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Threats to the Integrity of Our Tax System*

By MORTIMER M. CAPLIN†

I. SOME CURRENT ATTITUDES

It is often pointed out that ours is a self-assessing tax system, and that the soundness of such a system depends upon the good faith of our people and their continued willingness to report their income and assess themselves in a fair and honest manner. To this there is usually added that Americans are trustworthy, and that this facet of our internal revenue system is working effectively

I do not question the inherent honesty of the people of this country; nor do I have the facts to dispute the assertion that most of them report their income fully and fairly. But there are disturbing signs; there seems to be a current lack of confidence in our tax laws, marks of disrespect for the administration of these laws, and increased tendencies toward tax avoidance and dishonesty. Recently it was reported that more criminal convictions for tax fraud were obtained in the past five years than in the entire preceding twelve years.

People also appear to be developing a lethargy over tax enforcement, reminiscent of the former widespread attitude under the Volstead Act. Not that fraudulent tax evasion is currently accepted or approved by any large segment of our society; rather, the evidence is that of indifference and sometimes sympathy when a member of a locality is charged with tax violations, criminal or civil. Practitioners certainly weigh this factor carefully in deciding whether a jury is desirable in a tax proceeding.

* Statement, *Hearings on Topics Pertaining to the General Revision of the Internal Revenue Code Before the House Committee on Ways and Means*, 85th Cong., 2d Sess. part 3, at 2451 (1958).

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These attitudes constitute serious threats to the integrity of our taxing system. At a crucial moment in our history, when this system is being strained by an indefinite period of high taxation, it is imperative that firm steps be taken to reverse these trends.

Before considering possible remedies, it might be helpful to examine briefly some of the causes of our present plight.

II. PART OF THE BACKGROUND

What accounts for this lack of confidence in our tax law? I see at least five causes.

1. *Impact of Rates*

First, rates are extremely high at all levels of our graduated income tax. We certainly have marched a long way since the 1894 levy of 2 percent of net income, with a \$4,000 exemption for individuals—an act which Mr. Joseph H. Choate vilified as “communistic in its purposes and tendencies.” Our 1913 act also evokes pleasant memories, with a 1 percent normal tax and a graduated surtax of 1 percent to 6 percent on income above \$20,000. But the needs of the day have undergone remarkable change, and so too our tax rates.

High rates have made us a tax-conscious people. Taxes are a major part of the family budget, and a controlling force in the way we conduct our businesses. Many of us have developed an acute sensitivity to the importance of tax deduction and the costliness of nondeductible expenditures. This has led to increased interest in tax planning, in means for arranging one's affairs to minimize taxation, in tax avoidance.

It should also be recognized that there is a growing awareness of the artificiality of our highest brackets. Individuals frequently hear of expense accounts, fringe benefits, and persons earning huge sums but paying little taxes. The remark made the other day by a salaried employee is typical: “Why does everyone have a loophole but me? Why shouldn't I have a window to crawl out of?”

2. *Complexity*

Along with increased rates, our tax laws have become unbelievably complex. Many men are devoting their lives to the study, practice, and administration of these laws, laws developed

in a piecemeal fashion—to meet new situations that arise, to plug loopholes, to offer incentives, to provide equity, to create certainty, and even to attain simplification.

To attempt to comprehend the tax laws is an extremely difficult task. Accountants and lawyers in small communities complain about the complexity of the law as it applies to the small-business man and average client. Income-tax returns are detailed and involved, and people approach April 15 with frustration and dread. Many make a bona fide effort to prepare proper returns; some make a minimum of disclosure and decide all uncertain issues in their own favor; others deliberately misstate items, and leave the problem to the income-tax collector. People are sometimes heard to say—humorously or not—that they overstate travel and entertainment expenses, repairs, and depreciation, anticipating that revenue agents question these items with a readiness to compromise. The thought here is that an overstatement of a deduction coupled with an adjustment will produce the “right” tax consequences. Obviously, such practices are wrong and may constitute fraud on the Government. But they do exist.

Laws should be understandable to the great bulk of society when they materially affect individuals, and yet are not reasonably comprehensible to them, we are inviting widespread disregard of the laws, leading to innocent as well as calculated violations.

3. *Emphasis upon “tax gadgets”*

Another contributing force to the lack of confidence in our tax laws is the undue emphasis and publicity given to “tax gadgets” or “tax gimmicks.” I refer here not to the expected use of various provisions of the Internal Revenue Code, based upon normal business or family motivations. Instead, my reference is to a wide variety of proposed transactions, often unrelated to the usual activities of the individual, but which are being peddled solely on the basis of tax advantages to be derived from them. Many such proposals have been defeated by the ingenuity of our courts: the “business purpose” rule, the “step transaction” doctrine, the “substance versus form” approach, are all judicial replies to artificial plans. But the judicial process alone is not sufficient to prevent this type of trafficking in tax schemes.

A tax adviser performs a useful function when he aids his

client in culminating a necessary transaction in accordance with his wishes and with the least possible tax costs. Such services are to be sharply contrasted with the multifarious activities of the "tax broker"—a person who, for a commission, solicits sales and deals dependent for their validity upon a tax quirk. The operations of this latter group are publicized through personal contacts, through paid advertisements, and through repetition of many of their plans in publications and in the press. The public seems to be barraged with information about new "tax shelters" or "tax havens" designed primarily for tax avoidance with only secondary consideration being given to their economic soundness.

Recognition must be given to the eroding character of these practices—this exploitation of other people's tax brackets—on the respect of our citizenry for our tax laws.

4. *Discrimination*

Another factor to be taken into account is the sentiment that our tax laws discriminate in favor of particular industries or groups. Certainly when we examine the legislative history of the Internal Revenue Code, it is difficult to answer the charge that a large portion of the law has been enacted in direct response to the demands of particular industries or groups. This may be inevitable in a democratic society. But, if we are to have a sound and equitable tax system, we have gone too far in this direction. Under a fiscal program geared to a high budget, a tax favor granted to one group inevitably results in a tax burden to others. Whether we extend percentage depletion or create additional types of capital gain, or permit new exclusions, exemptions or credits, the resulting loss in revenue must be borne by less-favored taxpayers.

Frequently tax preferences are granted as incentives of one sort or another. But is our tax law the proper vehicle for providing special incentives or subsidies? Doesn't such a legislative policy weaken our tax system and result in continuing inequities to other taxpayers? The tax laws cut across the whole fabric of our complex society. We must recognize our inability to cure all of our ailments by new variations of tax relief. If we continue to attempt this, the main function of our tax laws—the raising of revenue—is destined to fail.

Furthermore, some of the distinctions made in granting tax

preferences are often illogical and unjustified. Take, for example, the distinction now made between traders in realty and traders in securities: the latter may be assured of long-term capital-gain treatment, while the former are usually relegated to the graduated rate structure.

I doubt whether the average man is conversant with the refinements of these tax favors. But I do gain the impression that many are of the view that certain groups are not paying their way. Local personal property tax systems have suffered greatly because of beliefs in the community that neighbors understate fair values. On a much larger scale, our national tax system would be grievously damaged if the sentiment was widespread that our laws were discriminatory or inequitable. People will declare their full tax liabilities only if they feel sure that the other fellow is paying his fair share.

5. *Sporadic enforcement*

A final important consideration is the sporadic enforcement of our internal revenue laws. The development of the Internal Revenue Service has fallen behind the vast increase in the tax-paying body. Whether it is a question of size, or lack of top-quality personnel, the Service is not adequately exercising its auditing functions. For the fiscal year ended June 30, 1956, almost 58 million individual income tax returns were filed; yet hardly 2 million individual returns were examined through contact with the taxpayer.

Not that we have need for a high-powered police force of Treasury men; but a broad exercise of the auditing procedure on a reasonable basis has a salutary effect. Knowledge among taxpayers that their returns will probably be examined serves to check possible abuses. Too often we encounter the taxpayer willing to take a chance on the gamble that his returns will not be scrutinized. His information that acquaintances similarly situated have not been questioned contributes to his engaging in the new game of roulette.

The Commissioner of Internal Revenue recently referred to the mass evasion psychology of a particular group of taxpayers. When we view the intense public interest in tax savings opportunities—fringe benefits, expense accounts, capital gains, depletion, intangible drilling costs, tax-free interest, foreign invest-

ments—we may well wonder whether this type of psychology isn't spread on an extremely broad scale.

If our self-assessing tax system is to be preserved, these trends must be reversed and a spirit of tax law compliance promoted. Our tax laws must earn the respect of the public; and to do this, they must be understandable and must be aimed at taxing persons of equal income—regardless of source—on an equal basis.

III. BASIC POLICY DECISIONS

In reexamining the basic policies underlying our tax laws, we must recognize the hit-or-miss fashion in which special relief provisions have been adopted. Some regard this as the only practical way of legislating; merely grant counter-balancing favors as each special problem is brought to Congress attention; extend capital gain opportunities to this group or to that type of earnings; provide deferred compensation arrangements for still others; allow percentage depletion for this situation, for that. It is hard to see where such a legislative policy of relief by proliferation would end; and how much more complex our tax laws would become.

The irresistible conclusion is suggested that, as these various forms of special tax relief are spread wider and wider, they tend to neutralize each other; and that a sounder system would be created by scrapping all in favor of a lower, non-discriminatory graduated tax.

In the announcement of these hearings, it was stated that the Committee on Ways and Means was looking toward revisions of our internal revenue laws in order to obtain a revenue system which is fair, equitable, neutral in impact between similar dollars of income, responsive to changes in economic conditions, and capable of compliance and administration with a minimum of taxpayer and governmental effort, and which will at the same time produce the needed revenues for the Government. It is my belief that these sound aims of the committee could be accomplished if policy decisions were made along the following lines:

1. *Rates:* Reduce the top tax brackets to 65 percent in conjunction with eliminating major relief provisions of the code.

Large numbers of taxpayers who might be expected to fall within our higher tax brackets are now permitted to reduce their

taxes through capital gain relief and other special treatment. Thus, while the high rates give the impression of taxing severely, they are effective only as to those high-bracket taxpayers unable to qualify under a relief provision—mostly individuals whose income is earned through personal services. A 65 percent top bracket, now reached at \$32,000 of taxable income, more closely approximates the present effective rates of persons with high incomes. At the same time, a dual program of rate reduction plus elimination of major relief provisions would tend to place taxpayers of equal income on the same tax basis. The effect of this proposal is to substitute a frank and straightforward presentation of our actual rate structure for the present misleading pattern. Any revenue lost from this rate reduction could be completely recaptured by the relief elimination.

2. *First bracket:* Create a 10 percent bottom bracket, in exchange for eliminating sick pay and dividend exclusions, and retirement income and dividends received credits.

To create a better balance in the rate structure, the first bracket should be split in half to create a 10 percent starting point. This should be adopted coincidentally with deletion of four special provisions: the sick pay exclusion, dividend exclusion, dividends received credit, and the retirement income credit.

The basic individual income tax return, Form 1040, owes much of its complexity to these four provisions. Their elimination would help simplify the law, and would be consistent with a program of reversing the special relief trend. It would also help offset the revenue loss resulting from the lowered first bracket.

3. *General averaging provision:* Adopt general averaging provisions for all forms of income.

Our present emphasis upon accounting for income on a rigid annual basis creates inequities for taxpayers of many classes. Hardships are inevitably encountered when progressive rates are applied to irregular and fluctuating amounts of income realized over a series of individual taxable years. Uniform averaging rules should be adopted, applicable to every type of income. A simple averaging provision comparable to the Canadian system, or a moving-average approach are some of the possibilities.

Whatever the choice such rules would nullify the main argument for our present distinction for long-term capital gain and would provide general relief on an equal basis for all taxpayers.

4. *Capital gains*: If capital gains remain in the law, extend the holding period to at least 1 year; eliminate the 25 percent alternative tax; and allow all taxpayers to claim only the 50 percent deduction for net long-term capital gain.

The capital gains provisions are among the primary causes of complexity of the code and discrimination among taxpayers of equal incomes. The situation is aggravated by the relatively brief 6-month holding period requirement, which has been in the code only since 1942. If capital gains are not to be superseded by a general averaging provision, their preferential treatment should be sharply limited.

To put capital gains in focus, it should be recalled that until 1922 they were subject to the same rates of taxation as other income. The original justification for special treatment was the unfairness of bunching in 1 year the accretion in value of property held for more than 2 years. The 2-year holding period continued from 1922 to 1924, when a sliding-scale system was adopted with variations for holding periods from 1 year to over 10 years. This continued until 1938. From 1938 to 1942, the minimum holding period was fixed at 18 months; and it was not until 1942 that the present 6-month rule was inserted in the code.

A short holding period requirement emphasizes the sharp disparity between the taxation of earnings from personal services and earnings from investment. As a first step in correcting this inequity, the holding period should be extended to at least 1 year and the alternative tax of 25 percent should be eliminated. All taxpayers should be limited to deducting a maximum of 50 percent of the net long-term capital gain in excess of net short-term capital loss. At the same time, there should be a broadening of the allowance for capital loss deductions.

5. *Gain on depreciable property*: To the extent of prior depreciation allowances, tax as ordinary income gain realized on the disposition of depreciable property

Taxpayers may fully deduct depreciation on property used in the trade or business, or held for the production of income.

In turn profit on the sale of these assets is treated as capital gain.¹ This is sometimes referred to as 2-for-1 treatment.²

The availability of rapid depreciation in the early life of a new asset, followed by a sale at capital gain rates, often results in artificial use of the tax law—particularly when property is purchased subject to a high mortgage. This is accentuated when code section 1231 applies, for a loss deduction is then assured should the market decline. So long as we continue to give preference to long-term capital gain, provision should also be made for taxing as ordinary income that part of the gain represented by past depreciation allowances.

6. *Basis on death*: Deny a basis adjustment for foreign realty transferred by death; determine basis for all property passing by death in the same manner as income in respect of a decedent.

Foreign buildings and land have been sold to individuals under tax plans aimed at depreciation being fully deductible during lifetime, property passing to heirs free of estate tax, and the heirs receiving an adjustment of basis of the property for income tax purposes. This completely unwarranted step-up in basis for foreign realty passing on death should be denied.

Under the general provisions of code section 1014 (a), property acquired from a decedent takes a new income tax basis equal to the fair market value of the property at the date of decedent's death or the alternate valuation date. Accordingly, any unrealized appreciation in value to these dates unjustifiably escapes income taxation. This could be corrected by adopting as the general basis rule the special provisions now contained in code sections 1014 (c) and 691 for "income in respect of a decedent" that is, the decedent's income tax basis should carry over increased by the portion of the Federal estate tax allocable to the property in question.

7 *Charitable contributions*: Limit charitable deductions to the lower of the donor's basis or the fair market value of property

A donor should not receive double benefits when he contributes appreciated property to a charitable organization. Under

¹ Int. Rev. Code of 1954, §1239 [hereinafter referred to only by Code section], limits this when depreciable property is sold to taxpayer's spouse or eighty percent controlled corporation.

² Under code section 1231, in the law since 1942, losses on property used in the trade or business are deductible in full.

present law, no income is realized at the time of such gift, yet the donor is allowed an income tax deduction based upon the fair market value of the property—even where the charity is his own family foundation. If the donor is in a high tax bracket, he may actually make a financial profit by contributing appreciated property instead of selling it and paying capital gain taxes. Works of art, too, have been marketed at discount prices on this theory: *i.e.*, the purchaser will pocket a tax-free gain, through a tax deduction, by making an immediate donation of the property.

Such abuses would be corrected if the charitable deduction was limited to the donor's basis or the fair market value of the property, whichever is lower. This would also serve to discourage tax devices whereby individuals rid themselves of preferred stock dividends tainted under code section 306.

8. *Percentage depletion*: Lower all percentage depletion rates; allow this depletion only until capitalized costs have been recovered.

If any extractive industry needs incentives or financial assistance, outright subsidies or grants-in-aid might be made by Congress as the occasions arise. Unlimited percentage depletion, particularly when coupled with the right to deduct intangible drilling costs, stands out as one of the glaring inequities and preferences in our tax laws.

Since 1926 unlimited percentage depletion has been a part of our law. It was inserted at that time in the interest of simplicity and certainty in administration. Difficulty in administering discovery depletion was the reason stated for the change—not any basic policy consideration for inducement or encouragement. The record is thoroughly reviewed by Prof. Harrop Freeman in *Percentage Depletion for Oil—A Policy Issue*.³

In 1933, the then Acting Secretary of the Treasury stated: "Our experience shows that the percentage depletion rates set up in the law do not represent reasonable depletion rates in the case of the designated properties, but are much higher than the true depletion to which the taxpayer is fairly entitled. Moreover, these provisions enable a taxpayer to obtain annual depletion deductions, notwithstanding the fact that he has already recovered the full cost of the property. The deduction is, there-

³ Ind. L. J. (1955).

fore, a pure subsidy to a special class of taxpayers. For this reason the Treasury recommends that these provisions be eliminated, in order to put all taxpayers upon the same footing.

Current history demonstrates how one depletion favor has led to another. How industry after industry has requested offsetting depletion to meet competition. How our present code allows percentage depletion to "all other minerals," excluding only "soil, sod, dirt, turf, water, or mosses, minerals from sea water, the air, or similar inexhaustible sources." How, in the case of minerals, the percentage depletion is not limited to the value of the mineral itself, as taken from the ground, but to the "commercially marketable mineral product"—to tile, to brick, to finish cement, to pulverized talc and talc crayons.

If all taxpayers are to be put upon the same footing, percentage depletion should, at least, be curtailed: Percentages should be lowered and the new percentages allowed only until the remaining capitalized costs have been recovered.

9. *Life insurance:* Deny to taxpayers the right to deduct interest on loans made to pay premiums on life insurance policies.

Life insurance policies have tax appeal, and are often sold to high-bracket taxpayers primarily on that basis. Companies are offering policies with high cash surrender values during the early years, and will loan most of the money for premium payments without collateral other than the policy. Insurance agents state, as the loan interest is deductible for income tax purposes, you are in effect paying premiums at an unusually low cost. In turn, predeath interest earned on the policy passes free of income taxes to your beneficiary; and, if the policy is to be paid to your spouse for a period of years under a policy option, she may receive up to \$1,000 a year of tax-free postdeath interest. This all makes life insurance a significant tax haven, especially when the proceeds may pass free of estate tax by lifetime assignment of the policy.

The soundness of a business or family plan should not hinge exclusively on a tax gadget. Where possible trading on tax avoidance should be discouraged. Extreme abuses could be prevented here by denying to taxpayers the right to deduct the interest paid on loans for life insurance premium payments.

10. *Withholding*: Require withholding of income taxes on dividends and interest.

The Treasury is reported to be losing hundreds of millions of dollars through the failure of taxpayers to report their dividends and interest. This could be corrected, without major business or administrative inconvenience, by a required withholding procedure.

11. *Internal Revenue Service*: Provide for the strengthening of the Internal Revenue Service.

Studies are already underway on the administration of the internal revenue laws. As one of the reports states: "The task of the Service is without a doubt the most sensitive of any task in the Federal administrative structure."

A determined effort should be made to strengthen the Service, with particular reference to perfecting its auditing procedures.

12. *Long-range projects*: Appoint a paid Commission to redraft a proposed new code; reappraise advisability of creating a Court of Tax Appeals.

Two long-range projects are submitted as further means for improving our internal revenue laws:

First, consideration should be given to appointing a salaried Commission charged with the responsibility of making a detailed study of our Internal Revenue Code, and preparing a draft of a proposed new statute. The 1954 statute represents an attempt to attain clarity and certainty by detailed specification of myriad controlling rules. We may have erred too far in this direction, and experience under the statute is indicating that drawing series of precise lines creates hardships, complexities, and opportunities for tax avoidance. Such a Commission might consider carefully the possibility of culling from the existing body of law the basic and underlying principles which govern our tax system. It might then be possible to draft a statute built around a clear statement of these principles, but without the minutiae of detail characteristic of the 1954 code.

Second, but related to the above proposal, a reappraisal should be made of the advisability of creating a Court of Tax Appeals, to have exclusive appellate jurisdiction in the review of all non-criminal Federal tax cases. Such a court's decisions would be

final, except where an occasional constitutional issue was involved. The existing problems of unresolved conflicts among the circuits, and between the Tax Court and courts of appeals, would be eliminated. Such a judicial hierarchy automatically assuring decisions of nationwide authority would provide greater certainty in interpreting and administering our tax laws. It would also be the available machinery for constant and final interpretation of a statute drawn in more general terms and based upon flexible, fundamental principles.

IV CONCLUSIONS

The foregoing recommendations are in response to the kind invitation of this committee for my "views—amicus curiae—of the need for revenue revision and the direction which it should take." As someone else has discussed taxation of foreign income, I make no mention of this difficult problem. Nor do I go into the question of taxing interest on State and municipal bonds: as a matter of priority, this complex issue can await further developments and may be alleviated in part by lowering the higher income-tax brackets.

A group of outstanding tax practitioners recently reported that the "single most important factor of successful Federal tax enforcement in this country is taxpayers' attitude."

As I stated at the outset, it is my view that this attitude is being adversely affected by high and artificial rates, complex laws, widespread emphasis upon tax avoidance, sporadic enforcement, and unjustifiable discrimination in our tax laws. We have reached a danger point which strongly evidences an undermining of the tax morality of large numbers of people. Yet I believe these threats can be met by adopting amendments aimed primarily at eliminating tax preferences and favors—amendments focused on creating a revenue system which is fair, equitable, neutral in impact between similar dollars of income. Only in this manner will taxpayer confidence be restored.