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TAX LOOPHOLES AS ORIGINAL SIN: LESSONS FROM TAX HISTORY

GERARD M. BRANNON†

THIS paper deals with a number of fundamental problems in the income tax. It looks at these from an historical point of view and draws some lessons for tax reform and for future decisions on possible new taxes.

In 1976, President Carter stated that our tax system is a disgrace to the human race. Much of contemporary tax reform discussion has had a good-guy/bad-guy theme.¹ A similar tone has characterized many of President Reagan's speeches which depict tax reform as a battle between people and interests.² Despite the perceived problems with the current tax structure, it remained unchanged. It has been suggested that "maybe the biggest reason we haven't changed the tax structure, is that change has been resisted at every point and is being resisted today by vested interests, those who profit from the status quo."³

Some commentators have suggested that one problem with the tax structure is that there have been many illogical special interest provisions enacted into tax law as a result of what can best be called "political bribery."⁴ In total, these are only a small part

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1. See Bradley, *Let's Have the "Fair Tax,"* 70 A.B.A. J. 12 (July 1984).

2. *Reagan Renews Tax Reform Sales Pitch*, 28 TAX NOTES 1165 (1985).

3. *Id.* at 1166; see also Bradley, *supra* note 1, at 16. Senator Bradley writes that a fundamental purpose behind the "fair tax" reform legislation that is currently before Congress is to eliminate special-interest tax provisions that benefit the few at the expense of higher rates for the majority. *Id.* However, "[n]ot everyone supports [the] tax reform, no matter how clear its advantages are. The special interests that benefit from tailor-made tax loopholes are hoping the idea will simply die." *Id.*

4. Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957). "Political bribery," as described by Professor Surrey, are those factors that might influence a Congressman in the area of tax legislation to enact provisions that favor special groups or individuals. *Id.* at 1148. These factors arise from the political pressure that exists within the institutional framework in which tax legislation is passed. *Id.* at 1149-58. Members of the taxing committees, who move up this institutional framework, are in a position to make tax laws that favor a particular individual or group. *Id.* at 1155. Pressures which influence committee decisions include pressure to continue historically recognized exemptions in favor of certain industries, and pressures

(1763)

of the tax reform problem. In John Witte's recent study of income tax history he categorizes tax expenditures in some useful ways. He goes on to conclude that those provisions providing benefits for special groups account for only 2% of the total revenue cost of tax expenditures.⁵

An alternative view of the income tax malaise is presented by contemplating the situation which surrounded the adoption of the modern income tax in the United States.⁶ At the time, the income tax was a small pawn in the battles between the agrarian, anti-tariff South and West and the moneyed Northeast. The income tax was not a polished academic product; it was a rough alternative to still higher tariffs. Not even the contemporary legal analysis was brilliant. Most lawyer efforts were devoted to insuring there was no violation of the constitutional prohibition against direct taxes. The only reference to the meaning of direct tax in Madison's *Debates* is, in its entirety, as follows: "Mr. King asked what was the precise meaning of *direct* taxation. No one

from those in high tax brackets to lower their burden coupled with a Congressional belief that such persons are paying too much tax. *Id.*

5. J. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 276-82* (1985). Witte places tax expenditures into the following six classifications: 1) need; 2) tax equity; 3) special group benefits; 4) general economic incentives; 5) specific economic incentives and 6) a miscellaneous category, which contains those provisions that cannot easily be classified in any of the former categories. *Id.* at 273. Witte's test for determining whether a tax provision falls within the special group classifications is as follows: 1) the provision affects a reasonably permanent and identifiable demographic or occupational group; 2) the economic conditions addressed by the provision cannot be assumed to be exclusive to that group and 3) there is no overriding presumption that the benefit is being granted primarily on other grounds. *Id.* at 274. Examples of special group benefits include exclusion of military benefits, expensing of farm capital outlays and excess bad debt reserves for financial institutions. *Id.* at 278. Witte recognizes the narrowness of his special group benefits category, but points out that even if the group is expanded to include provisions from the various categories such as exemptions for the elderly, disability payments and interest on life insurance, the percentage of total expenditures would only increase to 13%. *Id.* at 285.

Thus, even if the broader definition is used, it is incorrect to perceive the tax expenditure system as primarily a method of distributing hidden benefits to very narrow and highly organized groups. . . . As it is, most of the money is spread very broadly among large segments of the population and corporate world.

Id.

6. For a general history of the income tax, see R. BLAKEY & G. BLAKEY, *THE FEDERAL INCOME TAX* (1940); R. PAUL, *TAXATION IN THE UNITED STATES* (1954); S. RATNER, *TAXATION AND DEMOCRACY IN AMERICA* (1942). For a discussion of the background surrounding the adoption of the income tax, see *infra* notes 8-15 and accompanying text.

answered.”⁷

The concept of income was not clearly delineated when our society was struggling with the problem of whether income should be taxed. There was a general consensus that income was the amount available for consumption without impairment of capital.⁸ This definition was similar to that given by Adam Smith 135 years earlier⁹ as well as to ideas developed in German literature in the latter part of the nineteenth century.¹⁰ This whole approach to defining income, which includes savings as a part of income is basically consistent with the more elegant Haig-Simons definition often cited today.¹¹ A completely different definition which excluded the amount saved had been proposed by the American economist Irving Fisher, however, Fisher himself thought his definition was not practical.¹²

The method by which substantive statutory law is developed is a chaotic political process which is rarely scientific. Moreover, the circumstances surrounding the early income tax days were not propitious for good legislation. The crucial background work had not been done, staff work was negligible and the political payoff was in “getting” the moneyed East, not in conceptual elegance.¹³

7. 5 DEBATES ON THE ADOPTION OF THE FEDERAL CONSTITUTION 451 (J. Elliot ed. 1888).

8. E. SELIGMAN, *THE INCOME TAX: A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD* (1911). Seligman wrote his book while the income tax amendment was being considered.

9. A. SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 123 (1863). Smith notes:

The gross revenue of all the inhabitants of a great country comprehends the whole annual produce of their land and labor; the [net] revenue, what remains free to them after deducting the expense of maintaining, first, their fixed and secondly, their circulating capital, or what, without encroaching upon their capital, they can place in their stock reserved for immediate consumption or spend upon their subsistence, conveniences, and amusements.

Id. at 124.

10. The German literature is discussed in H. SIMONS, *PERSONAL INCOME TAXATION* 59-80 (1938). Two of the more prominent ideas of this time, that were illustrative of other ideas in German tax literature of that period, were put forth by Schanz and Hermann. Schanz's concept of income is stated in terms of consumption and of property values at given moments in time. *Id.* at 62. Hermann, although having a view similar to that of Schanz, was concerned about income from the viewpoint of social income as opposed to individual income. *Id.* at 63-64.

11. *Id.* at 50. Under the Haig-Simons definition, personal income is “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.” *Id.* at 50.

12. I. FISHER, *THE NATURE OF CAPITAL AND INCOME* 134-35, 247-55 (1906).

13. See J. WITTE, *supra* note 5, at 70-75. Witte writes that:

The result was that we built some substantial booby traps into the early income tax, original sins that would come back to haunt us. Some of these are in principle reparable under the income tax while others would be very difficult to change. Even where a mistake is reparable, it is hard to accomplish change after the mistake has been in place for decades because interests have been created and defensive institutions developed.¹⁴

Many of our apparently insoluble current tax problems were born in the original sin of sloppy thinking about defining income at a time when it was the subject of only a minor tax. Unfortunately, as the tax became major, its original sins resisted baptism.

The United States income tax did draw on the experience of other countries, notably the United Kingdom and Germany, which had long used the income tax. Professor Haig, writing in 1921, could praise the United States tax law as being "the closest approach to true economic income yet achieved by any country."¹⁵ We did avoid some of their errors (e.g., the omission of capital gains) but we made plenty of our own.

Non-Cash Income

In 1915, an academic commentator, Professor Roy Blakey, reviewed the Revenue Act of 1913.¹⁶ Anticipating the first round of amendments, he wrote: "[t]he rental value of residences is one of the forms of non-monetary income that it would be practicable and desirable to include, though such an amendment to the rulings might well be postponed a year or two."¹⁷

In 1915, this was not as silly a prediction as it sounds today. One giving thought to the matter would realize that when a land-

Those instrumental in the passage of the tax were mostly from the Middle West and South. . . . The opposition came almost exclusively from the East. . . . The debate that surrounded passage was magnificent, and although the geo-economic factors were raised, the issue was also posed as one of rich versus poor and the rights of property versus the specter of socialism.

Id. at 71; *see also* R. PAUL, *supra* note 6, at 32-39; S. RATNER, *supra* note 6, at 174-84.

14. Surrey, *supra* note 4, at 1152-53. Professor Surrey notes that it often takes several years for the mistakes of past tax acts to surface, and by that time, the benefited group is well-entrenched and has many strategic advantages in defending the legislation. *Id.*

15. R. Haig, *The Concept of Income: Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX 26* (R. Haig ed. 1921). Haig was specifically referring to the inclusion of capital gains in income.

16. Income Tax Act, ch. 16, 38 Stat. 114 (1913).

17. R. Blakey, *Amending the Federal Income Tax Act*, 58 ANNALS 39 (1915).

lord gives up a cash rent to move into the property, there should be the same income and ability to pay; the only difference being that the income is in the form of housing services, not cash. Moreover, at that time, the United Kingdom, German and Australian income taxes included imputed rent in the tax base.¹⁸ Henry Simons even quoted the German tax scholar, Georg Schanz, as reporting that he knew only one jurisdiction (Mechlenburg) where imputed rent was not taxed.¹⁹ Nevertheless, Congress understood better than did the Professors that their constituents either didn't understand, or didn't want to understand imputed rent.

After Congress made the erroneous decision not to tax imputed rent, it is not surprising that it enacted a law which allowed deductions for the costs of this non-includable income, i.e., home mortgage interest and property taxes on the residence. As indicated by the persistent tax shelter problem, the costs of such non-taxable income remains a subtle tax problem.²⁰

Once this set of home-owner benefits became established as part of the tax law, it was obviously hard to eliminate them. It was not that they were rational; it was simply that they were expected by the taxpayer. It was not until well after society had been in the business of encouraging home ownership that the arguments about social utility started. Until 1942, when the income tax began to be converted from a class tax to a mass tax, the arguments for encouraging home ownership did not even make sense. With taxability limited to the top 5% of the population, the decisions of those taxpayers to buy or rent should be respected. By 1921, Professor Haig was attributing the development of the coopera-

18. H. SIMONS, *supra* note 10, at 44, 112 n.3. Simons stated the reason they included imputed rent as taxable income was due to their acceptance of the idea that income can be derived from things: "There is, first, and most common in economic theory, the conception of what may be called *income from things*. In this sense, income may be conceived in terms of services derived from things or, quantitatively, in terms of the market value." *Id.* at 44.

19. *Id.* at 112 n.3 (Simons references Schanz's work as *Finanz Archiv* 35 (1896)).

20. See THE PRESIDENT'S PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 322-24 (1985) [hereinafter cited as PRESIDENT'S PROPOSALS]. The President noted that

a clear reflection of income for tax purposes requires that the costs of generating income be matched with the income actually earned. If a current deduction is allowed for the cost of producing income that is exempt from tax or includable in income on a deferred basis, the current deduction will offset other taxable income and thus eliminate or defer tax.

Id. at 322.

tive apartment institution in New York to the tax law.²¹

The omission of imputed rent on owner-occupied homes was only part of a wider pattern of ignoring non-cash income. The historical roots of such omissions are not hard to ascertain. In the early part of the twentieth century, one of the large aspects of non-cash income was food which was produced and consumed on farms.²² As noted previously, the income tax grew out of an agricultural protest against the moneyed Northeast. The supporters of the income tax were looking for an instrument with which to burden the financial class, in order to relieve agriculture of some of the burden of tariffs.²³ It would not have profited income tax supporters to consider how much the agricultural industry relies on non-cash income.

The orientation that income is cash is one of the basic defects of the modern income tax. The difficulty of recognizing non-cash income is certainly at the root of the scandalous amount of fringe benefits that are excluded from income.²⁴ It is quite absurd to say that exclusions for employer-paid health or term life insurance are in the law as an incentive for the benefits of this insurance.²⁵ Term life insurance and health insurance premiums are not excluded when bought by individuals; they are favored because they are employer-paid. The blind spot concerning non-cash income was involved in the failure to tax imputed interest on life insurance reserves, as well as in the capital appreciation problem discussed in the next section.

21. R. Haig, *supra* note 15, at 24.

22. Similar to imputed rent on owner-occupied homes, this is an income carried in the national income and product accounts.

23. E. SELIGMAN, *supra* note 8, at 493-95.

24. The fringe benefits that Congress permits to permanently bypass taxation can be categorized under the heading of employee fringe benefits. These benefits include: 1) employer provided meals and lodging, I.R.C. § 119 (West Supp. 1986); 2) employee health benefits and life insurance coverage, I.R.C. §§ 79, 106 (West Supp. 1986) and 3) a broad category of statutorily-enumerated employer-provided fringe benefits (any fringe benefit that qualifies as an employee benefit at no additional cost to the employer, an employee discount, a working condition fringe or a de minimis fringe), I.R.C. § 132 (West Supp. 1986).

25. See S. GUERIN & P. POSTLEWAITE, PROBLEMS AND MATERIALS IN FEDERAL INCOME TAXATION 178 (1986) ("To encourage employers to purchase life and medical insurance for their employees, Congress has excluded from gross income amounts paid by the employer for such insurance."); THE PRESIDENT'S PROPOSALS, *supra* note 20, at 24 ("Although this tax-based incentive for employee health insurance is an appropriate part of the national policy to encourage essential health care services, . . . the exclusion contributes substantially to horizontal inequity and to higher than necessary marginal tax rates.").

The argument in this historical review is not to condemn Congress for not taxing all non-cash incomes as much as it is to bemoan the fact that this set of problems was not systematically thought out. A reasonable compromise on housing would have been to ignore imputed rent and disallow the mortgage interest and home property tax deductions. This same problem was at least thought about in the Civil War tax, in which a compromise was reached whereby imputed rent was excluded and a deduction allowed for rent paid on a residence.²⁶

Another area in which Congress has elected not to tax imputed income is where there is a real return on the investment in such consumer durables as automobiles and televisions. It is probably not practical to impute an income on such assets but we should be aware that there exists non-taxable income regarding such assets.²⁷ The deduction of consumer installment loan interest is a problem largely because it is a cost of a non-includable income.

In 1985, when the Treasury finally proposed limits on the exclusion of employer paid insurance benefits and on the deduction of consumer interest, however, it was readily apparent that such proposals were helpless before the entrenched lobbies of the unions and the health insurance companies.

Capital Appreciation

For most of the history of the income tax, the majority of serious students of tax have adhered to the Haig-Simons definition of income as the ultimate logic behind the income tax.²⁸ The definition of income as consumption plus the increase of wealth calls for taxing accrued but unrealized appreciation. Congress could accept the theory of deducting accrued but unrealized de-

26. Act of Mar. 3, 1865, ch. 78, 13 Stat. 469 (1865).

27. Imputed income is excluded from the income tax base. S. GUERIN & P. POSTLEWAITE, *supra* note 25, at 86. There are two principal reasons for not taxing imputed income. First, the valuation difficulties regarding such situations, and, second, the early misgivings about the constitutionality of taxing such income. *Id.* Imputed income arises when a taxpayer derives an economic benefit from the ownership and use of his own property or when a taxpayer derives an economic benefit from performing services for himself. *Id.* Where a taxpayer derives an economic benefit from the ownership and use of his own goods, such as his automobile or television (i.e., consumer durables), the rationale for considering such goods imputed income relates to the valuation difficulties that arise or would arise in trying to assess what the dollar value of such benefits would be.

28. B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE 82-83 (1968).

preciation but the other side of the logical coin was too far removed from accepted accounting practice. Again, the complaint is not that there was no utopian solution to the problem; rather it is that the problem was not thought through logically enough to get to a reasonable compromise.

Early in the income tax, the issue of unrealized appreciation came up for explicit consideration. In 1916 the Congress extended the income tax to stock dividends.²⁹ The issue was litigated in the famous case of *Eisner v. Macomber*³⁰ in which the Supreme Court held that income as intended by the sixteenth amendment is “not a *growth or increment of value in the investment; but . . . something of exchangeable value proceeding from the property, severed from the capital . . . received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property.*”³¹

Thus, on the basis of a weak argument, was the realization principle born. It is interesting that the decision made more of an impression on the Congress than it did on later judges. The court decisions have moved away from a realization requirement while the Congress has accepted it shamelessly while steadily expanding the non-realization area.³²

It seems fair to say that Justice Pitney’s view on income was derived from an economist, Professor E.R.A. Seligman, who had published an article on the subject in 1919.³³ Substantially the same argument was published in a later work by that author, with the footnote that it had been submitted to the Supreme Court as a memorandum during consideration of *Eisner*.³⁴ The Pitney decision contains several passages wherein the wording as well as the argument is similar to the Seligman memorandum-article.³⁵ The Seligman argument was an unsuccessful attempt to find a middle ground between the Fisher view that limited income to consump-

29. Income Tax Act, ch. 463, 39 Stat. 756 (1916).

30. 252 U.S. 189 (1920). The majority opinion was written by Justice Pitney; the case was a five-four decision.

31. *Id.* at 207 (emphasis in original).

32. J. SNEED, *THE CONFIGURATION OF GROSS INCOME* 65-73 (1967).

33. E. Seligman, *Are Stock Dividends Income?* 9 AM. ECON. REV. 517 (1919). Seligman notes: “[I]n a stock dividend there is neither separation [of earnings from principal] nor realization, [therefore] the gain from a stock dividend is not income.” *Id.* at 536.

34. E. Seligman, *Studies in Public Finance* (1925), reprinted in REPRINTS OF ECONOMIC CLASSICS (1969).

35. REPRINTS OF ECONOMIC CLASSICS 98 (1969).

tion and the more common view that included savings.³⁶

Professor Haig, discussing the argument of his colleague Seligman, put his finger on the problem by pointing out that a cash dividend also does not increase wealth. Income arises when the corporation earns surplus which is a wealth increase for the shareholders. Whether this wealth is realized as increased value of one share of stock, or as one share plus cash or as two shares is not very significant.³⁷

Consider this case: *A* starts the year with \$100 of stock in company *X* which increases in fair market value during the year to \$200 at year end. *B* earns \$100 from wages during the year and at year end invests it in Stock *X*. Both *A* and *B* have advanced from the year start by \$100 worth of stock *X*. Logically, *A* and *B* have the same ability to pay.³⁸

It may be conceded that annual valuation is an administrative problem which argues for postponing tax on *A*'s appreciation. Logic tells us that *A* now has unrealized, as yet untaxed income. Furthermore, if tax is not paid until realization, *A* has a considerable interest advantage in tax postponement.

Legislators involved in the tax process, however, continued to follow Justice Pitney's logic. There was no provision made for ultimately taxing *A*'s appreciation, even when the property has to be valued anyway for death tax or for gift tax purposes.

Think about this case: *A* and *B* earn a basic wage from which, after tax, they support themselves. *A* earns from a second job \$1,000,000 over his lifetime and saves \$500,000 of it after taxes. *B* has property which, during his lifetime, rises in value from zero to \$500,000 without being realized. At death both pay the same

36. I. FISHER, *supra* note 12, at 41.

37. R. Haig, *supra* note 15, at 8.

38. This argument is similar to several developed by Justice Brandeis in his dissent in *Eisner*, 252 U.S. 189, 220-21, 226-27, 229-30 (Brandeis, J., dissenting). This idea is developed more rigorously in G. Brannon, *Euclid on Capital Gains*, in 6 TAX NOTES 139 (1978).

In examining how a corporation can distribute its profits among its shareholders, Justice Brandeis argued in his *Eisner* dissent that regardless of the method, there could be no question that the final effect was that the shareholder had taxable income. 252 U.S. at 220-21, 226-27, (Brandeis, J., dissenting). Justice Brandeis further noted that the result would be the same, i.e., taxable income to the shareholder, whether the corporation chooses to pay the dividend through cash taken from surplus in its treasury or from distributing a stock dividend. *Id.* at 226-27 (Brandeis, J., dissenting). Justice Brandeis also argued that it makes no difference in terms of the shareholder's taxable income whether a stock dividend is paid in common as opposed to preferred stock. *Id.* at 229 (Brandeis, J., dissenting).

estate tax, but *A*'s wealth accumulation will have paid both income and estate tax while *B*'s will have avoided all income tax. There is no rational reason for Congress to have legislated a different outcome in these situations.

If Congress had made any effort to follow through the simple idea that appreciation must be income at some time, even if not realizable when it accrues, then it would have acted differently in a number of practical areas and we would have a more uniform and lower-rate income tax. Certainly there would have been taxation of unrealized gains at death which would go a long way toward reducing the capital gains problem of lock-in.

For any given amount of tax burden to be imposed on transfers of property by death or gift, it would be fairer to raise more of that tax from unrealized appreciation that has not paid income tax and less from accumulations out of tax-paid income. The estate tax is for the most part a double tax on accumulated income on which the decedent has paid income tax during his/her lifetime.

Catching up on the postponed income tax after death is what is done now with IRA's and pension plan distributions. Logically, income in the form of appreciation, the recognition of which has been postponed for tax purposes, is no different from income the taxation of which has been postponed by some retirement pension arrangement.

There is a substantial interest advantage in the mere postponement of realization of capital gains. This might logically be dealt with by increasing the inclusion rate for assets which have been held a long time.³⁹ Congress regularly gives serious consideration to studies proving that lower taxes on realized gains increase tax revenues. However, little attention is given to the substantial inducements available for non-realization, income tax avoidance at death or effective tax reduction by tax postponement. It must be no surprise that in the face of these rewards for non-realization, the taxpayers must be offered competing inducements on realization to make voluntary tax payment worthwhile.

39. Roger Brinner reaches a similar conclusion. R. BRINNER, *Inflation and the Definition of Taxable Personal Income*, in *INFLATION AND THE INCOME TAX* (H. Aaron ed. 1976). Brinner examines the issue of capital gains through recent congressional proposals to adjust them for inflation. *Id.* at 145. Mr. Brinner argues that the proposals are misguided in that they seek to answer the question by reducing the proportion of gains subject to tax as their holding time increases. *Id.* He then concludes that the proper approach is to measure capital gains and then tax them. *Id.*

Improper treatment of unrealized gain is involved in a host of narrower problems from gifts of appreciated property to charity to the *General Utilities* doctrine.⁴⁰ In all of these cases we have a long-standing tax rule based on an incorrect analysis of income, but a rule upon which various institutions have come to rely.

The extent to which this original sin is deeply ingrained in the system can be seen from the utter futility of attempts to reform the system with respect to gains at death. Administration proposals have been rejected out of hand by Congress (notably in 1964) and the one sorry attempt that passed Congress, carryover basis, was shortly thereafter repealed.⁴¹ In the Treasury's superb base-broadening report in 1984, the appreciation at death issue was not even mentioned.⁴²

40. The *General Utilities* doctrine is an exception to the two-level taxation of corporate earnings (corporate earnings from sales of appreciated property are taxed twice, first to the corporation when the sale occurs, and again to the shareholder when the net proceeds are distributed as dividends). *General Util. & Operating Co. v. Helvering*, 296 U.S. 200, 202 (1935).

The *General Utilities* rule permits non-recognition of gain by corporations on certain distributions of appreciated property (footnote omitted) to their shareholders and on certain liquidating sales of property. Thus, its effect is to allow appreciation in property accruing during the period it was held by a corporation to escape tax of the corporate level. At the same time, the transferee (the shareholder or third party purchaser) obtains a stepped up, fair market value basis under other provisions of the Code, with associated additional depreciation, depletion, or amortization deductions.

H.R. REP. NO. 426, 99th Cong., 1st Sess. 274 (1985).

41. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a), 90 Stat. 1525, 1872 (repealed by Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299). The legislative history indicates that the earlier provision was repealed because administrators were faced with a significant increase in the time required to administer an estate, which resulted in a rise in the overall cost of administration. In addition, Congress felt that the 1976 provisions were unduly complicated to apply. 1980 U.S. CODE CONG. & AD. NEWS 410, 530.

Congress did, however, reinstitute carryover basis for one limited situation. See I.R.C. § 1014(e) (West Supp. 1986). Congress felt that preserving a stepped-up basis would allow an heir to transfer appreciated property to a decedent immediately prior to death, and receive it back at the decedent's death with a higher basis. Therefore, the stepped-up basis rules do not apply "with respect to appreciated property acquired by the decedent through gift within [one year] of death where such property passes from the decedent to the original donor or the donor's spouse." The rule applies regardless of the format of the bequest by the decedent to the donor. H.R. REP. NO. 201, 97th Cong., 1st Sess., 188-89 (1981).

42. See U.S. DEP'T OF TREASURY, 1 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 100 (1984) [hereinafter cited as TREASURY I].

Intergovernmental Relations

Another area of original sin is provided by the area of intergovernmental relations. At the time of the sixteenth amendment, the courts and the Congress were still mesmerized by the language in *McCulloch v. Maryland*⁴³ that "an unlimited power to tax involves, necessarily, a power to destroy."⁴⁴ Lots of good things, if abused, have the power to destroy. By the 1930's, the courts came to a view that was more oriented to results than to potential. The new view was that there was no constitutional reason to exempt states and localities from general tax laws that would apply to others in the same circumstances.⁴⁵ Exempting states from a general tax constitutes an indirect subsidy.

The federal income tax got off on the wrong foot by exempting both interest and wages paid by states and localities. It is slightly curious that when the Court saw the error of its ways in the cases involving wages and state sales taxes,⁴⁶ there developed federal taxation of state and local payment for labor services but not payment for capital services. It may have been that prior to 1942 not many wage earners paid income tax anyway so the wage exemption did not mean much. It may also have been significant that these workers were not organized.

After the wage case, the Supreme Court did not have occasion to review the constitutionality of a federal income tax on municipal bond interest. Here can be seen the weight of a dead hand that makes tax reform difficult. In 1959, a life insurance company

43. 17 U.S. (4 Wheat.) 316 (1819).

44. *Id.* at 327.

45. *Ohio v. Helvering*, 292 U.S. 360 (1934). The Court held that state activities not regarded as carrying on a strictly governmental function are not exempt from federal taxation. *Id.* at 369. In *Ohio v. Helvering*, the Court applied the principle to a state liquor business. Justice Sutherland, writing for the majority, stated:

If a state chooses to go into the business of buying and selling commodities, its right to do so may be conceded so far as the Federal Constitution is concerned; but the exercise of the right is not the performance of a governmental function, and must find its support in some authority apart from the police power. When a state enters the market place seeking customers it divests itself of its *quasi* sovereignty *pro tanto*, and takes on the character of a trader, so far, at least, as the taxing power of the federal government is concerned.

Id.; see also *Helvering v. Powers*, 293 U.S. 214 (1934) (officers of a state (Massachusetts) railroad were subject to federal income tax).

46. See *Alabama v. King & Boozer*, 314 U.S. 1 (1941) (state sales tax applies to purchase of materials by one who uses them even where federal government reimburses purchaser); *Helvering v. Gerhardt*, 304 U.S. 405 (1938) (salaries of state employees subject to federal income tax).

tax statute was passed which involved a proration formula, disallowing part of the reserve interest deduction to the extent of investment income from exempt sources.⁴⁷ Litigation was expected on the constitutional grounds that this statute effectively taxed exempt interest. For many in the Congress, the problem was not the tax on life insurance companies but the possibility that the Court would decide that the formula *did* tax exempt interest and that it was not unconstitutional for the federal government to do so. The “solution” was to add language to the bill to the effect that it was not the intention of Congress to tax exempt interest and if the formula should be interpreted to do so then it should be changed appropriately.⁴⁸ The sole function of the language was to foreclose the Court from considering whether Congress could tax this interest. The myth of unconstitutionality is part of the defense used to maintain this original sin.

Certainly, the bond community, as well as the state and local governments, have fought hard to preserve the legacy of intergovernmental immunity. It is so well entrenched that states and localities can, on a large scale, sell their immunity to private investors.

This history would seem to apply to the deduction for state and local taxes, which goes back to the 1861 Act.⁴⁹ In tax theory, one might make a case for the appropriateness of income tax deductions but not for deduction of sales and property taxes. Nor is there any good economic argument for exempting the income of state-owned business enterprises. The explanations must lie in the whole line of muddled thinking about intergovernmental immunity. The die cast long ago has prevailed, resulting in rejection of the 1984-85 Treasury proposals.⁵⁰

47. See Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112.

48. *Id.*

49. Act of August 5, 1861, ch. 45, 12 Stat. 292.

50. See 2 TREASURY I, *supra* note 42, at 135-37. Both the 1984 and 1985 proposals of President Reagan sought to accomplish the following: 1) limit the tax exemption for interest on state and local obligations to matters involving financing governmental activities, such as schools and building roads; 2) eliminate the federal income tax exemption for nongovernmental bonds issued in the future; 3) lighten restrictions on arbitrage with respect to tax-exempt obligations and 4) repeal the general stock ownership corporation provisions. *Id.*; see also PRESIDENT'S PROPOSALS, *supra* note 20, at 281-93; Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1301, 1303, 1986 U.S. CODE CONG. & AD. NEWS (100 Stat.) 518-74. Section 1301 amends I.R.C. § 103 in the following manner:

(a) EXCLUSION.—Except as provided in subsection (b), gross income does not include interest on any State or local bond. (b) EXCEPTIONS.—Subsection (a) shall not apply to—

Inflation Adjustment

A somewhat different kind of original sin problem is the matter of whether to tax real or money income. As we read the history, this problem received little attention in the early income tax days. Professor Haig, for example, mentions the problem but he saw little prospect for solution. He observed that there was not even a satisfactory price index.⁵¹

Jacob Viner wrote an exploratory article in the early 1920's that was concerned primarily with identifying the various price-related problems that the author thought had been ignored. Interestingly, Viner did not identify the distortions related to debt.⁵²

As inflation returned after World War II and in the 1970's, there was sporadic talk about indexing basis for purposes of depreciation or capital gains. However, in the end, inflation was merely cited as one reason for a speeded-up depreciation rate, or a lower inclusion rate for capital gains which were both inappropriate solutions which overlooked the countervailing inflation gain when an asset is financed by debt.

A conference at Brookings in 1976 highlighted the ambiguity of whether business was overtaxed or undertaxed by inflation and revealed the disagreement among the experts about what would be the best solution.⁵³

The Treasury proposal to index interest was the first serious

(1) PRIVATE ACTIVITY BOND WHICH IS NOT A QUALIFIED BOND.—

Any private activity bond which is not a qualified bond (within meaning of section 141.)

(2) ARBITRAGE BOND.—Any arbitrage bond (within the meaning of section 148.)

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1301, 1986 U.S. CODE CONG. & AD. NEWS (100 Stat.) 518.

Section 1303 indicates that only some provisions relating to general stock ownership corporations are repealed by the Tax Reform Act of 1986. *Id.* § 1303.

51. R. Haig, *supra* note 15, at 17.

52. J. Viner, *Taxes and Price Levels*, J. OF POL. ECON. 1923.

53. For a collection of the papers presented at the Brookings Institute conference, see *INFLATION AND THE INCOME TAX* (H. Aaron ed. 1976). Participants of the conference noted:

When inflation begins, an inflation-adjusted tax law would initially cause the average nonfinancial firm to pay more taxes than under current law. Over the long run, however, the inflation-adjusted tax law would result in lower taxes than under current law, with an average reduction in taxes of over one-half of 1 percent of assets if inflation averages 10 percent a year.

Tideman & Tucker, *The Tax Treatment of Business Profits under Inflationary Conditions*, in *INFLATION AND THE INCOME TAX*, *supra*, at 34.

proposal made to Congress attempting to deal with the debt side of the inflation adjustment.⁵⁴ It was not surprising that this proposal proved not to be very good. The inflation adjustment itself was too arbitrary and there was not enough attention to the subtle ways that interest can appear in accounts. A bank, for example, pays interest by undercharging for checking services; the Treasury's formula adjustment to the interest deduction would not reach this interest.

Part of the Treasury proposal to remove the inflation distortion related to debt was to apply a formula to the interest deduction and to identify part of it as true interest and part of it as repayment of debt.⁵⁵ The Treasury felt, however, that it was not judicious to disallow part of the deduction for home mortgage interest—a hangover from the other original sin of not dealing with imputed rent on owner-occupied homes. The omission of home mortgage interest significantly increases the tax favoritism for housing investment.⁵⁶

The author's reading is that only now is there beginning to develop an interest to solve the inflation problem. The matter has so long been ignored that little background is available, even to establish that the problem is solvable in the context of an income tax. It may be that the only way to deal with real income is by way of consumption taxation.

Savings and Investment

In addition to the problems related to appreciation and realization, the decision to follow a definition of income that includes savings has created another problem within the income tax. This difficulty shows up in the endless line of proposals to provide incentives for one or another kind of savings or investment. Ostensibly, these proposals relate to some perceived capital shortage but their roots are deep in the particular kind of income tax that was originally adopted.

One complication is that the traditional income tax imposes a double burden on income saved; it taxes both the savings and the return on savings. Income of \$100 used for current consumption is reduced by a 50% tax to \$50. That income could have been saved and invested at 6% to provide \$200 of consumption in ten

54. See 1 TREASURY I, *supra* note 42, at 111.

55. See *id.* at 111, 114.

56. P. Hendershott, *Tax Reform and Financial Markets*, in ECONOMIC CONSEQUENCES OF TAX SIMPLIFICATION 167 (1985).

years. A 50% tax reduces the initial investment to \$50 and the growth rate to 3% so final consumption is reduced more than 50% to about \$72. One can quibble about whether this is really double taxation, but it is a fact that increasingly in the last three decades, there have been expressions of national concern that not enough income was saved and invested. Consequently, there has been developed a panoply of savings and investment incentives.

A second complication is that there exists an income tax which not only disregards borrowing, as negative saving, but at the same time encourages borrowing by the interest deduction in excess of investment income. The response to the capital "shortage" has been a mishmash of incentives which are not fully compatible with the system that exists.

There exist savings incentives that apply where the appearance of saving has been created by borrowing even when there are no savings. Banks brazenly announce that they will lend individuals money to buy an IRA. The tax favoritism for individual life insurance is structured not to benefit insurance as such but saving in life insurance policies. There is an almost unlimited opportunity to acquire the savings by borrowing.⁵⁷

Our other approach to dealing with the capital shortage is by a variety of incentives for savings to be invested in particular ways. One justification for such incentives is the pre-existing incentive to housing investment noted earlier.⁵⁸ These incentives are so irregular between different types of investment that they create a massive inefficiency simply by the investment distortions that they introduce. Assume that competitive investments return 15% after tax. It will be profitable for a taxpayer to invest in an 11% opportunity which is tax free. The fact that some of the society's scarce capital was invested at 11% rather than 15% means that four points of return were wasted, simply thrown away. There is extensive economic literature on this matter of excess burden.⁵⁹

Use of a tax-free return in this illustration was not exaggerated. Under an income tax, a combination of fast write-off and

57. Cf. L. Shepard, *Minimum Deposit Life Insurance: The Seven-Year Itch*, 29 TAX NOTES 539 (1985) (Policy holder of "minimum deposit" life insurance policies can engage in tax arbitrage by borrowing the entire cash value of the policy, deducting interest on the loan and making fairly small premium payments).

58. For a discussion of the pre-existing incentive to housing investment, see *supra* note 56 and accompanying text.

59. See E. BROWNING & J. BROWNING, *PUBLIC FINANCE AND THE PRICE SYSTEM* 288-302 (1979); A. HARBERGER, *TAXATION AND WELFARE* (1974).

investment credit is equivalent to expensing which in turn is equivalent to zero tax on the return. An investment costing \$100 with a before-tax return of \$10 produces 10%. Immediate expensing against a 46% tax means that the cost to the investor is \$54 and the annual return after a 10% tax will be \$5.40 or still 10%. In the income tax of 1982, the equivalent of expensing was not unusual.⁶⁰ Some authors commenting on the Treasury tax reform plan argued that the efficiency gain from merely making the investment incentives more nearly uniform would more than offset the considerable reduction in overall investment incentive.⁶¹

A tax on consumption, or on income in the Fisher definition, achieves the results of the investment savings incentives more uniformly and without the spurious savings problem encountered with borrowing. This whole set of complications is attributable to Congress taking a wrong road at the very beginning in legislating the income tax.

Other Sins

There are a number of other sets of current tax problems, which will be mentioned only briefly, that can be traced to sloppy thinking in the early days of the income tax. The original framers were correct in concluding that income once taxed as it entered the family should not be taxed again simply because the earner transfers normal consumption rights to another family member. This original gift exclusion was, however, too broadly written and led to such foolishness as the non-taxation of social security benefits and to a long line of litigation and legislation on business gifts.⁶²

60. *Economic Report of the President*, H.R. Doc. No. 19, 99th Cong., 1st Sess. 83 (1985).

61. J. Gravelle & M. Boskin, *The Business Tax Issue: Two Views*, 29 TAX NOTES 651 (1985).

62. Benefits under Federal Social Security legislation are administratively excluded by way of interpretation of the relevant provision. See I.R.C. § 86 (West Supp. 1986); Rev. Rul. 217, 1970-1 C.B. 12. However, § 86 does require inclusion of some benefits in gross income. Specifically, the portion of social security benefits to be included in an individual's gross income is the lesser of one-half of the total social security benefits received during the taxable year or one-half of the amount by which the sum of the taxpayer's "modified adjusted gross income" plus one-half of social security benefits received exceed a specific basic amount. I.R.C. § 86(a), (b) (West Supp. 1986). In effect, where the recipient's income both from social security benefits and through other means exceeds the statutorily designated amount, then the benefits are included in gross income; gifts, however, remain excluded. See I.R.C. § 102 (West Supp. 1986).

The double taxation of corporate dividends can certainly be attributed to sloppy thinking about the relation of corporations and their shareholders under the income tax. There are other examples, which will not be mentioned in this paper.

Lessons

The argument developed to this point has some obvious lessons for various proposals to reform the income tax. One set of lessons that the author finds compelling is apparent in the hopelessness of the big reform packages such as Bradley-Gephardt,⁶³ Kemp-Kasten,⁶⁴ *Treasury I*⁶⁵ and the President's Proposals.⁶⁶ From the standpoint of serious analysis of the problems of income tax, they are essentially gimmicks that move tax burdens around with principal concern for political appeal, i.e., having more winners than losers.

Certainly the most thoughtful of these proposed reforms was *Treasury I*.⁶⁷ On the most basic of all the fundamentals, whether to draft *Treasury I* to tax income or consumption, the die was cast for income on the expedient grounds of having a plan on time—that a repair job on the income tax was better suited to the political time table.⁶⁸ The serious problem of owner-occupied housing was taken off the agenda before reform planning started.⁶⁹ The key problem in the area of capital gains and realization, the treatment of appreciation at death, was never mentioned.

Creditably, the *Treasury I* plan was ahead of the others in its effort to deal with non-taxed fringe benefits. Failure to tax non-

63. S. 409, 99th Cong., 1st Sess. (1985); H.R. 800, 99th Cong., 1st Sess. (1985). The Bradley-Gephardt bill, known as the Fair Tax Act of 1985, proposed to broaden the base of the individual and corporate income taxes, to significantly reduce tax rates, to smooth out the tax schedules of the individual income tax and to simplify the tax laws by eliminating most credits, deductions and exclusions.

64. S. 2600, 98th Cong., 2d Sess. (1984). This bill, known as the Fair and Simple Tax Act of 1984, was introduced by Senator Kasten as a method of reducing tax rates in a manner that is fair to all taxpayers and simplifying the tax laws by eliminating most credits, deductions and exclusions. *Id.*

65. *TREASURY I*, *supra* note 42. *TREASURY I* is a three-volume report on fundamental simplification and tax reform proposed by the Treasury Department to the President in November 1984.

66. See *PRESIDENT'S PROPOSALS*, *supra* note 20. The President proposed to reduce tax rates, reduce complexity, increase fairness and increase growth.

67. For a thorough discussion of *Treasury I*, see McLure, *Where Tax Reform went Astray* 32 *VILL. L. REV.* 1619 (1986).

68. C. McLure, Jr., *Rationale Underlying Treasury Proposals*, in *ECONOMIC CONSEQUENCES OF TAX SIMPLIFICATIONS*, *supra* note 56, at 35.

69. *Id.* at 37.

cash incomes was one of the original sins in our tax system.⁷⁰ Dealing with this required a basic effort to put across the idea that the economy will operate more efficiently if no particular form of income is favored over any other. This idea is not a matter of providing a tax reduction to a favored group, it is a matter of allowing people to make unbiased decisions about how to receive salary.

The Reagan tax reform was presented as massive tax reduction for most people, financed by closing loopholes that applied to special groups, mostly corporations. This was essentially a bidding-for-popularity strategy that was open to counter-attacks from the sellers of fringe benefits, the insurance companies, who encouraged taxpayers: "Do not let them take your benefits away. Write your Congressman." It was also subject to attacks that taxing fringe benefits was regressive.

The other theme exploited to push tax reform was simplicity.⁷¹ Obviously, taxing non-cash income does not make for simplicity, but this is irrelevant. In no logical sense can simplicity alone be held up as a goal for tax policy. One can talk about achieving a given level of fairness and efficiency more simply or making trade-offs between simplicity and fairness or efficiency, but simplicity by itself is an inadequate goal.

A serious strategic approach to tax reform would be to emphasize deregulation and freedom rather than rate reduction. It would have been possible to lay it on the line: "We must have an average tax of so and so. Not taxing fringes means that we must tax cash more heavily. There is no tax reduction either way."

Another kind of lesson that can be pursued is the importance of beginnings in any tax system. The arena of tax legislation is a poor place for learning by doing or by on-the-job training. The system does not forgive the making of a mistake.

It is certainly a possibility that within the next few years we will initiate a new tax form in the United States focusing on a broad based direct consumption tax ("DCT"). I see a great reluctance to increase income tax rates, while at the same time the tax base erosion is likely to continue. There will be demand for a new revenue source to deal with the deficits.

70. For a discussion of the failure to tax non-cash items, see *supra* notes 6-27 and accompanying text.

71. See PRESIDENT'S PROPOSALS, *supra* note 20, at 115-16. The President proposed a return-free tax system in which specified taxpayers could elect to have the Internal Revenue Service compute the taxpayer's liability based on withholding and information reports provided to the Service. *Id.* at 115.

The obvious forms of DCT are retail sales, the European-style value-added tax collected by the credit method, and a business transfer tax which is a value-added tax collected by the deduction method.⁷² All of these differ mainly in collection technique and could, in principle, be equally comprehensive. They also differ in some relatively technical ways which are not relevant at the level of basic discussion that I will pursue.

A major problem with any DCT will be regressivity, or the impact on poor people. A popular but improper way of handling this regressivity is to exclude from the tax base alleged necessities such as food and drugs. In the first place, these categories are basically undefinable, so the difficulties of identifying specific exempt products would be endless. In the second place, food and drugs, as such, are not necessities. A certain amount of food is a necessity but then a certain amount of many things are necessities. A considerable amount of food is a luxury or at least a comfort.

A straightforward way to deal with the matter of regressivity or necessities is to provide to everyone a refund of the amount of DCT attributable to expenditures on a poverty level of consumption. This is the practical equivalent of personal exemptions and a zero bracket amount in the income tax. The refund procedure, moreover, is the one that comes close to a logical concept of necessities. The refund approach probably lacks one of the appeals of exemptions, viz., it does enlist the lobby support of industries such as the food business, that would also benefit from exemptions.

Several DCT bills introduced in the United States provide for the food and other "necessity" exemptions, an approach which is common in Europe. It would be a fatal mistake to start off with this set of complications in a new tax, but that is likely to happen if decisions are made quickly in the political process.⁷³

From the income tax experience that the author has re-

72. See Doernberg, *A Workable Flat Rate Consumption Tax*, 70 IOWA L. REV. 425 (1985). Doernberg explores the feasibility of a flat rate consumption tax that is tax-neutral towards savings and consumption decisions faced by taxpayers.

73. For a collection of papers presented at a conference on the experience of six European countries with value-added tax, see *THE VALUE-ADDED TAX: LESSONS FROM EUROPE* (H. Aaron ed. 1981). In an introduction, the editor notes that the "value-added tax should not be regarded as a tax panacea or a simply surgical device for extracting revenue painlessly from the body politic. Rather, its desirability should be considered within the context of a larger debate on tax structure." *Id.* at 17.

counted, one of the areas of particular trouble was the treatment of owner-occupied housing.⁷⁴ The same problem arises in regard to imputed income from other consumer durables.⁷⁵ These problems are quite manageable in the context of a DCT.

There is in the public finance literature a remarkable parallel: a continuing tax on an income stream is substantially equivalent to a one-time tax at the same rate on the capital value of that stream. At a 10% interest rate a stream of payments of \$10 a year is worth \$100. A stream of taxes of 20% of the income, i.e., \$2 a year has a current value of 20% of \$100.

The tax on imputed rent could be substantially discharged by treating the purchase of a house as a fully-taxable event under a DCT, or equivalently as treating the payment of interest and principle on a home mortgage as taxable. The one-time tax on the purchase price would appear to be a burden, but obviously it could be financed in the mortgage as well as those parts of the house cost attributable to local building codes designed to enrich local builders. There is a transition problem connected with previously-acquired homes which could be solved by a one-time tax on the capital value at the start of DCT.

Once one begins to explore this line of argument, refinements could be developed. It would be elegant to have periodic reassessments and tax increase of capital values to get imputed rents not foreseen in the initial purchase price. On sale of the home, one should refund the tax rate times the sale price to the extent of previously taxed capital value. The ability to invent refined calculations could easily outstrip the ability of the system to handle complications. The author's argument is that an intelligent initial approach to the problem of drafting a new tax would reveal considerable resources for doing things correctly. Out of these, reasonable compromises could be fashioned in contrast to the horrors created under the income tax. Under a DCT, I would think it realistic to come very close to the right answer on consumer durables other than housing. Furthermore, one would expect that the chances are good for getting a much better result on housing than exists under the current income tax. In the value-added tax bill which he introduced several years ago, Mr. Ullman would have provided a tax at half-rate on the initial

74. For a discussion of the treatment of owner-occupied housing, see *supra* notes 20-21 and accompanying text.

75. For a discussion of the problems with regard to imputed income, see *supra* notes 17-27 and accompanying text.

purchase price of housing.⁷⁶

Another area that would require careful early planning under a DCT would be the matter of intergovernmental relations. One could argue that a decision to consume public schooling should be burdened with the same tax as the decision to consume private schooling. As investments, there is a good case for making the tax zero in both cases. Other state and local services would seem to be more clearly consumption. A particular function would ordinarily bear tax to the extent that it involved buying goods from the private sector. Complete taxation would require an additional tax for the value added by state and local government employees. This would be one of the more difficult areas of DCT design.

Another area calling for special effort in a DCT is the application to financial institutions. This area seemed so complicated that it was left out of the coverage of the European value-added taxes. Generally, financial institutions are treated by some other tax, such as a premium tax, in states that have retail sales taxes. In theory, the loading charge in insurance is the proper base for a consumption tax in insurance (not the premium) and the service charges, whether or not paid out of investment income, is the proper base for banks. The financial area is one in which forethought will pay dividends. Significantly, the volume of the Treasury's 1984 Tax Reform report dealing with the value-added tax indicated some hopelessness about applying a DCT to financials.⁷⁷ Recent academic research, however, has indicated that this is quite feasible.

The lesson of income tax experience is that there is little opportunity to construct detailed tax rules wisely and then only when the tax is new. It does not seem accurate to say that any new tax in the United States will quickly fall prey to the special interest exceptions that bedevil the income tax. For the most part, these can be traced back to errors in the original formulation of the income tax. The trick is to be more careful with any new tax which Congress sees fit to adopt.

76. Tax Restructuring Act of 1979, H.R. 5665, 96th Cong., 1st Sess. (1979).

77. See 3 TREASURY I, *supra* note 42. Volume 3 of *Treasury I* considers the issues involved in deciding whether the United States should adopt a national sales tax. For the Treasury Department's discussion of the complex problems of applying the value-added tax to financial institutions, see *id.* at 49-53.

Postscript

This article was written before the Senate Finance Committee's breakthrough that led to the adoption of the tax reform legislation in 1986.⁷⁸ The pessimism expressed in the article about tax reform was overstated but the amount of real reform accomplished was modest.

On the individual side there was real improvement in the limitation of the interest deduction, and the deduction for state sales taxes.⁷⁹ The limitation on tax shelter losses and the minimum taxes offend logic by making the treatment of certain transactions conditional on circumstances irrelevant to the transaction itself.⁸⁰

On the business side, there was a significant increase in the double tax on saving and investment offset by greater equality between various investments, e.g., repeal of the investment tax credit.⁸¹ One would expect from prior income tax history that this will not prove to be a permanent solution and we will soon be talking about policies to increase investment.

It was disappointing, but not unexpected that no progress was made toward taxing fringe benefits.⁸²

78. Tax Reform Act of 1986, Pub. L. No. 99-514, 1986 U.S. CODE CONG. & AD. NEWS (100 Stat.).

79. *See id.* §§ 134, 511(b), 1986 U.S. CODE CONG. & AD. NEWS (100 Stat.) 32, 160-65. Section 511(b) amends I.R.C. § 163(h) (West Supp. 1986) by disallowing the deduction for personal interest of individuals. *Id.* § 511(b). Section 134 repeals the deduction for state and local sales taxes. *Id.* at § 134.

80. *See id.* § 501. Section 501 amends the Tax Code by adding a new section which limits the losses and credits from passive activities. *Id.*

81. *See id.* § 211. The regular investment tax credit is repealed for property placed in service after December 31, 1985. *Id.* Under the provisions of a new § 49, the investment tax credit continues to apply to certain property, including property covered by transition rules. *Id.*

82. *See* I.R.C. § 132 (West Supp. 1986).

