with Professor Joel F. Handler for the President's Commission on Income Maintenance Programs (the Heineman Commission). [Section 8 of this proposed statute, set out in the appendix, will hereinafter be cited as Model Statute.] See Handler & Klein, *A Model Statute Reflecting the Recommendations of the President's Commission on Income Maintenance Programs* in THE PRESIDENT'S COMMISSION ON INCOME MAINTENANCE PROGRAMS: TECHNICAL STUDIES 293 (1970). That model statute, and particularly the portion reproduced in the appendix, is derived largely from rules that this writer developed for the University of Wisconsin's Institute for Research on Poverty income maintenance experiment in New Jersey and later refined for purposes of the Institute's rural income-maintenance experiment. See Klein, *Rules for Rural Income Maintenance Experiment* (unpublished paper available from the author) [hereinafter cited as *Rural Rules*]. Thus, the model relied upon here reflects the opinions of members of the Institute staff concerning the structure of a negative income tax statute. The Heineman Commission model is also similar to, and to some extent draws upon, *Yale Statute*, which in turn had drawn on the rules drafted for the New Jersey experiment and upon suggestions in Tobin. Thus, it seems fair to say that there is some consensus about major features of the negative income tax's definition of the "tax" base. There certainly has been a consensus among experts with whom I have discussed the matter over the past several years that a statute without a capital utilization component in the tax base

capital, even though this wealth or capital produces an adequate return that itself will be counted as income and will thereby reduce benefits.³ In traditional welfare programs a person could not receive any benefits until he had exhausted all his savings and other assets (with certain very limited exemptions). The same approach, though with fairly generous exemptions, was reflected in the various versions of the Nixon Administration's Family Assistance Plan.⁴ This approach might be viewed as the equivalent of imposition of a 100 percent tax on capital—and has been frequently so described in discussions among proponents of the negative income tax. That mode of description is, of course, pejorative. Under the positive tax a 100 percent rate on anything would be a patent outrage and any significant general revenue measure in the nature of an annual capital levy (one that, unlike a property tax, significantly exceeds actual or imputed income) would deeply offend our historic commitment to capitalism and private property.

Even in order to determine entitlement to welfare benefits, a rule requiring exhaustion of assets as a condition of eligibility is objectionable on several grounds. First, it simply seems heartless to force a person, as a condition of receiving benefits needed for bare subsistence, to rid himself of property that he may have worked all his life to acquire and that may possess great emotional significance for him, among other possibilities, as a symbol of his place in the mainstream of a society in which virtue is frequently associated with ownership of things. Secondly, an asset-exhaustion requirement may seem unfair in that it leaves the frugal citizen very little, if at all, better off than the prodigal. At the same time such a rule tends to reduce or eliminate the incentive to save for a rainy day—or to save for any other reason. And finally, it can be argued that such a rule unfairly discriminates between the welfare beneficiary and the person who receives other

would be totally unacceptable to Congress and the public. Most of the objection to including this component has been on grounds of administrative burdensomeness rather than on grounds of fairness.

3. There are two separate issues arising from the ownership of wealth. One concerns the possibility of investment in assets that yield little or no current tangible return. That is the problem of imputed income. The other problem is the policy decision that a person ought to consume capital, at least to some extent, as a condition to receiving income-maintenance payments. The text here is concerned with this latter problem alone. Other significant distinctions between the positive tax system and traditional welfare in their respective reckonings of economic well-being lie in the latter's concern with such resources as the income or wealth of relatives and the potential income from going to work or taking a better job. See Klein, *Basic Problems* at 786-87; Klein, *From the Thoughtful Tax Man*, 44 TAXES 461 (1966).

4. See H.R. 1, 92d Cong., 1st Sess. §§ 2152(a)(2), 2154 (1971) (proposed Social Security Amendments of 1971) [hereinafter cited as H.R. 1].

benefits from the government (even such generalized benefits as national defense). It is conceivable that every person might be allotted a pro rata share of total government expenditures and be required to pay his share by dipping into capital if his income is insufficient to meet his share of the total burden. It seems quite unlikely that anyone would seriously propose such a revenue system; but the traditional welfare approach to assets is, at least in spirit, quite analogous.

Few people, however, are outraged by the idea of forcing welfare beneficiaries to reduce the government's burdens by dipping into their capital in order to forestall the need for welfare payments. Indeed, my guess is that most people would probably be outraged by the absence of an asset-utilization rule in a welfare program. The reasons why this is so are not easy to pinpoint, but they probably reflect the fact that welfare benefits are regarded differently from other governmental benefits. They are, for one thing, more akin to charity, and traditionally charity has been reserved for the destitute—probably because charities have not had enough money to be more generous.⁵ Moreover, one reason why people save is, as suggested above, to provide for a rainy day. When the rainy day comes along it hardly seems draconian to expect a person to make use of his rainy-day fund. Welfare benefits are not, after all, the same as national defense; they are given to an individual for his benefit alone. Accordingly, a "tax" based on a benefit theory rather than an ability-to-pay theory may seem justified. In short, even if eligibility rules for welfare benefits are viewed as financing devices or tax rules, it must be remembered that the appropriateness of a method of financing cannot be considered independently of the benefit that is being financed⁶ and it is by no means self-evident that all benefits should be financed from general revenues raised by taxes related to a single concept of ability to pay.

C. Negative Tax as a Response to Changing Social Needs

At the same time, however, it may be that increasingly our economic and social patterns require looking upon income-maintenance programs not so much as charity and as a responsibility of the government only in the last resort, but rather as a guarantee of protection for all citizens against events over which they have little or no control. Thus, it may be that the point has been reached at which it is necessary increasingly to accept the proposition that unemployment is a burden

5. See Klein, *Basic Problems* at 782-86, pointing out that a capital-exhaustion rule ensures that limited welfare funds are distributed to those who are most needy.

6. See J. BUCHANAN, *PUBLIC FINANCE IN DEMOCRATIC PROCESS* (1967).

imposed almost randomly and arbitrarily on people who cannot be held responsible for this misfortune. To the extent that this is true, recipients of income-maintenance benefits should be treated like other citizens and the amount that they pay into the government till should be determined by the same formula that determines the amount that everyone else pays into the till, without regard to the amount or kinds of benefits they happen to be receiving. This would lead to a complete integration of income maintenance with the positive income tax, with all citizens theoretically receiving income-maintenance payments, offset for all by a tax (presumably an income tax) based on a single set of rules. The nation, however, has not yet come that far in its thinking about welfare. The proposals that have been made for a negative income tax⁷ are a step in that direction, but basically they reflect a compromise between the two extremes of ancient poor law and the theory that income maintenance is everyone's "right."

To the extent that the broad-sweep tax base⁸ of traditional welfare is adopted, many (though by no means all) of the problems that arise in defining "income" under the positive income tax do not arise under the negative income tax. Questions of economic incentive and administrability remain, and they are serious, but the most baffling issues associated with the goal of achieving interpersonal fairness⁹ virtually disappear once it is decided that everything is to be counted, not just income. On the other hand, to the extent it is decided that the negative income tax is indeed to be an analogue of the positive income tax, one must define income precisely; comparisons to the positive tax system become useful for both concrete issues and general philosophy, and one becomes involved in the perennial discourse of tax theoreticians over what has recently become known as the question of the comprehensive tax base.¹⁰

7. See note 1 *supra*.

8. I will hereinafter refer to the process of reducing welfare benefits by virtue of income and other resources as one of taxation, because doing so seems to me to highlight and clarify many issues.

9. The term usually used in the public finance literature is "equity" rather than "fairness." I use the term "fairness" because it seems to describe more accurately the kind of systematic, as opposed to individual, justice with which I am concerned.

10. See B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, A COMPREHENSIVE TAX BASE? (1968) [hereinafter cited as B. BITTKER, COMPREHENSIVE TAX BASE]. This volume is a compilation of the following series of articles: Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967); Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967); Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and ABA's CSTR*, 81 HARV. L. REV. 1016 (1968); Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968).

D. *The Bittker Debate—Fairness Overexalted?*

The debate generated recently by Professor Bittker over the comprehensive tax base revolves about significance of the Haig-Simons definition of income in shaping the federal income tax structure. In a book subtitled, "The Definition of Income as a Problem of Fiscal Policy," Simons had this to say about the problem thus delineated:

Personal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has to do not with sensations, services, or goods but rather with rights which command prices (or to which prices may be imputed). Its calculation implies estimate (a) of the amount by which the value of a person's store of property rights would have increased, as between the beginning and end of the period, if he had consumed (destroyed) nothing, or (b) of the value of rights which he might have exercised in consumption without altering the value of his store of rights. In other words, it implies estimate of consumption and accumulation. Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods); accumulation denotes the change in ownership of valuable rights as between the beginning and end of a period.¹¹

Summarizing these ideas, he produced this frequently cited formulation:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.¹²

This formulation produces the comprehensive tax base—one that includes all net receipts regardless of source or nature.

As Professor Bittker pointed out, the Simons position "has come to be the major organizing concept in most serious discussions of our

Later articles that have made very important contributions to the comprehensive tax base debate include a thorough, meticulous study by Professor William D. Andrews which lends support to the Bittker position. See Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972). Professor Bittker himself has added two brilliantly written articles, each of which is virtually dispositive of its subject matter. See Bittker, *Income Tax "Loopholes" and Political Rhetoric*, 71 MICH. L. REV. 1099 (1973); Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37 (1972).

11. H. SIMONS, *PERSONAL INCOME TAXATION* 49-50 (1938).

12. *Id.* at 50.

federal income tax structure."¹³ Professor Bittker's own position is that, in light of the myriad exceptions that are sanctioned by general acceptance and required by common sense, the proponents of the Simons view cannot really mean what they say and the Simons formulation cannot play the significant role in policy development that its adherents seem to claim for it.¹⁴

This author's view is that Professor Bittker, though perhaps appearing too nihilistic, clearly is on the right track.¹⁵ I can best summarize the Bittker-generated debate and at the same time create a framework and reference point for much of the remainder of this article by explaining why I take this position. This requires a return to fundamentals.

The goal in shaping the federal income tax laws is to devise an instrument that raises general revenue and still achieves an optimal balance among the many other purposes that must be served by a tax system and that often are in conflict with one another.¹⁶ Obviously, then, the ideal instrument will not be one that would be ideal if judged solely in terms of one of these goals alone. Of the several significant goals of tax policy, one is fairness; the system of rules must treat similarly situated people alike. The weakness of much tax-policy discussion appears to lie in a tendency to judge the tax system almost exclusively by this criterion, thereby giving inadequate consideration to others. Certainly Simons focused most of his attention on problems of fairness. Sometimes it is said that fairness is more important than other considerations, but the operational content of that statement is virtually impossible to specify. To say that fairness should be served unless it is outweighed by other goals is like saying that fairness should prevail except when it should not, which, of course, is a vacuous statement. Still, one can concede that fairness is always an important goal, and one cannot escape the challenge of trying to achieve fairness, of trying to identify what it is that makes people similar and dissimilar.

Similarity must be measured by a standard tied to some objective. For example, to select members of a football team, the standard might consist of size, speed and agility, and fairness would consist of giving equal treatment to players who are similarly big, fast and agile. In

13. See B. BITTKER, *COMPREHENSIVE TAX BASE* 1.

14. *Id.* at 10, 56-61 & *passim*.

15. See Klein, Book Review, 117 U. PA. L. REV. 633, 636-37 (1969); Klein, *Federal Income Tax Reform, A Reaction to Professor Blum's Twenty Questions*, 42 TAXES 175 (1964).

16. For an excellent, but brief, array of tax system goals, see J. SNEED, *THE CONFIGURATIONS OF GROSS INCOME* 3-5 (1967).

order to shape a general revenue system, the standard probably ought to be related to economic capacity or ability to pay. By adopting that general standard, to be sure, one might be sacrificing the opportunity to achieve even greater fairness by acknowledging other factors such as benefit received, but this article will ignore that dimension of the problem and assume that the correct standard is ability to pay. I suggest—and this point seems to me to be vital—that if one were interested only in achieving the most accurate measure of ability to pay one would examine not just income but several other factors as well. For example, two men with equal incomes might have entirely different tastes for the things that money can buy, and that certainly would be a relevant factor in determining their relative abilities to pay. The more such factors that could be included, the closer one would come to a perfect measure of similarity and dissimilarity of ability to pay. The objection to acknowledging factors such as taste for money is not that doing so, if it could be done accurately and without cost, would fail to promote fairness. The objection is based upon another characteristic of a good tax system—administrative feasibility. Of necessity there must be an accommodation between the conflicting goals of fairness and administrative feasibility (as well as between these and other goals or criteria).

“[T]his is man’s justice, not God’s.”¹⁷ It is the best a government can do. And I suggest that this would be so even if economic costs were ignored because, in achieving man’s justice, it is important to have standards that can be administered as objectively and impersonally as possible. This author has tried to suggest why this is so, stating that the importance of objectivity

seems to lie in the proposition that the government, in collecting taxes, should become involved as little as possible in making interpersonal comparisons. It is thought that government cannot make such comparisons without arousing the antagonism and resentment of the many people who (it is presumed) will inevitably think that others have, without reason, been treated better than they have. This problem is perhaps especially acute in an area such as taxation which is patently political and in which competing claims based on pleas of equity and fairness are not commensurable.¹⁸

E. The Role of Income for Determining a Tax Base

The foregoing discussion attempted to establish that income is a

17. Stein, *What's Wrong with the Federal Tax System?*, in 1 HOUSE COMM. ON WAYS & MEANS, TAX REVISION COMPENDIUM, 86th Cong., 1st Sess. 107, 112 (1959).

18. Klein, *Federal Income Tax Reform*, *supra* note 15, at 176 (footnote omitted).

rough measure of similarity of capacity to contribute to the general revenue. It is a crude device for achieving fairness. Its virtue lies in the fact that it is a reasonably good measure of similarity while at the same time it is reasonably consistent with the goal of administrability (and its subcategory, objectivity). To the extent that the concept of "income" has a substantial content or meaning that exists independently of the tax system, its use will serve "the justice of the distribution of prizes in an unrigged game that all can play."¹⁹ There can, of course, be deviations from the externally related concept that are based on objectively determinable phenomena and that therefore avoid personalized determinations by government officials vested with broad powers. But to the extent that people cannot understand and appreciate the grounds for such deviations, they will feel that the system is unfairly rigged; this is the best argument for the comprehensive tax base.²⁰

What, then, of the Simons formulation or definition of income? In this author's view it is merely a good touchstone for defining income. It is obviously too vague and too broad to be much more. It flourishes because it happens to work reasonably well—as long as it is not taken too seriously.

To recapitulate: (1) fairness is one of the several goals or criteria of a good tax system; (2) income is a good rough measure of similarity of capacity to contribute to the general revenue; and (3) the Simons definition of income is a viable, reasonably concrete concept that corresponds reasonably well to a phenomenon external to the tax system (the layman's idea of income) and that produces reasonably satisfactory results when applied with discretion.

Despite this agnostic view of the Simons definition of income and despite this author's inability to see the luster in the comprehensive tax base, the tax base devised here and endorsed for purposes of the negative income tax is one that should endear him to Simons and his disciples. As in other affairs, the behavior of apostates is often indistinguishable from that of true believers. The differences arise

19. Stein, *supra* note 17, at 111.

20. Cf. Blum, *More on "Twenty Questions,"* 42 TAXES 180, 182 (1964), stating: "As the stew becomes thicker we simply will lose our ability to make meaningful comparisons between persons—the only general standard on which the equity of a direct tax can be tested."

It is also sometimes argued that by conceding the acceptability of the principle of departing from a rigid concept of income broadly defined we encourage the proliferation of departures, and that experience teaches us that most departures will be unwise. But that is a matter of political strategy not of the fairness of the system. And I doubt, in fact, that it is true that the "bad" departures are significantly increased by virtue of the presence of "good" departures.

mostly with respect to wealth utilization provisions rather than with income provisions. This does not mean, however, that a truce in the battle over the positive tax base is imminent. Deafness to the rallying call of the comprehensive tax base leads this author to be much more impressed than otherwise he would be with, among other things, the significance of economic adjustments to mistakes of the past ("old taxes are good taxes") and to be much more tolerant of the use of the tax system for economic stimulation or to buy votes on other programs. For the negative income tax, however, such considerations may not seem important.

F. The Possibility of Using the Negative Income Tax for Achieving Certain Economic Objectives

Consider this question: Should the interest on bonds issued by state and local governments be exempt from taxation—that is, should such interest be ignored in counting income—for purposes of the negative income tax as it is for purposes of the positive income tax? The rationale usually offered for the positive tax exemption is that it reduces the cost of financing state and local government by inducing people to accept a lower rate of interest on such bonds than they would insist upon for taxable bonds. The federal government sacrifices revenue for the sake of conferring a benefit on state and local units. In the process it bestows on some individuals tax benefits that unequivocally offend the criterion of interpersonal fairness. The unfairness—the windfall to the individual—is accepted for the sake of the contribution to federalism. Why, then, should not the same kind of benefit be conferred by the negative income tax? After all, no one would suggest that certain *rentiers* receive the benefit of tax exempt interest because people whose income is from other sources deserve to pay more and the people who own the tax exempt bonds deserve to pay less. So the poor need not be deserving in order to reap the windfall; all they have to do is promote federalism by buying the low-yield bonds. Moreover, a dollar lost in taxes by virtue of the exemption is worth no less to the government than the dollar that would be lost by virtue of the same exemption in the negative income tax. It may be suggested that there is no sense to a negative income tax exemption because the poor do not have funds to invest in bonds anyway. That argument simply will not wash. To the extent that the poor fail to take advantage of the exemption it costs the government nothing; to the extent that they do, the objective of the exemption is achieved and the cost to the government is just as readily justified as it is in the case of the positive tax system.

What about the wealthy person whose entire capital is invested in tax-exempt bonds and who, as a result, has no taxable income? Should he be permitted to claim income-maintenance payments along with his tax bounty? Why not? As pointed out earlier, the payment of those income-maintenance dollars hurts the rest of the taxpaying public no more than the loss of the tax dollars. So why draw a line?

A similar argument can, of course, be applied to other holes in the tax net, such as percentage depletion. The dollar that an oil millionaire "is ahead by virtue of an extra-generous depletion allowance is worth just as much to him, and costs other taxpayers just as much in additional burden, as money that he would be ahead by virtue of a payment under the negative income tax."²¹

Possibly the only answer to this is simply that enough is enough. Or perhaps people think that the poor should set a shining example of fiscal rectitude. Maybe the idea is that people won't miss the income-maintenance benefits that they never had. In any event, there is apparently no significant support for the proposition that the poor should be treated to the same tax "incentive" windfalls as the rich.

Before examining specific issues, two additional general observations should be made. First, this writer's inclination as a lawyer, and particularly, perhaps, as a tax lawyer, has been to draft a statute that is reasonably explicit, one that apprises people formally and openly of rules that they can rely on. This is a departure from the "your-friendly-caseworker-knows-all" attitude of traditional welfare, under which legislatures have typically written mandates to the welfare administrators about as explicit as the injunction, "go out and do right."²² Secondly, it must be recognized that some of the rules that may seem out of place in a poverty-relief program, such as rules relating to oil depletion, are designed to prevent "horror" cases, such as welfare payments to the oil millionaire who, by virtue of percentage depletion, has no taxable income. It is a far greater "horror" that the government is deprived of many thousands of dollars of tax revenue from such a person than that it might be deprived of a few dollars of welfare payments, but that is another matter.

II. GIFTS, SUPPORT, ALIMONY, INHERITANCES AND LIFE INSURANCE PROCEEDS²³

In one of the most significant and revealing chapters in his classic work on the definition of income, Simons argues for inclusion of gifts

21. Klein, *Basic Problems* at 785.

22. See Klein, *From the Thoughtful Tax Man*, 44 *TAXES* 461 (1966).

23. See Model Statute §§ 8(B)(3)-(4), 8(C)(2)-(3).

and inheritances in the tax base.²⁴ That argument serves as the theoretical foundation for an important distinction between the negative and the positive income tax—namely, the inclusion in the negative income tax base of gifts from persons who are not members of the family unit.²⁵ The reason for inclusion of gifts and similar receipts is simple, though often difficult to grasp for people who are accustomed to the existing positive tax system or who are mesmerized by the word “income.”²⁶ Properly understood, the income tax is not really a tax on income but rather a tax on people according to their income. The source or nature of receipts that enhance one’s wealth is irrelevant. From the viewpoint of the recipient, money is money; money that is received as a gift is worth no less than money received as wages. The argument has been made that even under a negative income tax, gifts should be excluded (at least in part) because otherwise potential donors may be discouraged from making gifts²⁷ and presumably gifts to the poor should be encouraged. This is much like the kind of argument so familiar in the positive tax system—that fairness should be sacrificed²⁸ for the sake of economic incentive. Even if this dangerous gospel were embraced with respect to gifts,²⁹ there would remain another serious objection to excluding gifts from the tax base. The objection arises from the fact that support payments will be included in income (for reasons that will be stated shortly) and that it would be

24. See H. SIMONS, *supra* note 11, at 125-43. To argue that gifts are income is to ignore common parlance. As suggested above, pp. 455-57 *supra*, an argument can be made for adherence to a standard (the layman’s or accountant’s definition of income) that is external to the tax system and that thereby promotes objectivity. On balance, however, it seems appropriate to sacrifice that form of objectivity for the sake of the greater fairness that is achieved by including gifts and inheritances in the tax base. See Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word “Gift,”* 48 MINN. L. REV. 215, 224 (1963) [hereinafter cited as Klein, *An Enigma*].

25. If the family is treated as the appropriate unit for purposes of measuring economic well-being see Klein, *Family Unit passim*, then transfers within the unit must be ignored since they do not alter the economic well-being of the unit.

26. See note 24 *supra*.

27. See Tobin at 13-14.

28. The individual with income in the form of gifts would pay no tax while the individual with the same income from wages would pay a full tax. The argument based on effect on donors implicitly accepts the Simons definition and thus concedes that the difference in tax liability is inequitable.

29. It is curious that Joseph Pechman, a strong proponent of the comprehensive tax base, should accept this kind of erosion of the negative income tax base, see Tobin at 13, while a skeptic like me should regard the argument for it as wholly unpersuasive. My guess is that the explanation for this reversal of roles lies, at least in part, in different appraisals of the relationship between giving and favorable tax treatment of the recipient, and thus in different estimates of how much incentive would be achieved at the cost of how much unfairness. My view on this issue is no doubt related to the point that is discussed next in text—namely, that gifts to the poor will ordinarily be difficult to distinguish from support payments.

very difficult to distinguish gifts from support payments.³⁰ Indeed, it has seemed to this author that once it is decided to include support payments in income, the necessity for including gifts becomes almost inescapable to anyone who thinks seriously about how to draw a line between the two. To be sure, the problem of drawing the line is not likely to be serious in the case of support of minor children by their parents for two reasons. First, if the tax unit is the family, as is likely, then transfers (including support) within the family will be ignored regardless of whether they might otherwise be income. Secondly, almost any amount actually spent on a minor child is likely to be regarded as support; other transfers, such as the creation of a savings account or the gift of a luxury item, are likely to be rare. The line-drawing problems will be more serious, however, in the case of transfers to other persons, such as adult children, parents, brothers and sisters. What the legal or moral obligation of support may be in such cases becomes much less obvious and it is even difficult to imagine any commonly accepted nonlegal basis for differentiating between gifts and support—largely because in the past there has been little reason for differentiation.

If gifts are to be included then it should be made clear that gifts in kind, including food and lodging, must be treated the same as cash gifts. That raises the obvious administrative problem of estimating the value of in-kind gifts; rules of thumb would no doubt need to be developed. But it would be grossly inequitable to include gifts in cash and not gifts in kind. It does, of course, make sense to ignore certain kinds of benefits,³¹ such as a dinner bought at a restaurant by a parent for his child. To some extent administrative discretion can be relied upon to eliminate such problems, but it also seems useful to have a flat exemption to cover trivial benefits.³²

The Model Statute contains a provision that treats trust distributions of capital as income, on the theory that these distributions are like gifts for which delivery has been delayed. That provision was not,

30. See Klein, *An Enigma* at 226 n.50.

31. See H. SIMONS, *supra* note 11, at 135-36.

32. Such an exemption might become an umbrella for regular cash gifts, as experience with the \$3,000 per year federal gift tax exemption illustrates. Nonetheless, the rules for the rural negative income tax experiment seem to limit the exemption both too severely and at the same time not severely enough in providing for inclusion of all gifts "except that gifts for special occasions (e.g., birthdays, anniversaries, graduation, Christmas, etc.) [are] included only to the extent that they exceed \$50 in value (to the recipient) per gift." *Rural Rules* at 16. The limitation by occasion seems too restrictive; the \$50 per gift not restrictive enough. The idea of value "to the recipient" is a very sensible one. The enforcement problem has led one writer to suggest exemption of all gifts. Popkin, *Administration of a Negative Income Tax*. 78 YALE L.J. 388, 392-93 (1969).

however, intended to cover distributions of capital that had previously been reported for tax purposes by the distributee—as, for example, in the case of a distribution of the corpus of a revocable trust that the distributee had established with his own funds.³³

As in the positive tax system, alimony³⁴ payments are included in the income of the recipient and are deductible by the payor. The negative income tax, unlike the positive tax, does treat support payments the same way,³⁵ and the reasons for this seem obvious. The negative income tax is, after all, an effort to respond to the problems of economic need; a person who receives support from someone else has reduced his need to that extent and it would seem absurd to ignore the fact. Alimony and support are likely to be major components of the resources of many families. Thus, whatever may be the justification for excluding support payments from income for purposes of the positive income tax, the appropriateness of inclusion for purposes of the negative income tax seems beyond dispute.

There is one problem with alimony and support payments that is not so easily resolved: the lump-sum settlement. In the positive tax system lump-sum transfers incident to the dissolution of a marriage are not treated as income to the recipient.³⁶ The rationale for this rule is that such transfers are in the nature of capital divisions. For example, suppose that a husband and wife have two cars, and that the husband has legal title to both. Assume that, incident to divorce, the wife takes one car and the husband takes the other car, or that the husband transfers the house and the savings account to the wife. It seems inappropriate to treat such transfers as income to the wife; it would be unrealistic to think of her as having become richer.³⁷ Rather, there

33. The Model Statute inclusion of all trust distributions of capital reflects a sacrifice of accuracy for simplicity. A provision dealing precisely with all possible trust arrangements would have been excessively complex, but the problem of how to treat ordinary distributions of capital from a trust seemed to me sufficiently significant to warrant some mention in the statute.

34. Technically it is unnecessary to have a rule expressly including alimony in income, since the rules begin with a provision sweeping in everything that would be included in adjusted gross income under the Internal Revenue Code, and that covers alimony. While technically unnecessary, express inclusion serves to avoid confusion for people who are not familiar with the Code or who lose sight of the general provision and who would begin to wonder about alimony when they note the inclusion of support payments.

35. The Model Statute fails to make clear, as it should and as the rural statute does, that support in kind, as well as cash support payments, should be included.

36. INT. REV. CODE OF 1954, § 71. Nor are such transfers treated as gifts for gift-tax purposes. See INT. REV. CODE OF 1954, § 2516.

37. It may be that in a more legalistic sense, too, she has not become more wealthy on the occasion of the divorce, since marriage gave her inchoate claims against

has been what most people would consider, in most cases, a mere division of the family assets.³⁸ Thus, such lump-sum settlements³⁹ should not be regarded as gifts, alimony or support payments, and should be excluded from income. The rule should be limited, however, to transfers between husband and wife.⁴⁰ No matter how badly a child wants, and feels he deserves, his father's wealth, he does not have the same kind of claim to it that a wife has to assets held in her husband's name.

Inheritances and life insurance proceeds are included in income for essentially the same reason that gifts are included. There is an exception, however, for inheritances from a deceased spouse, for the same reason that a lump-sum settlement incident to divorce is excluded—namely, that the assets passing by inheritance are likely to be thought of as family assets that, as a practical matter, had belonged to the survivor already.⁴¹ Perhaps by analogy one could justify a modest exclusion for property passing to children by reason of the death of a parent, though in my view such inheritances seem enough like substitutes for support payments to justify their full inclusion.⁴²

III. CAPITAL UTILIZATION⁴³

Already examined in general terms was the question of whether the level of an individual's benefits should vary with his wealth or

her husband in the event of divorce. On this theory, the enrichment occurred at the wedding or during the marriage. *But see* United States v. Davis, 370 U.S. 65 (1962).

38. In community property states this is the legally correct characterization with respect to property acquired from earnings during marriage. One reason for excluding the lump-sum settlement from income, then, is to eliminate disparities between states based on their property law.

Any attempt to distinguish between assets acquired from earnings during marriage and assets held before marriage or inherited would seem unduly complex and sophisticated for purposes of the negative income tax, particularly in light of the fact that inclusion of an item in income will only affect payments for a limited period, probably a year at most. *See generally* Asimow & Klein.

39. The rules of the positive tax system can be used to distinguish between lump-sum transfers in installments and alimony or support, though somewhat more restrictive rules might be thought appropriate for purposes of the negative income tax.

40. Normally transfers during marriage will be excluded by virtue of the fact that they will be transfers within the same unit. If the husband has deserted but there has been no divorce or other legal separation, it is more difficult to fashion a rule providing for exclusion of lump-sum settlements; it seems advisable, therefore, simply to treat all payments as support. Thus, the negative income tax should follow the positive tax rule limiting the exclusion of lump-sum settlements to those transfers that are incorporated into a judicial decree of divorce or separate maintenance.

41. *See* H. SIMONS, *supra* note 11, at 142-43.

42. Again, one must be careful not to exaggerate the significance of inclusion of a substantial lump sum. The inclusion of income will affect payments for a limited period. *See* note 38 *supra*.

43. *See* Model Statute §§ 8(B)(1), 8(B)(9), 8(B)(17)-(18), 8(B)(24).

capital—in other words, whether an individual should be expected to support himself by dipping into capital, before turning to the government for income-maintenance payments. Assuming an affirmative answer to this question, the problem now to be considered is, how far should the utilization-of-capital concept be carried—that is, at what rate should capital putatively be consumed and what kinds of assets should be exempt?

Preliminarily, the distinction between capital utilization and imputed income must be emphasized. Suppose a person owns 10,000 dollars worth of publicly traded common stock⁴⁴ and that the stock pays no dividends, but experiences capital appreciation at a rate of five percent a year. Although the owner will have no income for positive tax purposes, we can assume that he expects gain in the form of capital appreciation. A strong case can be made for imputing a return at the market rate and for including this amount in income.⁴⁵ At the same time we might agree that in determining the level of benefits we should assume that the individual can reasonably be expected to sell some portion—say 10 percent—of his stock each year, or borrow a comparable amount against it, and treat this amount as current income. Thus, the owner of the common stock valued at 10,000 dollars would have imputed income of 500 dollars (five percent) and capital utilization income of 1000 dollars. The reason for separate provisions to measure imputed income and capital utilization “income” would be to assure similar treatment for those whose assets yield differing current returns below the codified fair market return. The original drafts of the rules for the New Jersey income-maintenance experiment⁴⁶ contained the

44. Perhaps more typical among the poor would be ownership of comparable amounts of farm land or other real property.

45. For situations in which there is some current income, but it is low, income would be imputed at the market rate but actual income below that rate would be ignored. The imputation of income at the market rate is far simpler than calculation and inclusion in income of unrealized appreciation, and it does not seem unfair to tax a person on the income he could have earned. The arguments for income imputation on such assets as owner-occupied homes are familiar to tax theorists and are reviewed briefly in section IV of this article. Basically, the argument for income imputation from home ownership assumes a value of occupancy to the individual equal to his economic opportunity cost. The argument for income imputation from investment assets can rest on the analogous notion that the appreciation in the value of property that does not yield income will equal the opportunity cost in current income. Alternatively, imputation of income from investment assets could rest on the harsher notion that one ought to earn as much as he can, and if he doesn't, we will nonetheless treat him as if he did—just as we do in traditional welfare practice with a person who refuses to take a job.

46. These were rules drafted in 1967 during the planning stages of the New Jersey experiment. Neither an imputed income (other than from home ownership) nor a capital utilization provision was actually used in that experiment, since it was concluded that such provisions would be more trouble administratively than they would be

two separate components, "imputed income" and "utilization of capital."⁴⁷ Ultimately, however, it was decided that this approach was overly refined for application to the people for whom the negative income tax is designed. Consequently, precision was sacrificed for simplicity and administrative convenience, and the imputed income component was dropped, with the thought that any concern about imputed income could be allayed by the presence of the utilization-of-capital provision.⁴⁸

Another refinement that makes some sense but that was ultimately rejected as excessively complicated and sophisticated concerns the rate at which capital is to be utilized. Under traditional welfare and the defunct Family Assistance Plan,⁴⁹ the rate of utilization has been 100 percent. That is, no benefits are paid until nonexempt assets have been exhausted. Once this extreme position is abandoned, however, one is confronted with the question of how fast a person should consume his capital. One obvious consideration is his life expectancy. This suggests that capital should be annuitized, or at least that the rate of utilization should somehow vary with life expectancy. This was the refinement that was ultimately abandoned. The rate finally adopted for inclusion of capital in the tax base was 10 percent⁵⁰—a nice, round, easy-to-work-with figure that is about as liberal as it can be without scrapping the capital utilization concept completely.

The potential harshness or unfairness of a capital utilization provision can be mitigated not only by a low rate but also by liberal exemptions. Liberal exemptions also act to reduce some very serious valuation problems. The decisions about exemption reflected in the Model Statute⁵¹ seem reasonably self-explanatory. The dollar amounts

worth among the particular population selected for the experiment. In the rules for the rural experiment a capital utilization provision was adopted and has been applied.

47. The same approach was later followed in *Yale Statute* §§ 12, 13.

48. This position is reflected in the Model Statute. The rural rules, however, do contain a provision imputing income from home ownership. See *Rural Rules* at 17.

49. H.R. 1, § 2152(a)(2).

50. See Model Statute § 8(B)(24)(a). It must be noted that 10% is the amount that is treated as income and that income is taxed at a rate less than 100%. Thus, a person is putatively expected to consume capital at a rate less than 10% (depending on the tax rate) if he chooses to live at the poverty level of resources. Alternatively, he can live at a higher level by consuming the full 10% of his assets—just as he could live at a higher rate by consuming fully a comparable amount of current earnings. *Yale Statute* § 13 incorporates an inclusion rate of 30% (in addition to imputed income at a rate of 5%). Tobin at 18-19 wrote in terms of reducing benefits by 10% of capital; assuming, as did that article, a 50% tax rate, this would be equivalent to inclusion in income of 20% of capital.

51. See Model Statute § 8(B)(24)(b). A few minor points may need clarification. The phrase "trade or business that includes an owner-occupied home" in § 8(B)(24)(i) has reference primarily to farms.

are matters of taste and unscientific judgment. Only one aspect seems worthy of brief discussion: the use of separate exemptions for different classes of property. The rationale for separate exemptions is dual. First, it may seem more reasonable to expect a person to liquidate for current consumption some kinds of assets (such as a bank account) than others (such as a home or business). Secondly, if there is an overall exemption and if a rough estimate suggests that the exemption might be exceeded, all classes of assets must be valued. With separate exemptions for different classes of property, valuation of some assets can be avoided even if the value of another class of assets is so great that any overall exemption would be exceeded. Similarly, valuation problems may lead to a much higher exemption for difficult-to-value assets, such as businesses, than for relatively easy-to-value assets, such as stocks and bonds.

On the other hand, exemption by classes of assets inevitably produces unfairness. The person whose wealth is invested in one form of property may be better off than the person whose wealth is invested in another. At the same time, people will be induced to transfer their wealth from low-exemption assets to high-exemption assets and there may be no good reason for such economic incentives. On balance, however, the drafters of the Model Statute elected to use separate exemptions.

The use of separate exemptions requires that rules be fashioned so that, before the exemption is applied, the value of each class of assets is reduced by the debts those assets secure.⁵² This explains the drafting technique of referring to the equity in each separate class of assets. The reason for this approach, and its effects, can best be explained by use of an example. Suppose that the exemption for business assets is 10,000 dollars, and that the exemption for a home is also 10,000 dollars. Suppose further that a man owns a business with a value of 10,000 dollars, and that it serves as security for a loan of 6000 dollars so that the man's equity in the business is 4000 dollars. Finally, suppose that the man also owns a house with a value of 20,000

The exclusion in § 8(B)(24)(b)(v) for "the value of any pension, annuity, or retirement benefit" should be expanded to cover life estates. The exclusion avoids overlap with § 8(B)(1). The rural rules contain the additional phrase, "or of any other such conditional assets that can reasonably be expected to terminate upon the members' death," which strikes me as a sensible addition, though I might phrase it differently. The rural rules seem to have achieved another improvement by striking "retirement benefit" from their counterpart of § 8(B)(1) and from the exclusion in § 8(B)(24)(b)(v).

52. The alternative is to apply the exemption to the gross value of each class of assets and then to offset the sum of all debts against the sum of net (after exemption) values of all assets.

dollars and a mortgage of 4000 dollars, leaving an equity of 16,000 dollars. Now, if the purpose of the exemption for homes is to "protect" the home up to a value of 10,000 dollars, and no further, this man should have 6000 dollars included in his wealth because of his home ownership. The mere fact that he will be "wasting" 6000 dollars of his business exemption is irrelevant; a man who had no business at all would be wasting the full 10,000 dollars exemption for business assets. Yet to allow him to use any of that exemption for his home would be in effect to adopt an overall exemption.

Obviously this hypothetical man can improve his position by manipulation of his debts. If he can convince his banker to convert 6000 dollars of his business loan into a loan secured by the mortgage on his home, his equity in each class of assets will be reduced to 10,000 dollars so that he will be able to use fully both exemptions and will show no net wealth after exemptions.⁵³ This possibility simply reflects the potential inequality of exemption by asset class.

Finally, under this rubric of capital utilization, brief mention should be made of annuities, and retirement benefits from Social Security and the Railroad Retirement Act. In each of these there is likely to be an element of recovery of an individual's own contribution—a recovery of his savings or capital. Under the positive tax system there is already an exclusion for the capital-recovery element in pensions and annuities.⁵⁴ This kind of capital return is, of course, the kind that most people treat as income in the sense that they regard it as available for purposes of current consumption. It may therefore seem sensible to treat it as income for purposes of determining the need for other benefits. At the same time, however, with this particular

53. To prevent this kind of manipulation, a rule could be drafted under which loans are related to assets by the original purpose of the loan. But that approach makes much less sense than might be imagined and would be difficult to administer. Suppose our hypothetical man owned his home, with a \$16,000 equity, and then borrowed \$20,000 and bought a business worth \$30,000 which served as security for the loan. Why can it not be said that he borrowed the \$20,000 to permit him to continue to own his home while also owning the business? And what if he borrowed money using his home as security and used the money to buy a business?

The problem of allocating loans to particular assets by reference to purpose is handled under the current Code by denying a deduction for "interest on indebtedness incurred or continued to purchase or carry" tax-exempt bonds. INT. REV. CODE OF 1954, § 265. The problem is avoided under § 163(d) (added by the Tax Reform Act of 1969), which, in effect, creates an overall, rather than an asset-by-asset, limitation on the interest deduction. See INT. REV. CODE OF 1954, § 163(d).

54. See INT. REV. CODE OF 1954, § 72. Social Security retirement benefits were initially exempt from tax by virtue of administrative ruling, Rev. Rul. 3447, 1941-1 CUM. BULL. 191, and are now exempt by administrative regulation. Treas. Reg. § 1.61-11(b) (1965). The Railroad Retirement Act expressly exempts from taxation benefits under that Act. 45 U.S.C. § 2281 (1970). See INT. REV. CODE OF 1954, § 6334(a)(6).

capital utilization rule as with others, there is a strong element of unfairness and a strong danger of adverse effects on incentives. The person who saves for retirement (whether voluntarily or not) and acquires a pension or annuity (public or private) is taxed on those savings, as they are used, under the negative income tax; the profligate avoids this tax. To the extent that saving for retirement is voluntary (and even the Social Security System is subject in the long run to the control of its beneficiaries through the political process), the negative income tax will tend to reduce the amount of saving for retirement. It will also at least partially replace other means of providing for retirement, which is not a function that many people would intentionally assign to a negative income tax. These problems of equity and of disincentive to save cannot be ignored under the negative income tax any more than they can be ignored under the positive tax system, and it may well be that the negative income tax rules relating to periodic lifetime benefits should ultimately be reconsidered. At the present time, however, exclusion of the capital portion of such benefits from the negative income tax base would require such a drastic alteration of attitudes toward welfare that it would be futile to press the issue.

IV. IMPUTED, IN-KIND AND POTENTIAL INCOME

Section III analyzed the possibility of a general imputation of income from all assets that do not yield otherwise-taxable returns. That discussion focused primarily on the problem of investment assets that produce gain in the form of capital appreciation rather than current returns. Even conceding that imputation of income from such assets would be unwise, it might be argued that there should be imputation in the case of certain investments—most notably the owner-occupied home—that yield significant returns in the form of current consumption. One reason for distinguishing an owner-occupied home from an investment in, for example, forest land, is that the gain on the forest land will ultimately be realized in a taxable form, while the value of the use of the home, if not captured currently, never will be taxed. Moreover, it may be feasible to respond to the problem of imputing income to the forest land by having a high rate for capital utilization “income.” But the same rate, if applied to the family home (without a very large exemption), would be considered unacceptable. And the forest land problem can probably be dismissed as trivial much more readily than can the problem of the owner-occupied home.

In traditional welfare programs the determination of a person's need, and thus the determination of the payment he will receive, is usually based on a budget calculation that includes a separate compu-

tation of housing costs. The person whose housing costs are reduced because he owns his own home is simply held to have less need for welfare payments, thus accounting for the imputed income from home ownership. In the positive tax system there has never been any such recognition of the value of home ownership, although the argument has often been made that there should be.⁵⁵ An argument on grounds of fairness could be made for ignoring imputed income from home ownership, but at best that argument would be a weak one.⁵⁶ There are other objections to imputation, however, that are more serious. First of all, imputation of income to a family with no other income will result in reduction of cash benefits below the level of the basic allowance—that is, below a level that will presumably be bare subsistence. This reduction will be tolerable in situations in which home ownership results in a low level of out-of-pocket housing expenditure. But it may be that the house is a reasonably valuable one—one that the family could not afford to live in but for its equity—and that the out-of-pocket costs (for mortgage payments, insurance, taxes, maintenance and repair) are comparable to the average rents paid by non-owners in otherwise similar economic circumstances; indeed, there is some evidence that among the poor this is generally the case.⁵⁷ When this is true, if there is a benefit reduction because of income imputation, the family will be faced with a cruel choice: either to sell the house

55. See, e.g., R. GOODE, *THE INDIVIDUAL INCOME TAX* 120-29 (1964).

56. One argument might be that since the gain from investment assets with low current yields is ignored, the imputed income from home ownership should be ignored as well: that one loophole justifies another. I would reject this argument on the ground that it is never sensible to extend a source of inequity unless it is clear that the reason for permitting that unfairness applies with equal force to the extension. Another argument that might be made for ignoring imputed income from home ownership is that such income is comparable to the psychic return that might have been achieved by other uses of the assets invested in the home. For example, suppose two people in identical circumstances each inherit \$10,000. One of them "blows" it on a lavish trip to Europe, while the other "blows" it on a house that he could not otherwise have afforded. The house buyer might genuinely think of his \$10,000 as having been squandered just as if he had spent it on a trip to Europe; it might therefore seem unfair to him that he should be taxed on the return on that outlay while the person who did go to Europe is not taxed on the psychic return on his outlay. This argument seems to me to have some appeal, if it is assumed that the house buyer is not being relieved of a current expenditure for housing that he otherwise would have incurred, so that the claim that his gain is psychic has some basis in fact. (My guess is that many poor people are in a comparable position: they own homes that they could not currently afford to rent.) Even so, the house buyer has not in fact "blown" his \$10,000; he can always sell his house and recover his investment (otherwise there would be no imputed income). And he knows it. The fact that our tax system does not tax psychic gains cannot be used as a justification for failure to tax more tangible returns without abandoning the entire notion of an income tax.

57. See *Measuring Retired Couples' Living Costs in Urban Areas*, MONTHLY LAB. REV., Nov. 1969, at 3, 5-6.

or to pare expenditures on food, clothing and other necessities, to a level even below that provided by the basic allowance.⁵⁸

Another problem with imputation, one that is both more obvious and more serious, is the difficulty of administration. There are many ways, of course, in which the amount of the imputed income can be computed. Probably the simplest is to determine the owner's equity in the house and then impute a return on this amount at the current fair-market rate.⁵⁹ Even this kind of calculation is difficult because it requires knowledge of the house's value—a piece of information that may not be readily available and may change from year to year. Moreover, this method of imputation fails to take account of the rental value of the house to its owner⁶⁰ or of actual out-of-pocket expenses.

Another approach to the problem of imputation is to estimate rental value and reduce this by actual expenses, treating the difference as income.⁶¹ This approach seems fair, assuming that accurate measures of rental value and accurate records of expenses will be available. That is a heroic assumption. At the very least, obtaining the needed information would be very cumbersome.⁶² This administrative barrier by itself would be enough to lead this author to the conclusion that imputed income from home ownership should be ignored. That conclusion is buttressed by the observations previously made, that for most poor people the out-of-pocket expenses of home ownership are likely to equal the rents paid by nonowners in comparable economic circumstances, and that the need for benefit payments is not in fact reduced by home ownership. Moreover, inclusion of home value in the amount on which capital utilization income is based may reasonably be thought to offset the failure to tax the imputed income.⁶³

58. This element of harshness could be avoided by a rule under which imputation could not exceed the difference between a reasonable housing allowance (perhaps a reasonable portion of the basic allowance) and the amount of out-of-pocket housing expenses. This solution produces inequities, to be sure, but perhaps these are less serious than the inequities resulting from a complete disregard of the value of home ownership.

59. See Tobin at 12.

60. For example, the house could be extremely valuable because the land on which it rests is suitable for commercial development.

61. This is basically the approach of both the New Jersey and the rural experiments.

62. In the rural experiments the rules for imputation have become extremely complex and rather arbitrary. In both the New Jersey and rural experiments it is my impression that a great deal of ad hoc, individualized decision-making has been necessary and that imputation has proved workable (and only barely so) solely because of the intelligence, discretion and leniency with which ad hoc judgments have been made. I would be quite pessimistic about the possibility of duplicating such a result on a nationwide basis.

63. Under the Nixon Administration's Family Assistance Plan, H.R. 1, there is no imputed income from home ownership. Eligibility for benefits depends on exhaustion of

A problem related to that of imputed income from home ownership is that of imputed income from living in publicly subsidized housing. Again, imputation creates serious problems of administration—that is, of determining the fair-market rental value of the housing—although these problems are by no means as severe as those arising in the case of owner-occupied housing. Consideration must also be given to the fact that a person may have used the subsidy to acquire better housing than he would otherwise have purchased so that his need for income maintenance payments is not reduced. To resolve these problems, public housing might be viewed simply as a bargain purchase that should be ignored like many other bargains.⁶⁴ Moreover, it may be best to ignore the value of publicly subsidized housing in the hope that such a policy will lead to the ultimate elimination of the subsidy. If the negative income tax does not reflect the housing subsidy then, at least if one can assume that there will be adequate negative income tax benefits, the housing authorities will tend to reduce the subsidy by charging higher rents; ultimately there will be no need for the subsidy. Welfare benefits will then probably assume the form of cash payments rather than in-kind benefits. This is an effect that proponents of the negative income tax applaud because it allows the poor to make their own decisions about what they need the most. These are all reasons why the Model Statute does not include an income imputation for public housing.⁶⁵

At some point, however, the value of low-rent or rent-free housing cannot be ignored. Housing (and food) supplied with a job is often intended as a substitute for other forms of compensation and clearly must be included in income,⁶⁶ despite problems of valuation. Only by eliminating any reward for manipulation can the interests of equity be protected and respect for the system be preserved. The fairest standard for valuation seems to be value to the recipient in terms of the amount that he saves, rather than the amount that the food or housing might bring on the open market.

resources, including the home, but there is an exception to this rule for "the home, to the extent that its value does not exceed such amount as the Secretary determines to be reasonable." See H.R. 1, § 2154(a)(1).

64. Presumably, however, most other bargains are ignored because their value is not determinable. The problem of valuation is less severe in the case of housing, though it is still possible that the subsidized apartment is worth no more to its tenant than what he pays for it.

65. For similar reasons there is no imputation for the value of food stamps, although if it were clear that the food-stamp program were never to be eliminated then it seems to me that the value of the stamps probably ought to be included.

66. See Model Statute §§ 8(B)(7), 8(B)(11). Possibly there should be an exception (as there is in the rural rules) for food and lodging received on a temporary job, on the theory that normal living expenses are not reduced in such a case.

Another issue that is frequently raised in discussions of imputed income, particularly when one thinks of rural areas, is whether home-grown food should be treated as a source of such income. A farmer, for example, may seem considerably better off than a city dweller because of his ability to grow a vegetable garden and to raise and slaughter animals. Unfortunately, difficulty of measuring the value of home-grown food is great and, according to a recent Ways and Means Committee Report, there are "studies which indicate that there is generally very little net financial gain from home produce consumed at home."⁶⁷ Thus this potential source of imputed income is also best ignored.

At this point one may begin to reflect on the other economies and diseconomies that a person may encounter, many of which are related to geographic location. Clearly it is cheaper to live in some places than in others, and the question therefore arises whether the negative income tax should take account of this fact. My own view is that one of the important distinctions between the negative income tax and traditional welfare programs is that the negative income tax is not so tightly tied to need; the individual is given more incentive to make his own decisions and to improve his lot in various ways, including the achievement of certain economies. The economic advantage of living in a rural area is only one of a range of economies of which a person might take advantage. One man might choose to live in the country while another, while staying in the city, might decide to economize by living in a very cheap room or eating very inexpensive food. A welfare budget is, to be sure, a minimal budget for the average family. But it is nonsense to suggest that some people cannot maintain themselves adequately on less money. The freedom to make economic choices is in my view something well worth preserving not only for the sake of personal freedom, but also for the sake of encouraging people to improve themselves. For this reason this author would ignore the economies, and the diseconomies, of geographic location and would have a single payment level for all parts of the country. Others, focusing more on the meeting-the-minimum-needs function of income maintenance programs, have disagreed.⁶⁸

At this point it is convenient to consider a problem that is closely related to that of imputed income, namely, the problem of potential income. One source of potential income is, of course, the job that an unemployed but employable person might take. Conceivably one

67. H.R. REP. NO. 91-904, 91st Cong., 2d Sess. 15 (1970). The cited quotation is part of the Report's explanation of the failure to include the value of home-grown food in income for the purpose of the Family Assistance Plan.

68. See *Yale Statute* at 295-96, 299.

might impute income to a person who turns down a job,⁶⁹ though perhaps it is simplest to follow the traditional approach of declaring such a person (and his family) ineligible for benefits. This raises the question whether there should be a work test in the negative income tax—a question that is beyond the scope of this article.

Another source of potential income is payments that might be made from other government programs such as veterans' benefits. Again, the question is the extent to which the negative income tax should be designed to force people to seek such payments. In the Family Assistance Plan, under which those payments were categorized as unearned income and taxed at 100 percent, compulsion apparently was thought to be necessary.⁷⁰ In the negative income tax scheme such payments would be taxed like any other income, at a rate less than 100 percent; such compulsion seems unnecessary and therefore inappropriate.

A significant source of potential income is the gifts or legally required support payments given by relatives. Of course, amounts actually received from relatives (or anyone else) will be included in income. Presumably minor children will not be allowed to claim benefits themselves so they are not a problem. There is concern most often about young persons, including college students, who lack independent incomes, but have wealthy parents. No matter how wealthy the parent, if he has no legal obligation to provide support and in fact refuses to do so, it is difficult to see why his child's benefits should be reduced at all.⁷¹ It may be thought sensible to place upon the child the burden of establishing that in fact the parent has refused to provide support, though the prospect of determining what constitutes "refusal" and how it can be established is rather appalling. When the parent does have an obligation to support, then perhaps the child should be expected to enforce that obligation. It would be exceedingly difficult to determine how much the parent could be expected to contribute; legally this is a matter of state law. In the interest of simplicity, however, an arbitrary portion of the parent's income might be treated as imputed income of the child. The question that must also be faced is whether other obligations of support, such as the child's obligation

69. The amount of the imputation can be sufficient to eliminate benefits for the entire family or just for the person who refuses to work.

What about the possibility of imputing income for positive tax purposes to the professor who easily can make more money, and thus make greater tax contribution to the Treasury, by taking a job in industry?

70. H.R. 1, §§ 2152(g)(1), 2153(a)(2)(A); H.R. REP. No. 92-231, 92d Cong., 1st Sess. 175 (1971).

71. Of course, benefits might be denied to those individuals, in or out of college, who refuse to earn their living. That is another matter.

to support his parents, should also be the subject of a rule designed to induce enforcement of the obligation. This author has heard no suggestion that there should be such a rule. But if only parental obligations to young children are the subject of such a rule, then it must be recognized that the federal law is revising what has traditionally been regarded as a matter for the states to decide. Efforts to deny benefits to young people because of their life style or because they have rejected their parents and shunned help from them are likely to produce harsh and unfair results.⁷²

V. MISCELLANEOUS PROBLEMS

There are several sources of income for which it is virtually impossible to fashion any persuasive argument to justify the exclusion from taxation that the present positive tax laws provide. For such items—for example, certain prizes and awards and unemployment compensation⁷³—there is sufficient consensus on the desirability of inclusion in the tax base, even within the positive tax system, that no discussion is included in this article. For other sources, such as capital gain (excluded in part under the positive tax system and taxed in full under the negative income tax), the consensus may not be so strong.⁷⁴

72. Against the chance that this conclusion would not be accepted, we drafted the following section that can be added to the Model Statute:

8(B)(25)(a) In the case of any person who is less than 21 years old, an amount equal to one-tenth of the income (as defined in subsection 25(b) below) of his parents (other than a parent who is a filer or a member of a unit receiving benefits under this Part), except to the extent that it can be established, under Regulations promulgated by the Secretary, by such person under 21 years old, if a filer, or by the filer who claims such person as a member of his unit, that such parents have no legal obligation to support such child, or cannot with reasonable diligence on the part of the filer be induced to provide such legally required support; but nothing herein shall alter or reduce the effect of section 8(B)(4), relating to the inclusion of gifts and support payments in income.

(b) For the purposes of the subsection income means taxable income as defined in section 63 of the Internal Revenue Code of 1954, less \$5,000 for two parents filing a joint return or \$2,500 for each parent filing a separate return (or treated as if filing as separate return under subsection 25(c) below).

(c) If the parents of a person under 21 years old do not file a joint return, and if either of them files a joint return with some other person, the income of such parent filing with such other person will be determined as if such parent had filed a separate return.

73. See INT. REV. CODE OF 1954, §§ 74, 104.

74. Probably the most persuasive arguments for special treatment of capital gains have to do with the use of the tax system to promote economic growth (at the expense of current consumption) and with ensuring economic efficiency by reducing an impediment to mobility of capital. Most people seem to think that a negative income tax should not be designed to promote economic goals at the expense of the fisc, and to the extent that that is the case the principal justification for special treatment of capital gain under the positive tax system does not apply to the negative income tax.

but no special problems arise under the negative income tax and repetition of the pros and cons regarding inclusion in the positive tax base would be pointless. Certain other items do, however, raise some special problems and therefore deserve brief discussion.

The portion of a scholarship that is available for support (including room and board provided in kind) certainly reduces a student's need for negative income tax payments. A comparison with other sources of financial support for students, such as parental gifts or summer earnings, strongly suggests that such scholarships for living expenses must be included in income.⁷⁵ Under the positive tax system, the fact that the scholarship is tied to a particular use might support two separate arguments for exclusion. First, the value of the scholarship may be difficult to estimate. The student who receives free room and board may find the room so depressing and the food so tasteless that his award is virtually worthless to him. Secondly, the scholarship cannot be sold and it provides its recipient with no money to pay taxes. These arguments have very little force in the positive tax system. They seem to have even less force under the negative tax system, in light of the latter's function as a device to provide subsistence and in light of the fact that the "tax" under the negative tax system merely offsets benefits. The propriety of treating the support portion of a scholarship as income would therefore be reasonably clear but for another provision that has characterized negative income tax proposals—namely, the exclusion of public (and, in some proposals,⁷⁶ private) benefits based on need. To the extent that the amount of a scholarship is based strictly on need, one can make much the same argument for exclusion here that is made for exclusion of other benefits based on need. Still, a scholarship is not usually regarded as charity in the same sense that benefits conditioned solely on the recipient's poverty are; it has an incentive or reward element that makes it more like earnings. Moreover, it might be difficult to distinguish between those scholarships that are based strictly on need and those that are not. The arguments for exclusion of welfare benefits based on need are by no means overwhelming. Accordingly, the Model Statute treats scholarships as income, to the extent that they exceed the cost of tuition, fees and books.⁷⁷

An earlier part of this article discusses the question whether the negative income tax ought to be designed to accomplish the same kinds of economic goals as does the positive tax system and that discussion is, of course, pertinent to the question of the proper treatment of capital gains. See pp. 458-59 *supra*.

75. That comparison also suggests that tuition scholarships should be included in income.

76. See *Yale Statute* at 311 (§ 11(b)(4)), 317. See also *Tobin* at 13-14; H.R. 1, § 2152(b)(5).

77. See *Model Statute* § 8(B)(10). To the extent that scholarships are in fact based

The portion of a scholarship that pays tuition, fees and book costs raises similar difficulties but the balance of considerations seems to be in favor of exclusion.⁷⁸ It is true that the negative income tax recipient who is receiving a scholarship is that much better off than the person who must find some other way to finance his education. And if the tax on the tuition portion of the scholarship leaves a person with that much less than the basic, minimal negative income tax allowance, he can work part time or make other adjustments in order to compensate for the deficit. Buying an education can be compared to buying any other extra for which the basic allowance does not provide. On the other hand, the tuition scholarship does not relieve its recipient of any basic support expense that the negative income tax is designed to cover. It does not give him any assets over which he has control. Moreover, the value of the tuition scholarship to the recipient may reasonably be regarded as minimal in most cases. For example, consider the person who accepts a full tuition scholarship to Harvard when he could have attended a state college for virtually nothing, and would have done so but for the scholarship. He has received a benefit, to be sure, but it does not seem to be the kind of benefit that ought to be recognized by the tax system any more than are a variety of governmental services.

Publicly provided welfare benefits and their private charitable counterparts are excluded from income under the positive tax system. The foundation for that exclusion is shaky both as a matter of law and as a matter of policy. Perhaps poor people should not be required to pay income taxes and personal exemptions should be raised to ensure that they do not. But it is difficult to see why a person who earns a given amount should pay a tax while a person who receives the same amount as a welfare benefit does not. Exclusion also seems a crude device for protecting poor people from tax burdens. A person may receive welfare benefits during part of the year and later in the same year may find a job and earn a reasonably good income, in which case, on an annual basis, he is not poor. Perhaps the strongest arguments for exclusion are: (1) that in most instances recipients are in fact poor even on an annual basis and the other cases can be dismissed as trivial; (2) that if a tax were imposed the benefit would have to be increased;

on need, they will be reduced by virtue of the negative income tax. This will mean that the negative income tax will tend to replace scholarships as the principal means of supporting poor students. This prospect raises the question of whether students should be eligible for negative income tax payments. For a discussion of the problem see Klein, *Family Unit* at 400.

78. Cf. H.R. 1, § 2153(b)(7), excluding from income the portion of a scholarship "received for use in paying the cost of tuition and fees."

and (3) that it is simpler to eliminate the tax.⁷⁹ This theory justifies exclusion of benefits supplied by government, and perhaps it is not too great a leap to exclude privately supplied benefits, if such benefits are viewed as substitutes for government benefits. If benefits bestowed by private charity are viewed as counterparts of ordinary gifts and support payments from relatives and friends, however, the case for exclusion becomes much weaker. The drafters of the Model Statute finally decided (but with no great sense of conviction) that governmentally supplied benefits based on need should be excluded but that all privately supplied benefits should be taxed as income.⁸⁰

There is a special rule designed to reduce administrative problems caused by payments from persons—particularly relatives—who are living with a family but who are not members of the family unit for purposes of the negative income tax. It is necessary to decide whether the payments made represent just a fair share of expenses or whether they include as well an element of gift or profit.⁸¹ The drafters agreed that it would be wise to have an arbitrary rule designed to eliminate any question about such payments if they are within reasonable ranges. Thus, the Model Statute provides that if the payment is 25 dollars per week or less for room and board⁸² then it is conclusively presumed that the recipient has no net income from it. For higher payments the recipient is permitted to prove higher costs.

Finally, two special provisions deserve brief explanation. First, included in income is an amount equal to double the amount of any

79. We envisioned that the negative income tax would supplant other welfare programs and would provide payments adequate to meet all basic needs. Other remaining welfare programs would therefore be ones designed to meet needs arising from special circumstances. Where, as in the Family Assistance Plan, the basic allowance is quite low, it must be supposed that state programs supplying basic needs will continue. This raises extremely difficult problems of integrating the state and federal programs. Such problems are beyond the scope of this article.

80. See Model Statute § 8(B)(4). A tax on privately supplied benefits will tend to reduce individual disparities in welfare based on circumstances that are not recognized as significant under any governmentally approved program. Whether or not that is thought to be a good thing will depend in large part on the extent to which one thinks that decisions on the welfare of the poor should be left in the hands of private charities.

81. The problem could also be viewed in terms of allocating costs for purposes of arriving at a proper deduction for expenses. For boarders who are not relatives this may be the most realistic way to approach the problem. For family members it seems more realistic to think about a contribution to joint expenses plus a gift.

82. See Model Statute § 8(B)(4). In accordance with a general inclination to minimize administrative discretion, we specified the amount of \$25 for room and board in the statute. Probably the amount should be tied to a price index and, arguably, it should be an amount determined from time to time by the administering agency. Probably the administering agency should be directed to promulgate rules to cover situations in which varying numbers of means are supplied.

income tax refund. This provision corresponds to one allowing a double deduction of income taxes paid. This is the most convenient way to offset entirely the effect of any positive tax that might be paid, assuming a tax rate of 50 percent under the negative income tax.⁸³ The reason for completely offsetting the effect of the positive tax is simply to ensure that the rate of taxation decided upon under the negative income tax is the effective rate for everyone receiving benefits under it.⁸⁴ Secondly, there is a provision treating as income certain amounts that a person might receive from a trust.⁸⁵ This is designed to remove any incentive to refrain from making discretionary distributions from the trust.

VI. SPECIAL TREATMENT OF EARNED AND UNEARNED INCOME

The subject matter of this section, while perhaps strictly speaking not part of the problem of defining income, is sufficiently closely related to that problem to deserve brief (and therefore admittedly superficial) consideration. A reasonably complete discussion of whether distinctions ought to be drawn between earned and unearned income and, if so, how the line should be drawn,⁸⁶ would require another article at least as long as this one.

To many—perhaps most—people it will not seem unreasonable to view income-maintenance programs as “welfare” (in the sense of quasi-charity) and to conclude that each individual ought to exhaust all his own resources before turning to the government for help.⁸⁷ Under this very traditional view, a 100 percent tax on income and on capital

83. If the tax rate is something other than 50% then the amount of inclusion or deduction is the amount of the tax multiplied by the reciprocal of the tax rate.

84. An argument can be made that a simple deduction of income taxes is enough. See Asimow & Klein at 17-18 n.22.

85. See Model Statute § 8(B)(13).

86. Complexities that arise in distinguishing between earned and unearned income have been exposed in other areas. Under the Federal Insurance Contribution Act, and the corresponding provisions covering self-employment income, taxes are imposed only on earned income (though the term “earned income” is not used). See INT. REV. CODE OF 1954, §§ 3101, 1401. Old age insurance retirement benefits under the Social Security Act may be reduced by virtue of earned income but not by virtue of unearned income. See 42 U.S.C. §§ 403(b), 403(f)(3), 403(f)(5) (1970). Under both sets of provisions, there has been extensive development of detailed rules and interpretations. See, e.g., 20 C.F.R. 404.1026-65 (1973). Under the positive income tax system the distinction has also been applied, though sparingly. It appears most recently as part of the maximum tax on earned income, under which earned income is entitled to certain benefits that are denied to unearned income. See INT. REV. CODE OF 1954, § 1348; Asimow, *Section 1348: The Death of Mickey Mouse?*, 58 CAL. L. REV. 801 (1970). See also Revenue Act of 1971, § 301, adding §§ 4(d)(5), 141(e), and 144(a)(4) of INT. REV. CODE OF 1954, relating to the availability of the standard deduction and low income allowance of dependents.

87. See discussion of capital utilization, pp. 463-68 *supra*.

resources may seem perfectly fair and it may seem that the only reason for a tax at less than 100 percent is to preserve incentives to earn income and thereby reduce program costs.⁸⁸ This view was reflected in the Family Assistance Plan, which imposed no tax on a limited amount of earnings from employment and from self-employment and a tax of 66 2/3 percent on such earnings above that amount.⁸⁹ Most other receipts are taxed at 100 percent, although there is an exception for alimony and child support, which are taxed at 66 2/3 percent.⁹⁰ The House Committee Report on the Family Assistance Plan, however, took the position that there should be a less-than-100-percent rate because "a family would have little incentive to assist in obtaining support from an absent parent if all such income were counted to reduce assistance payments."⁹¹ The incentive consideration did not prevail, however, for many other sources of income that might be expected to disappear in the face of a confiscatory tax.

The position taken in the Family Assistance Plan regarding unearned income was consistent with its provision denying benefits until assets (above certain exemptions) have been exhausted.⁹² For example, to tax fully dividends paid on shares of stock becomes scarcely significant once it is decided that the value of the shares themselves are to be taxed at 100 percent. If the Family Assistance Plan had been implemented either provision probably would have removed any incentive to save and invest for those who expected to rely eventually upon Family Assistance Plan benefits. Certainly, these provisions would have made it impossible for people receiving benefits (particularly the working poor) to save enough to raise their standard of living above poverty level. Moreover, such a confiscatory tax could be highly unfair because it would reduce the prudent saver who requires assistance to the same category as his profligate counterpart. But presumably this unfortunate assault on the puritan ethic is accepted from concern for

88. Under the Social Security Act, by comparison, there was initially a tax of 100% on earned income (and no tax on unearned income). One reason for the 100% tax was simply that where there was earned income there had not been a retirement and therefore there was no occasion for retirement benefits. See Myers, *Earnings Test Under Old-Age, Survivors, and Disability Insurance: Basis, Background, and Experience*, Soc. Sec. BULL., May 1964, at 3. In addition, the 100% tax "reflected the prevailing pessimistic attitude toward the labor market in 1935, when it was hoped to encourage retirement, thus vacating jobs for younger people." E. BURNS, *THE AMERICAN SOCIAL SECURITY SYSTEM* 87 (1949). Presently, there is no tax on the first \$1680 of earned income, a 50% tax on the next \$1200 and a 100% tax thereafter (up to the amount of the benefit). See 42 U.S.C. §§ 403(b), 403(f)(3) (1970).

89. H.R. 1, §§ 2152(b), 2153(b)(4).

90. H.R. 1, § 3153(b)(9).

91. H.R. REP. No. 92-231, 92nd Cong., 1st Sess., 178 (1971).

92. See H.R. 1, § 2152(a)(2).

reducing short-run program costs⁹³ and from a belief that no one should receive government income-maintenance payments while he still has any resources with which he can support himself.

In contrast to the position taken by the drafters of the Family Assistance Plan, the drafters of the Model Statute believed that the distinction between earned and unearned income should be rejected. This belief in part reflects that the reference point for the Model Statute is the positive tax system⁹⁴ and that the statute views income maintenance to be more like insurance protection than like charity.⁹⁵ Moreover, the drafters did not want to discourage habits of thrift, whether in the form of a savings account, a private pension, the equity in a home or some other asset. Finally, they were certain that much of the "unearned" income of the people who are most likely to receive negative income tax benefits would be exhausted very quickly if subject to a 100 percent tax,⁹⁶ so that even in the short run the tax would increase program costs without improving the position of beneficiaries.

VII. DEDUCTIONS

A. Business Deductions

(1) Wage Earners

The positive tax system is rather parsimonious in its allowance of deductions to wage earners for the costs incurred in connection with their wage-earning activities. For example, commuting expenses are nondeductible although in many situations such expenses may be an unavoidable cost of taking or holding a job.⁹⁷

It seems likely that for most poor people, commuting costs do not arise because of any personal preference for a specific residential location, but rather because of a decision to take the only job available.⁹⁸

93. In the long run, of course, depending on the extent to which people can anticipate their future need for Family Assistance Plan benefits, costs might be reduced by leaving an incentive to save and invest.

94. The form taken by the Family Assistance Plan, on the other hand, plainly reflects the fact that it was drafted by people whose prior experience had been with the traditional welfare system. For example, instead of imposing a "tax" on income, at a given rate, the Plan offsets benefits from income on a dollar-for-dollar basis, but then "ignores" part of certain income. See H.R. 1, §§ 2152-53.

95. See pp. 452-53 *supra*.

96. *E.g.*, rent from lodgers and income from modest savings accounts.

97. One such situation arises when a construction worker unable to find work near his home takes a temporary job requiring him to drive many miles daily to reach the work site and to return home. See Klein, *Income Taxation and Commuting Expenses: Tax Policy and the Need for Nonsimplistic Analysis of "Simple" Problems*, 54 CORNELL L. REV. 871 (1969).

98. See *id.* at 896.

Thus, for them, commuting costs are expenses of earning an income; refusing to allow this deduction not only is unfair but, by substantially reducing the incentive to work, it also undermines one of the principal goals of the negative income tax.

Allowance of a deduction for commuting expenses obviously would create a difficult administrative problem, though seemingly not much more difficult than the one arising from the positive tax system's rule allowing the deduction of travel expenses away from home.⁹⁹ Rules of thumb no doubt would be required—for example, a rule allowing 12 cents per mile as the cost of commuting in one's own automobile. Through such rules, and perhaps an arbitrary limitation on total deductions, it seems that allowing a deduction for commuting expenses would be entirely feasible.

To avoid the administrative burdens imposed by a commuting-expense deduction while simultaneously including some provision for such costs to preserve incentives to work, an exemption of a flat dollar amount of earnings has been proposed. The exemption presumably could be large enough to defray not only commuting expenses but also the cost of clothes, meals and union dues. Such a deduction could even be generous enough to cover amounts withheld from wages for private pension plans and for OASDHI. The obvious objection to such an approach is that, if it is adequate for most workers, it will certainly overcompensate some.¹⁰⁰ This is particularly true if the exemption is a fixed amount for a relatively long period of time—such as 720 dollars per year¹⁰¹—rather than a daily allowance or one that is related to the amount earned. The more accurate approach, allowing actual costs, should at least be tried. If it proves not to be worth the cost of administration then other approaches can be tried.¹⁰²

Even those who doubt that commuting expenses should be deductible are unlikely to deny the importance of allowing a child care deduction; it is generally conceded that allowance of such a deduction

99. See INT. REV. CODE OF 1954, § 162(a)(2).

100. It might be argued that, for the worker who in fact has no significant work-related expenses, the exemption can be thought of as a device for improving incentives to work; it is difficult, however, to justify providing an incentive only to those workers who by chance have jobs involving low work-related costs.

101. See H.R. 1, § 2153(b)(4), allowing an exemption of "the first \$720 per year (or proportionately smaller amounts for shorter periods)."

102. My view on this issue did not prevail in the drafting of the Model Statute, under which there is no deduction for commuting expenses. As I recall, my cohorts in the Model Statute venture were not persuaded (as I was) that there are compelling reasons for departing from the well-known rule of the positive tax system. I would contend that my article on commuting expenses, note 97 *supra*, adequately meets that burden of persuasion.

is essential to preserve the work incentives of poor people.¹⁰³ The only serious questions are: how much of a deduction should be allowed, and under what circumstances? The Model Statute adopted the provision found in the positive tax law,¹⁰⁴ which at the time the Model Statute was adopted was a narrow provision¹⁰⁵ with some rather bizarre limitations.¹⁰⁶ In 1971 Congress liberalized this provision significantly by allowing a deduction for household expenses other than child care.¹⁰⁷ It is certainly questionable whether a welfare program could be similarly generous without incurring the public's wrath.

In the positive tax system amounts withheld from an employee's wages and paid into a pension plan are included in his income even though he could not choose to take the money¹⁰⁸ in lieu of the pension

103. An alternative to allowing such a deduction is to provide free child-care services, as under the Family Assistance Plan. See H.R. 1, §§ 2112, 2132. Providing such services in kind seems inconsistent with one of the important objectives of the negative income tax in that it limits freedom of choice. In addition, if the service is provided free, as it would be under the Family Assistance Plan, the incentive on the part of the user to find more economical alternatives and to monitor the costs of the program are eliminated. With a 50% tax rate under the negative income tax, half of the cost of child care still rests on the user. Moreover, the poor are treated like the nonpoor in that they are relied upon to make their own choices about how their children should be cared for—and for that matter about whether or not it is worthwhile to work in light of the child care cost.

104. Revenue Act of 1964, Pub. L. No. 88-272, § 212(a), 78 Stat. 19, as amended, INT. REV. CODE OF 1954, § 214[hereinafter cited as Revenue Act of 1964; provisions of the Act as codified in the Internal Revenue Code will be indicated in parentheses].

105. Under § 214(b)(1), the maximum deduction was \$600 per year for one child and \$900 per year for two or more children (regardless of how many days or months in the year the taxpayer worked). In certain instances the deduction was reduced dollar for dollar as income exceeded \$6000 per year—which, of course, for people with such deductions, doubled the tax rate from what it otherwise would have been in the range just above \$6000. See Revenue Act of 1964, § 212 (§ 214(b)).

106. For example, a married man was entitled to a deduction only if his wife had been incapacitated or institutionalized for at least 90 consecutive days. Revenue Act of 1964, § 212 (§ 214(c)). A married woman could ignore the deduction phase-out for income over \$6000, see note 105 *supra*, if her husband was "incapable of self-support because mentally or physically defective" or if he had deserted. Revenue Act of 1964, § 212 (§§ 214(b)(2)(A), 214(d)(5)). But a man got no deduction at all if he had an able-bodied wife, even if she had deserted. Revenue Act of 1964, § 212 (§§ 214(a), 214(d)(5)).

107. Deduction of "expenses for household services" is now allowed. See INT. REV. CODE OF 1954, § 214(b)(2)(A).

108. The employer's contribution, however, is not treated as income of the employee. Thus, if an employer purports to pay an employee \$105 and to withhold \$10 for a pension plan "contribution," the entire \$105 is currently taxable to the employee. If, on the other hand, the employer purports to pay only \$95 to the employee and to make an employer contribution of \$10 to a pension plan, the employee is taxed currently on only \$95. Often, an employer will purport to pay \$100, will withhold \$5 as an employee contribution and will make an employer contribution of \$5, in which case the taxable income is \$100. The fact is, then, that significant tax consequences will flow from what may be purely formalistic differences in the way in which a pension plan is

benefit. It seems likely, however, that the poor are more motivated by the size of their take-home pay than the promise of a future pension.¹⁰⁹ Accordingly, to preserve the incentive intended by the normal tax rate under the negative income tax it would be necessary to allow a deduction for amounts involuntarily withheld from wages for a pension "contribution."¹¹⁰ The Federal Insurance Contribution Act (FICA) tax¹¹¹ on employee wages (which supports OASDHI) has the same effect as the employee's contribution to a private pension plan and raises the same problem. Thus, a strong argument can be made that the FICA tax should be deductible just as any other tax on wages,¹¹² in order that the negative income tax rate, which presumably will be very high, will not be increased. But to accept the argument that the "contribution" to OASDHI should be viewed simply as a tax is to undercut an article of faith for many—namely, that the amount collected under FICA is not a tax at all but rather the purchase price of a benefit of great value to all workers. The Model Statute shrinks from battle on this issue; no deduction for the FICA tax is allowed.

(2) Self-Employed Workers and Investors

The business expenses of farmers, newsstand operators, self-employed carpenters and other self-employed people obviously must be deductible. At the same time, if "loopholes" are to be closed on the income side then it hardly makes sense to leave them open on the deduction side.¹¹³ Thus, percentage depletion,¹¹⁴ accelerated deprecia-

described (though frequently the employer contribution will be nonvested while the employee contribution is vested).

109. A distinction between the poor and the nonpoor may be drawn on the basis of an expectation that most poor people will be less likely than nonpoor people to want to sacrifice current income for a future pension, simply because the poor cannot afford to buy the pension right.

110. "Contribution" is the word that is normally used despite the fact that the employee has no choice.

The Model Statute does not allow a deduction. This is another point on which I deferred to those who considered that a strong enough case had not been made for departure from the rules of the positive tax system. Refusal to allow a deduction may also reflect an unwillingness to endorse the notion, implicit (at least) in the argument for allowing the deduction, that pension rights are of little present value to the poor—that is, that the poor worker would not think of himself as buying a benefit of much value to him. To endorse that notion is to disparage a major effort of trade unions.

111. See INT. REV. CODE OF 1954, § 3101. The discussion applies equally to the self-employment tax also imposed. INT. REV. CODE OF 1954, § 1401.

112. There never has been any serious question about the necessity for allowing a deduction for income taxes.

113. See pp. 458-59 *supra*, discussing the advisability of closing any loopholes.

114. See INT. REV. CODE OF 1954, § 613.

tion,¹¹⁵ the investment credit¹¹⁶ and other special deductions must be disallowed.

The Model Statute disallows the net operating loss carryover¹¹⁷ because the special accounting rules of the negative income tax already account for prior losses.¹¹⁸ Current business losses, however, should remain deductible. Capital losses should also be fully deductible because capital gains are fully taxed.¹¹⁹ Interest on money borrowed to use in a trade or business should be deductible even if the business loses money. Other interest should be deductible only to the extent that the loan proceeds produce income so that the interest is properly regarded as a cost of producing, and therefore a proper offset to, income subject to taxation.

B. Personal Deductions

There are certain expenditures that, even though personal in nature, ought to be deductible. One category of such expenses is court-ordered alimony and support payments. To the extent that a person's income is devoted to such payments it is simply not available to meet living expenses. It may be sensible to ignore certain other expenses that might equally reduce the amount available to live on—for example, losses suffered at the race track. But it seems exceedingly unwise to take a harsh attitude toward payments that are made in fulfillment of both a legal and moral obligation and for which the basic negative income tax allowance does not compensate.

If the level of the alimony or support payment reflected actual in-

115. Straight-line depreciation is all that should be allowed, but the Model Statute mistakenly allows the accelerated depreciation permitted under INT. REV. CODE OF 1954, §§ 167(b)(2)-(3). The rural rules contain a useful catch-all provision to the effect that "expenditures for assets having a useful life of more than one year shall be treated as capital expenditures"—a provision of no small significance to farmers using the cash method of accounting.

116. Assuming that there is one in the positive tax system. See INT. REV. CODE OF 1954, §§ 38, 49. This is actually not a deduction but a credit, of course, but is properly considered together with the deductions.

117. See INT. REV. CODE OF 1954, § 172.

118. See Model Statute, *supra* note 2, § 9. See Asimow & Klein at 6-7.

119. There is, however, a limit in the Model Statute rules designed to first offset capital losses against earlier capital gain that received favorable tax treatment because the individual was subject to the positive tax system.

It might be argued that capital losses should be ignored except to the extent that capital gain was counted as income that reduced benefits under the negative income tax in earlier years. Otherwise a person with a one-time large capital loss might become entitled to benefits, despite a high normal level of income. The carry-over concept in the accounting rules, see Model Statute, *supra* note 2, § 9; Asimow & Klein at 10-16, would substantially reduce benefits in such cases, but would not totally eliminate benefits because of the limited life of the carryover.

come then this would undermine the work incentive contemplated by the negative income tax rate structure. And if the state courts did not adjust the level of alimony and support payment to the payor's actual income (but rather to potential income) then the federal government would probably be compelled to intervene in some way. Otherwise the negative income tax payments intended to provide basic support for a man's present family would be diverted to the family of his previous marriage whenever a state court determined that he ought to be earning more than he was.

It would be possible, of course, to deny a deduction for alimony and support payments, while simultaneously increasing the payor's basic allowance, by allowing him to treat as a dependent any person to or for whom an alimony or support payment is made. But then in order to avoid inaccuracy, the increase in the basic allowance would still have to reflect the amount of the payment. The allowance of a deduction seems the simpler, more direct method of reaching the same result, although increase of the basic allowance would avoid hardship whenever a person must continue to make alimony and support payments despite the loss of his job.

Among the poor, voluntary support payments and gifts are likely to be made under much the same circumstances and serve much the same function served by court-ordered alimony and support payments. The principal difference that might cause concern is that voluntary payments could be made to "beat the system." It is conceivable (but, to this author, barely so) that a poor person might make a gift to a wealthier friend or relative for this purpose if a deduction were allowed. The gift, if deductible, would result in an increase in the donor's benefits while the recipient (subject only to the positive tax, under which gifts are not treated as income)¹²⁰ would suffer no corresponding detriment. Thus, this gift would cause a net increase in government expenditures. To foreclose this admittedly remote possibility, the Model Statute allows a deduction for gifts only when the donee is subject to the negative income tax and therefore required to include the gift in his income.

The basic allowance should also compensate the recipient for reasonable, foreseeable medical expenditures. If this is done, free basic medical services need not be provided and the incentive for individuals to avoid the frivolous use of medical services is preserved. Substantial disbursements for nonrecurring medical problems cannot be covered by the basic allowance. Perhaps such costs should be borne by the federal government under the negative income tax or under

120. See INT. REV. CODE OF 1954, § 102.

some other program of universal health care or insurance for the poor. But the possibility of providing such a benefit raises issues that are beyond the scope of the negative income tax to resolve. The negative income tax offers no relief to the family with extraordinary medical expenses and no income (other than negative income tax benefits), but it does seem appropriate to allow a deduction from income for such expenses. The positive tax system affords precedent for such a subsidization of medical care;¹²¹ supporters of the deduction need not break new ground in a difficult and controversial area.

The question of the deductibility of taxes based on income has already been examined.¹²² There remains the question of the deductibility of other taxes that can now be deducted under the positive income tax—most notably the property tax and the general sales tax. Both of these can properly be viewed as costs of consumption. As such they should not be deductible. Refusal to allow a deduction would seem correct but for the fact that some states have no income tax and therefore rely heavily for revenue on property taxes and, even more so, on sales taxes. People in those states will be worse off, in the absence of a deduction, than people living in other states, simply because of the tax policies of the states of their residence. Despite these problems of fairness and federalism, the Model Statute allows a deduction only for income taxes.

The other major categories of personal deductions allowed under the positive tax system are charitable contributions,¹²³ casualty losses¹²⁴ and interest on personal debts.¹²⁵ No one has seriously proposed that such deductions should be allowed under the negative income tax (which may tell something about the positive income tax).¹²⁶ Discussion in this article of the possibility of allowing such deductions seems unnecessary.

VIII. CONCLUDING REMARKS

This article reveals that determination of *who* is entitled to *what* benefits requires an elaborate set of (possibly unarticulated) rules. These rules can significantly affect the success of the negative income tax in achieving its goals and, in the aggregate, they may be vital to its success.¹²⁷

121. See INT. REV. CODE OF 1954, § 213.

122. See pp. 480-83 *supra*.

123. See INT. REV. CODE OF 1954, § 170.

124. See INT. REV. CODE OF 1954, § 165(c)(3).

125. See INT. REV. CODE OF 1954, § 163.

126. See R. GOODE, *supra* note 55, at 157-63, 168-75.

127. Cf. Klein, *Family Unit passim*; Asimow & Klein *passim*.

The emphasis here has been on the negative income tax; but the negative income tax is merely a member of a larger class of programs to relieve poverty. The problem of defining income also arises in programs for public housing, medical care, food stamps and education subsidies. Thus an analysis of problems faced in implementing the broad objectives of the negative income tax are relevant to other programs in which benefits are based on need.

It seems clear, if only for political reasons, that the negative income tax cannot merely adopt the rules of the positive income tax as early proponents suggested.¹²⁸ Nor can it imitate the pattern of traditional welfare programs (as, to a considerable extent, the Family Assistance Plan did) without sacrificing many of its goals. Goals of income maintenance and other poverty-relief programs, and the social and ethical assumptions on which those goals are founded, often remain vague, imprecise and confused until people are forced to examine them in order to reach concrete rule-making decisions. It is my hope that beyond simply supplying a diagram of the necessary plumbing for an income-maintenance structure, this article will promote and contribute to such an examination of goals and assumptions.

128. *E.g.*, M. FRIEDMAN, *CAPITALISM AND FREEDOM* 192 (1962).

APPENDIX

The following provisions relating to the definition of income are taken from Handler & Klein, *A Model Statute Reflecting the Recommendations of the President's Commission on Income Maintenance Programs*, in *THE PRESIDENT'S COMMISSION ON INCOME MAINTENANCE PROGRAMS: TECHNICAL STUDIES*, 293, 297-300 (1970).

Section 8. Definition of income.

A. In General.

For the purposes of this part, a person's available income shall be his adjusted gross income, as defined in section 62 of the Internal Revenue Code of 1954, with the modifications provided by subsections (B) through (H).

B. Amounts Added to Adjusted Gross Income.

For the purposes of subsection (a), adjusted gross income for any period shall include the amount of the following items which accrue or are received during such period to the extent they are not already included in the definition of adjusted gross income in section 62 of the Internal Revenue Code of 1954:

- (1) The entire amount of any payments received as an annuity, pension, or retirement benefit,
- (2) The amount or value of any and all prizes and awards,
- (3) The proceeds of any life insurance policy in excess of \$1,000,
- (4) All gifts (cash or otherwise), support and alimony payments, inheritances, and trust distribution of capital, in excess of a total of \$50 per year, except for any gift or support payment or other transfer received from a member of the same family unit or from a private charity and except for any property (other than insurance proceeds) inherited from a deceased spouse, provided that amounts received from any person who is living in the same dwelling as the filer but is not a member of the filer's unit shall not be considered gifts or support payments to the extent that they do not exceed the greater of \$25 per week or the actual cost of housing and feeding such nonmember person, and provided that any amount that is received and paid for tuition, fees, and books at any institution described in section 151(e)(4) of the Internal Revenue Code of 1954 shall not be deemed to be a gift or support payment, and provided that no amount received under any government program in which the need of the recipient is an essential prerequisite of the award shall be deemed to be a gift or support payment,
- (5) Interest on all government obligations,
- (6) Except as otherwise provided in this part, any amount received in the form of damages, insurance payments, workmen's compensation, or in any other form as (i) compensation for physical, mental or any other personal injuries or sickness, (ii) wage or income continuation payments, or (iii) payments for medical expenses,
- (7) The rental value of parsonages,
- (8) Certain combat pay and mustering-out payments to members of the Armed Forces excluded from adjusted gross income by sections 112-113 of the Internal Revenue Code of 1954,
- (9) The full amount of all dividends, including periodic payments that are a return of capital, except insurance dividends, that are used to offset premiums,
- (10) The full amount of any scholarship or fellowship, including the value of room and board supplied without charge, to the extent that such scholarship or fellowship exceeds the costs of tuition, fees, and books,
- (11) The amount by which living expenses of the family unit are reduced when an employer supplies meals or lodging at less than their fair market value, regardless of whether the arrangement was made for the convenience of the employer,
- (12) An amount paid by the government to a member of the Armed Forces as an allowance for quarters or subsistence or a gratuity pay,
- (13) The amount of current or accumulated income that could, within the discretion of any person with a nonadverse interest, be paid to an individual from a trust or estate of which he is a designated beneficiary, except that any such amount not exceeding \$3,000 and in fact paid to some other person shall not be so included,

(14) All amounts deductible under section 1202 of the Internal Revenue Code of 1954,

(15) All unemployment compensation, from whatever source derived, whether from government insurance programs or otherwise,

(16) Strike benefits received from any union or other organization or agency,

(17) All cash benefits received pursuant to Title II of the Social Security Act,

(18) Railroad Retirement Act cash benefits,

(19) Cash benefits under laws administered by the Veterans' Administration except for those which are income conditioned,

(20) Foreign source income presently excludable under sections 893, 894, 911, 912, 931, and 943 of the Internal Revenue Code of 1954,

(21) Amounts received as loans from the Commodity Credit Corporation,

(22) Items presently deductible under sections 173, 175, 180, 182, 263(c), 615, and 616 of the Internal Revenue Code of 1954,

(23) An amount equal to the total of all federal and state income tax refunds multiplied by two, and

(24) (a) An amount equal to 10 percent of the "net usable wealth" owned by all members of such unit less the amount of any capital distribution from a trust that has been included in income by virtue of Section 8(B)(4) where the principal of such trust is included in the computation of net usable wealth and less the amount of income actually derived from property described in subsection (b)(v) below.

(b) Net usable wealth is an amount equal to the sum of:

(i) the equity in property used in a trade or business in excess of \$10,000, or the equity in a trade or business that includes an owner-occupied home in excess of \$20,000;

(ii) the equity in an owner-occupied home not included in (i) above in excess of \$10,000;

(iii) the amount by which the total of all cash, checking accounts, savings accounts, and equity in savings bonds, of all members of the unit taken together, exceeds \$1,500;

(iv) the cash value of life insurance policies owned by all members of the unit in excess of \$5,000; and

(v) the amount of equity in all other property, real or personal, tangible or intangible, of any kind (including property held in trust if such property is required to be or, in the discretion of a member of the unit or any person, may be distributed presently to any members of the unit) except clothing, furniture, automobiles with a total value less than \$4,000, and personal effects, with a total value of less than \$250 per member of the filing unit, and except the value of any pension, annuity, or retirement benefit, less the total of all unsecured debts of all members of the unit.

(c) The term equity as used above means the fair market value of the property less the amount of debt secured by it.

C. Deductions Allowed.

For the purposes of subsection (a), adjusted gross income for any period may be reduced by the amount of the following items which accrue, are paid, or are otherwise deductible during such period, to the extent that they have not already been deducted from adjusted gross income under the provisions of the Internal Revenue Code of 1954:

(1) All expenses for medical care within the meaning of sections 213 (e) of the Internal Revenue Code of 1954, except that—

(A) this deduction shall not apply to expenses compensated for by insurance or otherwise, where such compensation has been excluded from available income, and

(B) deductions can be made under this section only to the extent that the aggregated medical expenses of the family unit during the current reporting period plus the preceding eleven reporting periods exceeds \$120 multiplied by the number of members of the unit.

(2) Alimony, separate maintenance, and support payments made by any member of the unit,

(3) The value of any gift to a member of a family unit other than the donor's where the donee is a member of a family unit receiving payments under this Act,

(4) All deductions presently allowable under sections 162 and 212 of the Internal Revenue Code of 1954,

(5) Any deduction allowable under section 214 of the Internal Revenue Code of 1954, except that for purposes of this Act "dependent" in section 214(d)(1) shall mean any person under 18 years old who is a member of the unit,

(6) All amounts deductible under section 404 of the Internal Revenue Code of 1954, and

(7) An amount equal to the total of all federal and state income taxes paid by all members of the unit multiplied by two.

D. Losses.

In determining adjusted gross income the losses that are deductible under Sections 165 and 166 of the Internal Revenue Code of 1954, except for losses described in Section 165 (C) (3), shall be allowed as deductions and losses from the sale, exchange, or disposition of capital assets, used in a trade or business or held for the production of income may be deducted without limitation, to the extent that they exceed capital gains realized during the preceding three years (other than capital gains that were reported and reduced benefits that would otherwise have been payable under this part).

E. Interest.

No deduction shall be allowed for interest except for (1) interest on a loan, the proceeds of which are used in the payor's trade or business, or (2) interest on a loan secured by property that produces income that is included in the unit's income under any provision of section 8 (including Section 8 (B) (24)), but only to the extent of such income.

F. Depreciation and Depletion.

In determining available income, a deduction shall be allowed for depreciation and depletion only to the extent permitted by sections 167 and 611 of the Internal Revenue Code of 1954; but no deductions shall be permitted for depletion calculated pursuant to section 613 of the Internal Revenue Code of 1954.

G. Deductions Disallowed.

Deductions from income other than those specifically allowed in this section are disallowed. No item shall be deducted more than once.

H. Subchapter S Corporations.

Any amount attributed to the available income of a member of the family unit by operation of section 1373 of the Internal Revenue Code of 1954 shall be increased by an amount proportional to the amount by which the taxable income of the electing corporation would be increased if computed under this section.

I. Internal Revenue Code Applicable.

Except where this Act provides or necessarily implies otherwise the provisions of the Internal Revenue Code of 1954 shall apply in the determination of available income.