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## The Tax Reform Act of 1986: Simplification and the Future Viability of Accrual Taxation

The distinction between capital gain and ordinary income has long been perceived as unduly complicating.<sup>1</sup> Because of the distinction, the Internal Revenue Code has had to include numerous provisions defining capital assets and guarding against attempts to shift income and losses between capital and ordinary.<sup>2</sup> A common view among tax scholars is that eliminating the capital gain structure would substantially reduce the size and complexity of the Code.<sup>3</sup> As a result, it was not surprising that Congress repealed the popular long-term capital gain exclusion in the Tax Reform Act of 1986 (1986 Act).<sup>4</sup>

While simplification, of course, was an avowed purpose of the 1986 Act,<sup>5</sup> the Act did nothing more than abolish the preferential rate for long-term gains. To truly simplify the Code, Congress must confront the need to control the taxpayer's power to recognize capital losses at will, while at the same time postponing recognition of capital gain. One method commonly proposed to alleviate this problem is the periodic accounting of accrued capital gains and accrued capital losses.<sup>6</sup> Unfortunately, tax commentators have routinely condemned this type of system as administratively infeasible.<sup>7</sup> Recently, however, Professor David

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1 See, e.g., Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 4 (1974) ("The fact that long-term capital gains are subject to a lower tax rate than other types of income is perhaps the single most complicating aspect of existing law."); Hickman, *Capital Gains and Simplification*, in FEDERAL INCOME TAX SIMPLIFICATION 223 (C. Gustafson ed. 1979) ("Capital gains is often cited as one of the greatest complicating features of the federal income tax system."); Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got To Do With It?*, 39 SW. L.J. 869, 870 (1985) ("[Capital gains taxation] is the source of much of the complexity of the Code . . ."); Mayhall, *Capital Gains Taxation—The First One Hundred Years*, 41 LA. L. REV. 81 (1980) ("Indeed, the presence of . . . [preferential treatment of capital transactions] in the income tax laws of the United States is largely responsible for the complexity of those laws.").

2 See, e.g., I.R.C. §§ 1221, 1239, 1245, 1250, 1252, 1255 (1982 and Supp. III 1985).

3 See *supra* note 1.

4 Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a) (Oct. 22, 1986).

5 See SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1986, S. REP. NO. 313, 99th Cong., 2d Sess. 3-4 (1986). In fact, both the major tax reform proposals made by the Treasury Department in November 1984 (TREASURY I, *see infra* note 26) and the President's response (*see infra* note 26) used the term in their title.

6 See, e.g., R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 231 (2d ed. 1976); TWENTIETH CENTURY FUND, INC., FACING THE TAX PROBLEM 476-84 (1937); Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 254 (1957); Shoup, *The White Paper: Accrual Accounting for Capital Gains and Losses*, 18 CAN. TAX J. 96 (1970).

7 See, e.g., *General Tax Reform: Panel Discussions Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 285 (1973) (testimony of Professor Richard Musgrave) ("Obviously, . . . taxation of all current but unrealized gains on an annual accrual basis would be unmanageable."); U.S. DEPT. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 5 (2d ed. 1984) [hereinafter BLUEPRINTS] ("The proposal does not recommend taxation of gains as accrued (that is prior to realization) because the administrative cost of annual asset valuations is prohibitive and because otherwise taxpayers might face problems in making cash tax payments when no cash had been realized."); Bradford, *The Case for a Personal Consumption Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 83 (J. Pechman ed. 1980) ("The difficulty of obtaining annual valuations and the potential cash flow problems for taxpayers with large accrued income but no cash income have generally led to the acceptance . . . of a realization basis for capital gains accounting."); Lowndes, *Current Conceptions of Taxable Income*, 25

Shakow has offered a proposal which attempts to make accrual taxation a true alternative for tax reform.<sup>8</sup>

This note examines Professor Shakow's claim that a tax system based on taxation of capital gains can actually be simpler than a system which defers taxation of capital gain. Part I outlines the reasons why only the preferential rate on capital gains was repealed, and why the capital gain-ordinary income distinction was retained. Part II discusses the competing models of accrual and consumption taxation, and locates the current system on the tax spectrum. Part III summarizes the Shakow model of accrual taxation. Part IV analyzes the recent tax reform's effect on the Code's complexity and the additional simplification that might be achieved by a further move toward an accrual tax system. Finally, Part V questions whether accrual taxation is a pragmatic alternative following the recent tax reform.

### I. Tax Reform Act of 1986: Repealing the Preferential Rate

The 1986 Act eliminates the previous highly progressive rate schedule with rates ranging to fifty percent, and establishes two tax brackets with rates of fifteen percent and twenty-eight percent.<sup>9</sup> Because of this overall rate reduction, Congress concluded that the need to provide a reduced rate for net capital gain was eliminated.<sup>10</sup> Congress justified this elimination not only by lower individual rates, but also by the resulting "tremendous amount of simplification for many taxpayers since their tax will no longer depend upon the characterization of income as ordinary or capital gain."<sup>11</sup> Furthermore, Congress perceived that this action would result in a greater willingness to invest in freely traded assets, because Congress also eliminated the requirement that taxpayers hold capital assets for an extended period of time in order to receive favorable treatment.<sup>12</sup>

The 1986 Act also eliminates the distinction between long-term and short-term losses for purposes of offsetting ordinary income.<sup>13</sup> As a result, it no longer takes two dollars of long-term capital losses to offset one dollar of ordinary income. Instead, taxpayers can offset any capital losses, dollar-for-dollar, against up to three thousand dollars of ordinary income.

OHIO ST. L.J. 151, 181 (1964) ("The administrative difficulties in connection with such a plan are so great that it is unlikely that Congress will ever adopt it."); Wetzler, *Capital Gains and Losses*, in COMPREHENSIVE INCOME TAXATION 115, 120 (J. Pechman ed. 1977) ("Completely eliminating deferral means taxing on accrual, which must be ruled out because it would be extraordinarily difficult to value nonmarketable assets every year in order to measure the accrued gain or loss.")

8 Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

9 Pub. L. No. 99-514, § 101(a).

10 S. REP. NO. 313, 99th Cong., 2d Sess. 169 (1986).

11 *Id.*

12 *Id.*

13 Pub. L. No. 99-514, § 301(b)(10). See also Gardner and Stewart, *Capital Gains and Losses After The Tax Reform Act of 1986*, 65 TAXES 125 (1987). Elimination of the preferential treatment of long-term capital gain required changes to other provisions of the Code making reference to the preferential treatment. See Pub. L. No. 99-514, § 301(a) (providing conforming amendments to §§ 62(a), 172(d), 129(f), 223, 642(c), 643(a), 691(c), 871(a), 1211(b), 1212(b), and 1402(i)).

These changes raise three questions. First, does the elimination of the preferential rate address the problems peculiar to capital gains that may have originally justified their favorable treatment? Second, is the preferential rate elimination stable? Third, could Congress have simplified the Code further by eliminating the distinction between ordinary income and capital gain entirely?

### A. *Rationale for Favorable Treatment*

The preferential rate for capital gains mitigated three major inequities in the federal income tax system: Bunching, lock-in, and illusory gains due to inflation.<sup>14</sup> Gains are normally accrued in increments over several years. In certain situations, however, these increments may be taxed in a single year at progressive rates. This could propel a large part of the gain into unduly high tax brackets.<sup>15</sup> The preferential rate on capital gains had alleviated the bunching problem because it excluded a substantial portion of the gain from tax. Similarly, the substantial flattening of the tax structure under the 1986 Act reduces the bunching problem, because no part of the gain can be propelled into a higher than twenty-eight percent tax bracket.

The lock-in effect is a consequence of the realization requirement.<sup>16</sup> Because capital gains are not taxed until realized, investors are discouraged from selling appreciated assets.<sup>17</sup> This disincentive to sell impedes the free flow of investment capital, resulting in a misallocation of resources and a reduction in market efficiency.<sup>18</sup> The capital gains exclusion had reduced this effect because it reduced the tax on property sold by only taxing forty percent of the gain.<sup>19</sup> With the 1986 Act's repeal of the exclusion, the tax rate on realized gains increases from a maximum of twenty percent to a maximum of twenty-eight percent.<sup>20</sup> This increase in

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<sup>14</sup> Congress provided the first form of preferential treatment for capital gains in the Revenue Act of 1921 in an attempt to mitigate the bunching and lock-in problems. The Act segregated the excess of capital gains over capital losses, *i.e.*, net capital gain, from other income and taxed the amount at a flat 12.5%. Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 227, 233. See generally STAFF OF JOINT COMMITTEE ON TAXATION, 98TH CONG., 1ST SESS., TAXATION OF CAPITAL GAINS AND LOSSES 5-6 (Comm. Print 1983) (discussing the various arguments for preferential treatment of capital gains); Waggoner, *Eliminating the Capital Gains Preference. Part I: The Problems of Inflation, Bunching and Lock-In*, 48 U. COLO. L. REV. 313 (1977).

<sup>15</sup> See Hickman, *supra* note 1, at 230; Wetzler, *supra* note 7, at 130. See generally J. PECHMAN, FEDERAL TAX POLICY (3d ed. 1977).

<sup>16</sup> Waggoner, *supra* note 14, at 366.

<sup>17</sup> Hickman, *supra* note 1, at 231; Wetzler, *supra* note 7, at 135.

<sup>18</sup> Wetzler, *supra* note 7, at 138 (stating that lock-in, by inhibiting transfers of assets, reduces the productivity of the capital stock, interferes with the efficient allocation of new investments across firms and industries, and induces rearrangement of asset portfolios). See also Conda, *Next Year's Tax Bill: Fix Capital Gains*, 33 TAX NOTES 409, 411 (1986).

<sup>19</sup> Use of the capital gains preference to reduce lock-in, however, gave that taxpayer an additional tax benefit; namely, the addition of the lower tax rate applied to the ultimate gain on the sale plus the tax benefit of deferral. Waggoner, *supra* note 14, at 367.

<sup>20</sup> Capital gains tax rates in lower brackets will increase even more. For example, in the 1986 marginal tax bracket of 42%, capital gains were taxed at 16.8%, while the rate in 1987 increases to 28% and after 1987 to as high as 33%. Thus, individuals in the highest tax brackets will experience a 40% increase in federal capital gains taxes. Conda, *supra* note 18, at 411.

the effective rate of taxation will correspondingly increase the incentive to avoid realization, and thus aggravates the problem of lock-in.<sup>21</sup>

Perhaps most importantly, the preferential rate on capital gains compensated, albeit crudely,<sup>22</sup> for the overstatement of capital gain that occurs in inflationary periods.<sup>23</sup> In these periods, part or all of a capital gain may reflect inflation and therefore is not real income.<sup>24</sup> The result is an increase in the effective rate of taxation.<sup>25</sup> Although previous tax reform proposals to abolish the preferential rate suggested indexing gains to the inflation rate,<sup>26</sup> the 1986 Act has no such provision.

### B. *Stability of the Repeal*

Because the 1986 Act does not address the problem of lock-in and the tendency of inflation to overstate income from capital gain, the stability of the repeal is open to question. Congress openly admitted that it retained the current statutory structure for capital gains in order to "facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase."<sup>27</sup> Thus, if Congress increases rates above the twenty-eight percent ceiling now scheduled for post-1987 tax years, "the distinction between ordinary income and capital gain will resume its former im-

21 The lock-in problem may be magnified because the repeal of the long-term capital gain preference at the federal level will probably be adopted at the state level as well. Since most states conform their tax structures to the federal tax base, eliminating the capital gains preference will automatically require that most states do likewise. Consequently, if states do not lower income tax rates, capital gains will be exposed to the maximum tax brackets. For most states, the effective tax rates on individual capital gains will rise from 20-22% to 36-37%. *Id.*

22 The long-term capital gains exclusion was not only crude, but also inequitable for those taxpayers with other types of investment income and income as compensation for services. See Blum, *Taxation of Capital Gains in the Light of Recent Economic Developments—Some Observations*, 18 NAT'L TAX J. 430, 433 (1965). See also Waggoner, *supra* note 14, at 318-19.

23 J. PECHMAN, *supra* note 15, at 111-12; Blum, *supra* note 6, at 255; Hickman, *supra* note 1, at 232; Wetzler, *supra* note 7, at 128.

24 For other discussions on the inflation problem, see McDonald, *Inflation: Concepts of Income, Tax Reform*, 28 TAX LAW. 533 (1975); Note, *Inflation and the Federal Income Tax*, 82 YALE L.J. 716 (1973); Comment, *The Feasibility of Adjusting for Inflation in Computing Taxable Income*, 49 WASH. L. REV. 873 (1974).

25 See Brinner & Munnell, *Taxation of Capital Gains: Inflation and Other Problems*, NEW ENG. ECON. REV., Sept.-Oct. 1974, at 7, reprinted in M. MCINTYRE, F. SANDER & D. WESTFALL, READINGS IN FEDERAL TAXATION 406 (2d ed. 1983).

26 See, e.g., *Capital Gains Tax Bills: Hearings on S. 2428, S. 2608, and S. 3065 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 95th Cong., 2d Sess. 151 (1978) (statement of William Penick) (advocating the indexation of capital asset basis to inflation in order to include only real economic gains in income); BLUEPRINTS, *supra* note 7, at 5 (proposing full taxation of capital gains realized upon sale or exchange after allowing a step-up in basis for inflation); U.S. DEPT. OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 101 (1984) [hereinafter TREASURY I] (proposing indexation of the basis of capital assets for the inflation which has occurred since purchase of the asset or January 1, 1965, whichever is later); PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985).

27 H. REP. NO. 841, 99th Cong., 2d Sess. II-107 (1986). Not only is the current statutory structure retained, but the tax rate on long-term capital gains is automatically limited to 33%, even if the top marginal rate is raised above that level after 1987. S. REP. NO. 313, 99th Cong., 2d Sess. 169 (1986).

portance and complexity."<sup>28</sup> Most commentators predict that the repeal will not be stable.<sup>29</sup>

### C. *Eliminating the Distinction*

In the event that the commentators' predictions are erroneous, however, and the preferential rate is not reinstated, must the Code retain the structural complexity caused by the distinction between capital gain and ordinary income or could Congress have simplified the Code further by eliminating the distinction entirely? Clearly, Congress could not eliminate the distinction entirely. Congress' stated reason for retaining the capital gain structure—facilitation of reinstatement—was only a partial reason why Congress left the current statutory structure intact. The full reason why Congress did not go further lies in the realization requirement as manifested in the capital loss provisions.

The preferential tax treatment of capital gain has always been accompanied by a roughly corresponding limitation on the allowance for capital losses, because the recognition event that triggers a tax liability or deduction is the realization of an asset's value through sale.<sup>30</sup> Any accrued appreciation or depreciation is not taxable until that time. Accordingly, a taxpayer can minimize his taxes by carefully scheduling the realization of his gains and losses. The taxpayer will realize gains in years when his marginal tax rate is low, and realize losses when his marginal tax rate is high. This manipulation results in the mismeasurement of accrual income.<sup>31</sup>

Moreover, even if the marginal tax rate does not change, which currently is a more probable scenario given the flatter rate structure introduced by the 1986 Act, the taxpayer still benefits from deferral. The deferral provides the taxpayer holding accrued but unrealized gains, in essence, an interest-free loan from the government for the amount of tax deferred.<sup>32</sup> Conversely, deferral decreases the tax saving value of capital losses.<sup>33</sup> As a result, taxpayers are motivated to time their sales so as to

28 *Tax Reform 1986: Capital Gains Lose Special Status*, 73 Stand. Fed. Tax Rep. (CCH) ¶ 1 (1986).

29 See, e.g., Barker, *Fixing Capital Gains*, 32 TAX NOTES 143 (1986) ("[A]s the top marginal rates creep up the economics of the tax shelter industry . . . start to make sense again, and pressure for a special low rate of tax on capital gains becomes almost irresistible.").

30 This has not always been true. The Revenue Act of 1913 permitted the deduction of losses incurred only on the sale of trade or business assets. 17 Treas. Dec. Int. Rev. 2135 (1915). These deductions were then limited by The Revenue Act of 1916 to the extent of profits earned on all trade or business investments. Revenue Act of 1916, ch. 463, § 5(a)(5th), 39 Stat. 756, 759. The Revenue Act of 1918, however, eliminated the loss deduction limitation and as a result, losses incurred in any transaction entered into for profit were fully deductible even if they exceeded that year's total investment profits. Revenue Act of 1918, ch. 18, § 214(a)(5), 40 Stat. 1057, 1067. Losses remained fully deductible until the Revenue Act of 1924. This Act allowed only 12.5% of capital losses to offset tax liability and abolished the carry forward of net capital losses because capital gains under the 1921 Act were taxed at a maximum rate of 12.5%. Revenue Act of 1924, ch. 234, § 208(c), 43 Stat. 253, 263 (repealed); see *supra* note 14. From 1924 to the present, Congress has made numerous statutory changes in the capital loss provisions, but they never reverted to the full deductibility that was present in the 1921-24 period. See generally Mayhall, *Capital Gains Taxation—The First One Hundred Years*, 41 LA. L. REV. 81 (1980).

31 R. GOODE, *THE INDIVIDUAL INCOME TAX* 188 (1976).

32 D. BRADFORD, *UNTANGLING THE INCOME TAX* 47-48 (1986).

33 *Id.*

realize their losses as they accrue, and to postpone realizing their gains for as long as possible.<sup>34</sup> By realizing his losses immediately and holding gains until death, a taxpayer could eliminate virtually all tax liability.<sup>35</sup> Consequently, restrictive rules on the deductibility of capital losses are necessary.<sup>36</sup>

This need for capital loss restrictions precludes the complete elimination of the distinction between ordinary income and capital gain. If the entire distinction were eliminated, logic would require that capital losses be fully deductible.<sup>37</sup> Full deductibility, however, would undoubtedly result in taxpayers realizing their losses, but declining to realize their accrued gains.<sup>38</sup> This tax minimizing behavior could have detrimental effects on revenues.<sup>39</sup> The loss of revenue resulting from loss deductions could well exceed the revenues from gains realized during the same period.<sup>40</sup> Taxpayers with unsuccessful investments would real-

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> This argument has prevailed in Congress since 1924, when capital losses were first made partially deductible. An alternative argument can be made, however, for full deductibility under two theories: Net income and economic incentive for risk taking. See Warren, *The Deductibility by Individuals of Capital Losses under the Federal Income Tax*, 40 U. CHI. L. REV. 291 (1973).

First, a capital loss is indistinguishable from any other loss such as business losses incurred in a transaction. A taxpayer's ability to command goods and services is dependent on his net income. If the taxpayer incurs a loss, he has less ability to buy goods and services than a second taxpayer with equal ordinary income. This result should be reflected in the first taxpayer's tax liability by permitting a deduction. If that loss is not deductible because it is a capital loss, then part of the tax effectively falls on a portion of the taxpayer's capital.

Second, full deductibility is beneficial because it creates an incentive for risk taking. This incentive makes new capital ventures more attractive. (In fact, the 1986 Act has made such ventures even more *unattractive* because 100% of capital gains are now taxed while capital loss deductions are limited.) The relationship between full offsets and risk taking has empirical support. Domar & Musgrave, *Proportional Income Taxation and Risk Taking*, 58 Q.J. ECON. 388 (1944). This theoretical model has subsequently been modified and criticized. See, e.g., C. HALL, *FISCAL POLICY FOR STABLE GROWTH* 164-73 (1960); R. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 312-25 (1959); E. ROLPH, *THE THEORY OF FISCAL ECONOMICS* 285-302 (1954); Feldstein, *The Effects of Taxation on Risktaking*, 77 J. POL. ECON. 755 (1969); Litner, *The Valuation of Risk Assets and Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 REV. ECON. & STATISTICS 13 (1965).

The basic conclusion that proportional taxation with loss offsets encourages risk-taking is now widely accepted by economists. See, e.g., Feldstein, *supra*; Helliwell, *The Taxation of Capital Gains*, 2 CAN. J. ECON. 314 (1969); Russel & Smith, *Taxation, Risk-Taking and Stochastic Dominance*, 36 So. ECON. J. 425 (1970).

<sup>37</sup> Hickman, *supra* note 1, at 237.

<sup>38</sup> This assumes, of course, that all dispositions are tax motivated. In fact, many probably are not. Investors often make decisions regarding when to sell based on the economic risk potential of their investments without regard to tax consequences.

<sup>39</sup> Commentators disagree on the tax rate's influence on investor selling. Compare STAFF OF JOINT COMMITTEE ON TAXATION, 98TH CONG., 1ST SESS., *TAXATION OF CAPITAL GAINS AND LOSSES* 5 (Comm. Print 1983) ("[D]ata on tax returns for the years 1979 through 1981 show a significant increase in realization of capital gains, enough to be consistent with the proposition that the 1978 capital gains tax cuts did not lose revenue for those years.") with H. AARON & J. PECHMAN, *HOW TAXES AFFECT ECONOMIC BEHAVIOR* 279 (1981) ("[A] simple comparison of changes in tax rates and changes in aggregate realizations of gains gives little support to those who believe that tax rates strongly influence realizations.").

<sup>40</sup> Hickman, *supra* note 1, at 237. See also Blum, *supra* note 6, at 253. In fact, the 1930s loss limitations were originally intended to protect federal revenues. See H.R. REP. NO. 708, 72D CONG., 1ST SESS. 12-13 (1932), 1939-1 C. B. (Part 2) 465; H.R. REP. NO. 704, 73D CONG., 2D SESS. 10 (1934), 1939-1 C. B. (Part 2) 562; PRELIMINARY REPORT OF A SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., *PREVENTION OF TAX AVOIDANCE* 6, 32-37 App. exhibit C (Comm. Print 1933); SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, 75TH CONG., 3D SESS., *PROPOSED REVI-*

ize sufficient capital losses to offset their taxable income, and thus could defer payment of all their taxes.<sup>41</sup> In short, the distinction between capital gain and ordinary income, with all its complexity, must be retained unless an alternative tax system can eliminate the need for the realization requirement.

## II. The Tax Spectrum

Recent tax scholarship has focused on two competing models of an ideal tax base—the “consumption” model and the “accrual” model. In many respects, these models represent two ends of a spectrum. Since the inception of the income tax, tax policy has been driven between these two ideals in the search for a simpler, fairer, and more efficient tax system. As a result of this vacillation between accrual and consumption, tax policy has been plagued by instability.

The Haig-Simons definition of income as the sum of consumption plus accumulation is the intellectual basis for accrual taxation.<sup>42</sup> In monetary terms, consumption and accumulation are represented by spending and saving.<sup>43</sup> If economic activity were wholly reflected by monetary transactions, then computation of income could be accomplished easily by reference to the source of income without regard to its uses.<sup>44</sup> Realistically, however, economic activity is only partly reflected in monetary transactions.<sup>45</sup> Money income, when bifurcated into consumption and accumulation, reflects only purchased consumption and accumulation in the form of money savings.<sup>46</sup> Total income includes unpurchased consumption and accumulation as well.

Thus, in order for the accumulation component to be accurately taxed, it must reflect unrealized capital appreciation. The present system falls short of this requirement because appreciation is not recognized as a taxable event until it is realized—when the taxpayer disposes of the asset. This failure to tax unrealized appreciation is the main difference between the current system and the accrual system. Under a pure accrual system,

SION OF THE REVENUE LAWS 32 (1938); H.R. REP. NO. 1860, 75th Cong., 3d Sess. 7-9, 33-42 (1938), 1939-1 C. B. (Part 2) 732-33, 751-58.

41 See U.S. TREASURY DEPT., FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES 59, 62 (1951) (stating that “the principal basis for modern loss limitations” is the protection of federal revenues in the event of a severe price decline). See also W. SCHULTZ & C. HARRIS, AMERICAN PUBLIC FINANCE 248 (1965); Blum, *supra* note 6, at 254.

42 H. SIMONS, PERSONAL INCOME TAXATION 50 (1938) (“Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and the end of the period in question.”). This definition has become the starting point for income determination for most commentators. See, e.g., Bittker, *A Comprehensive Tax Base as a Goal of Income Tax Reform*, in A COMPREHENSIVE INCOME TAX BASE? A DEBATE 7-9 (1968); Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA’s CSTR*, 81 HARV. L. REV. 1016 (1968); 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); Pechman & Okner, *Simulation of the Carter Commission Tax Proposals for the United States*, 22 NAT’L TAX J. 2 (1969); Shachar, *The Importance of Considering Liabilities in Tax Transition*, 98 HARV. L. REV. 1842, 1853 (1985).

43 Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1114 (1974).

44 *Id.*

45 *Id.*

46 *Id.*



no realization requirement exists.<sup>47</sup> Instead, the taxpayer must account for all changes in the value of his assets and liabilities each year.<sup>48</sup> Requiring this annual accounting would bring the whole tax system closer to the Haig-Simons ideal since unpurchased accumulation, in the form of unrealized appreciation, would be included in taxable income.

Accrual taxation has been widely criticized, however, on the grounds that it is attainable only with unacceptable complexity.<sup>49</sup> The complexity arises first from the administrative burden of having to value all assets each year. Such a process would be difficult, expensive, and subject to potential controversy.<sup>50</sup> Second, complication results from the possible inequity of requiring individuals to liquidate their assets simply to pay the tax due on them.<sup>51</sup>

In part because many economists<sup>52</sup> and tax scholars<sup>53</sup> do not believe that an accrual tax system is administratively feasible, they have advanced consumption-type or cash flow taxation as an alternative to income taxation.<sup>54</sup> These consumption tax advocates often cite the inherent problems of a pure accrual tax system, valuation and liquidation, as support for a shift to a consumption tax system. A consumption tax system

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47 Even though the realization requirement was given constitutional status by *Eisner v. Macomber*, 252 U.S. 189, 207 (1920), most commentators do not think courts would impose such a requirement today. See, e.g., Andrews, *supra* note 43, at 1129; Bittker, *supra* note 1; Shakow, *supra* note 8, at 1113 n.9.

48 Because the taxpayer must account for changes in value each year, the taxpayer no longer gets the benefit of deferral. The value of deferral is important to the individual taxpayer as well as to tax policy. See, e.g., S. SURREY, *PATHWAYS TO TAX REFORM* 108-11, 117-25, 317-19 (1973); Shoup, *The White Paper: Accrual Accounting for Capital Gains and Losses*, 18 CAN. TAX J. 96 (1970).

49 See *supra* note 7.

50 Hickman, *supra* note 1, at 244.

51 The debate on the equity or inequity of requiring a taxpayer to sell an asset in order to pay tax on it is intellectually similar to the debate on whether a taxpayer's tax liability should be based on ability to pay or on how much he removes from society. Those favoring the ability to pay argument predominate in the United States. R. MUSGRAVE & P. MUSGRAVE, *supra* note 6, at 207-08.

52 See, e.g., I. FISHER & H. FISHER, *CONSTRUCTIVE INCOME TAXATION* (1942); T. HOBBS, *LEVIATHAN* ch. 30 (1651); N. KALDOR, *AN EXPENDITURE TAX* (1955); J.S. MILL, *PRINCIPLES OF POLITICAL ECONOMY* bk. V, ch. I, § 4 (Laughlin ed. 1898); A.C. PIGOU, *A STUDY IN PUBLIC FINANCE* 135-44 (1928); Boskin, *Taxation, Saving, and the Rate of Interest*, 86 J. POL. ECON. 53 (1978); Bradford & Toder, *Consumption vs. Income Base Taxes: The Argument on Grounds of Equity and Simplicity*, 69 NAT'L TAX A. PROC. 25 (1976); Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. S29, S37-S39 (1978).

53 See, e.g., Andrews, *supra* note 43; Bradford, *The Case for a Personal Consumption Tax*, in *WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE?* 75 (J. Pechman ed. 1980).

54 The seminal discussion is in Andrews, *supra* note 43. *But see* Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975) (criticizing Andrew's proposal). See also Andrews, *Fairness and the Choice Between a Consumption-Type and an Accretion-Type Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975).

According to proponents of the consumption-type tax, such a tax system would be easier to administer because all costs of investments would be deducted immediately when they occurred, rather than depreciated over the life of the asset. This system also would eliminate realization problems. For example, all inventory costs would be deducted when inventory was created, rather than recognized only when goods were sold. Further, a consumption tax system would eliminate the computation of gain and determination of basis, capital gain treatment, and unrecognized realized gain due to special statutory provisions, including those governing corporate reorganizations. Finally, a consumption tax system would eliminate the mismeasurement of income which occurs in the present system as a result of inflation. Under the consumption tax system, consumption is measured in nominal terms so inflation does not distort the tax base. Similarly, inflation cannot erode the value of future deductions since depreciable assets and inventory investments are already expensed. Capital gains received due to inflation are not taxed since no tax exists on capital gains per se.

focuses exclusively on the consumption branch of the Haig-Simons definition because of the belief that most inequity, distortion, and complexity arises out of the inconsistent treatment of accumulation under existing law.<sup>55</sup> Taxable income under a consumption tax system consists of personal money income, or in other words, purchased consumption.<sup>56</sup> Savings are deducted from taxable income and dissavings, or receipts, are added.<sup>57</sup> Capital transactions under this system then are treated on a cash flow basis. Investments are deducted from income when they are made, and the proceeds of sales and other capital transactions are added to income when received.<sup>58</sup>

The Treasury Department<sup>59</sup> and tax commentators have criticized and rejected consumption taxation, however, as inequitable because of its distribution of the tax burden.<sup>60</sup> Under a consumption tax, tax burdens fall most heavily on low-income households with high consumption ratios relative to income.<sup>61</sup> Moreover, consumption taxes fail to mitigate disparities in wealth. By excluding accumulation of assets, a consumption tax may encourage wealth concentration.<sup>62</sup>

The current tax system is a hybrid of the consumption and accrual models in terms of the Haig-Simons definition. It is not a pure accrual system because some accumulation, notably unrealized appreciation, is not taxed.<sup>63</sup> Obviously, it is not a consumption tax system either.

55 Andrews, *supra* note 43, at 1115-16.

56 *Id.*

57 *Id.*

58 *Id.* at 1133. The system requires only that the taxpayer separate business and investment activities from personal consumption activities. Present law already makes this distinction. The taxpayer must then keep track of business and investment activities on a cash flow basis. This too is presently accomplished by cash flow accounting.

59 More specifically, the Treasury Department dismissed a consumption tax system due to complexity, transition, perception, and international problems.

First, the Treasury contended that complexity would increase because borrowing and withdrawals from savings would be taxable—thus, withholding on these amounts might be required. In addition, many young adults and retired individuals who presently are not required to file or pay tax would have to do so under a consumption tax.

Second, transition problems would arise, since a substantial amount of wealth has been accumulated from after-tax income. Taxing consumption from such wealth would penalize those who saved after-tax income. In addition, such a change to consumption would provide an incentive to avoid taxes by hoarding money before the new tax's effective date. After the effective date, the funds could either be deposited for a substantial deduction or used for living expenses without having to pay tax on them.

Third, the consumption tax suffers from a perception problem. Under the consumption system, amounts borrowed are taxable and repayment of loans are deductible. This may be perceived as unfair and has the effect of increasing an individual's tax liabilities during early adulthood and early retirement—periods when financial resources are commonly strained. Conversely, tax liability would be lowest during middle age, the time when many taxpayers receive most of their income.

Finally, an international problem could also result. All other countries have income taxes and thus foreign tax treaties would have to be renegotiated. TREASURY I, *supra* note 26, at 31-33.

60 See, e.g., Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370 (1979); Warren, *supra* note 54; Warren, *Would a Consumption Tax be Fairer than an Income Tax?*, 89 YALE L. J. 1081 (1980). But see Andrews, *supra* note 54.

61 J. PECHMAN, *supra* note 15, at 198.

62 See Warren, *supra* note 54, at 941-44.

63 Money savings and investment purchases are included in taxable income, but unrealized appreciation is not. In fact, much of this appreciation may escape taxation altogether because of the step-up in basis at death. I.R.C. § 1014(a) (1982 and Supp. III 1985). Even realized gains may go untaxed due to special statutory nonrecognition provisions. I.R.C. §§ 1031-1041 (1982 and Supp.

Although the current system incorporates certain elements of both the consumption and accrual methods of taxation as a result of the tax policy's vacillation,<sup>64</sup> the tax system is currently moving toward the accrual end of the spectrum<sup>65</sup> as evidenced by the Tax Reform Act of 1986.<sup>66</sup> The consequences of this movement are as yet unclear. What is clear is that an accrual tax system would provide greater consistency in the measurement of income than the current hybrid. Professor Shakow's analysis suggests that providing greater consistency, and hence greater equity, in an accrual system may not involve as much complexity as consumption tax proponents have perceived. Indeed, Professor Shakow's analysis suggests that a pure accrual tax system may be simpler than the current hybrid system.<sup>67</sup>

### III. The Shakow Model for Accrual Taxation

While Congress was drafting the recent tax reform, Professor Shakow contemporaneously developed a specific proposal for an accrual tax system which attempts to solve the plaguing problems of valuation

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III 1985). Further, the cost recovery provisions do not reflect accrual taxation since depreciation is computed from historical cost and not from annual decline in value. I.R.C. §§ 167-168 (1982 and Supp. III 1985). Finally, employee and self-employed retirement savings are excluded to a limited extent from taxable income. I.R.C. §§ 401(a), 402(b), 403(a), 415, 404 (1982 and Supp. III 1985). See also I.R.C. §§ 219(a) (1982 and Supp. III 1985) (Individual Retirement Accounts), 219(e)(5) and 408(b) (payments for retirement annuities).

64 The tax system has periodically adopted consumption tax approaches. For example, the 1981 Economic Recovery Tax Act (ERTA), Pub. L. No. 97-34, § 201, 95 Stat. 172, adopted consumption tax approaches to investment. The 1981 Act introduced basically three provisions which allowed substantial expensing of investment purchases when they occurred: The Accelerated Cost Recovery System (ACRS), the liberalized investment tax credit, and "safe-harbor" leasing. Under the ACRS method, a taxpayer's deductions greatly exceed the value of economic depreciation in the early years of an investment. Tangible personal property could be depreciated at a 150% declining balance method, switching to a straight line method at a time to maximize the depreciation allowance. Even faster depreciation would have been allowed under ERTA for years 1985 and later, but in 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, which repealed the additional accelerated depreciation allowances scheduled for 1985 and beyond. See generally Gann, *Neutral Taxation of Capital Income: An Achievable Goal?*, 48 LAW & CONTEMP. PROBS. 77, 94-96 (1985).

The 1981 Act also adopted a consumption tax approach to saving for retirement by expanding the deduction for contributions to various retirement plans. Pub. L. No. 97-34, §§ 311-312, 95 Stat. at 274-85.

65 The 1984 Treasury Department's proposal for tax reform was influenced by the accrual ideal even more than the 1986 Act was. In its proposal, the Treasury Department proposed that the tax system be adjusted so that it accurately measured real economic income in an inflationary environment. In order to achieve this accuracy, the Code would establish explicit inflation adjustments for the basis used in calculating both depreciation allowances and capital gains.

Under the Treasury Department's plan, the investment tax credit and the accelerated cost recovery system would be unnecessary. Explicit indexing for inflation would ensure that future depreciation allowances would maintain their real value, regardless of the rate of inflation. Accordingly, the Treasury Department proposed that the investment tax credit be repealed, that the basis of depreciable assets be indexed for inflation, and that depreciation allowances for tax purposes be set to approximate real economic depreciation. TREASURY I, *supra* note 26, at 98-115.

66 Under the 1986 Act, for example, many business tax credits were modified or, in the case of the investment tax credit, repealed. Pub. L. No. 99-514, §§ 201-203, 211. The 1986 Act modified depreciation rules, increasing the write-off period for most assets by 40%. The combined effect of these changes is a closer approximation of accrual taxation. The longer depreciation period reflects more accurately the actual length of economic utility, and the repeal of the tax credits adds investment purchases back to the tax base.

67 See Shakow, *supra* note 8, at 1115-17.

and liquidation in an administratively feasible way.<sup>68</sup> Under this proposal, individuals would be taxed on gains and losses on investment assets at ordinary income rates in the year the gains or losses accrue.<sup>69</sup> Because the proposal aims for administrative feasibility, however, it would exclude some items, such as owner-occupied houses and inexpensive consumer items, from the system completely.<sup>70</sup>

Similarly, a practical system for accrual taxation cannot require valuation of every asset of every taxpayer.<sup>71</sup> For example, assets such as closely held stock or collectibles are particularly hard to value.<sup>72</sup> For these assets, the Shakow model favors retaining the realization requirement while imposing an interest deferral charge based on the holding period of the asset.<sup>73</sup> Conversely, recognized losses would be adjusted to account for the decrease in tax saving value of losses.<sup>74</sup> The realization rules for such assets, however, would not include all the special non-recognition rules of current law.<sup>75</sup>

68 *Id.*

69 *Id.* at 1119.

70 *Id.* at 1183. Owner-occupied residences are excluded because investment and business real estate will be valued on an annual basis, reflecting changes in value due to both market changes and depreciation. Since owner-occupied residences only recognize gains reflecting market changes, a method for differentiating these two types of value would have to be added. Accordingly, this proposal retains the favored treatment of gains on residences. *Id.* at 1144. Owner-occupied residences account for approximately 16.9% of assets held by individuals. Owner-occupied lands add another 7.8%. *Id.* at 1141.

The Shakow model also excludes assets consisting essentially of cash and cash equivalents (savings accounts, checking accounts, money market fund shares). These assets constitute approximately 17.4% of all assets held by individuals. Accrual should not need to include these assets since they retain the same nominal value from year to year. Any increases in value derived from these assets are reflected in interest payments already included in income. *Id.* at 1126.

71 *Id.* at 1120.

72 *Id.* at 1183. The Shakow model would recognize other assets on realization with an adjustment to take account of deferral, including: Intangibles (goodwill, patents, trademarks, and other intangibles); consumer durables; and possibly other debt (state and local obligations, corporate and foreign bonds held by individuals that are privately traded). Cumulatively, these assets constitute approximately 10.5% of all assets held by individuals. Consumer durables and collectibles account for 8.6%, closely held stock accounts for 1.8%, and other hard to value debt constitutes approximately 0.1%. No estimate of the cumulative size of intangibles exists.

73 *Id.* at 1122-24. The Revenue Act of 1934 made an early attempt at an interest deferral system by implementing a step-scale plan based on the length of an asset's holding period. Revenue Act of 1934, ch. 277, § 117(a), 48 Stat. 680, 714. Under the 1934 Act, capital gains were taxed at ordinary income rates, but the amount of gain taxed was based on the length of time the capital asset was held. Congress premised the plan on the theory that the tax liability should approximate the amount that would have been paid if the gain had been taxed as it accrued. 78 CONG. REC. 6170-72 (1934).

Some commentators have proposed interest deferral as a substitute for accrual. See, e.g., INSTITUTE FOR FISCAL STUDIES, *THE STRUCTURE AND REFORM OF DIRECT TAXATION* 129, 129-35 (1978); Brinner, *Inflation, Deferral and the Neutral Taxation of Capital Gains*, 26 NAT'L TAX J. 565 (1973); Diamond, *Inflation and the Comprehensive Tax Base*, 4 J. PUB. ECON. 227 (1975); Helliwell, *supra* note 36.

74 The deferral charge's potential for simplification lies in the fact that it reduces the difference between the treatment of realized gains and unrealized appreciation. Much of the present complication stems from the rules required to compensate for that different treatment.

Deferral charges, coupled with taxation at ordinary income rates, could enable the removal of capital loss limitations. These limitations are currently necessary to prevent taxpayers from realizing and deducting their capital losses while declining to realize their accrued gains. A deferral charge would discourage this manipulation. Therefore, eliminating the limitations on capital losses and taxing capital gains at ordinary rates would make it possible to abolish the definition of capital assets and the corresponding definitional problems. Hickman, *supra* note 1, at 245. This was a level the current 1986 Act could not achieve.

75 See Shakow, *supra* note 8, at 1124.

Certain business assets whose treatment already approximates accrual taxation, such as inventories and accounts receivable, could be included in the system through modified versions of current law.<sup>76</sup> Other intangible business assets—goodwill and going concern value—would be omitted from the accrual tax system due to the major practical difficulties in valuation and the relatively insubstantial net effect on revenue of including them in the tax base.<sup>77</sup> Business and investment liabilities generally would be incorporated in the system by providing for gains when the liabilities decrease in value and allowing for losses when the liabilities increase in value.<sup>78</sup>

With respect to the liquidity problem, Professor Shakow points out that it may not be as formidable as it first seems. First, empirical studies show that taxpayers with real liquidity problems are, in fact, rare.<sup>79</sup> Second, since the accrual system would expand the tax base it would enable a reduction in tax rates without loss of revenue.<sup>80</sup> Thus, a taxpayer with a gain on illiquid assets might not incur any substantial new tax liability under the system.<sup>81</sup> Finally, taxpayers with illiquid estates currently face a more severe liquidity problem under estate tax law.<sup>82</sup>

For those taxpayers who would still encounter liquidity problems, the Shakow model proposes that they pay at least a certain percentage of their income, excluding their accrued gains, as a tax on those accrued gains.<sup>83</sup> If tax liabilities exceeded that percentage, and the taxpayer could prove a liquidity problem, the taxpayer could defer payment with

76 *Id.* at 1155-56. Under current law, two major methods of valuing inventories exist: Cost and lower of cost and current market price. The second method would simply carry over into an accrual system because it requires some form of valuation every year. The cost method could be modified to carry over into an accrual system by indexing increases and decreases in the prices of relevant inventory categories, with the number and precision of the categories dependent on the relative importance of precisely mirroring inventory price movements.

With regard to accounts receivable, the current structure would carry over into an accrual system with one modification. For business with long-term accounts receivable, a taxpayer would be required to prepare a reasonable estimate of their value based on the relationship between the interest rate on the accounts receivable and some benchmark rate, such as an average federal rate in the year of sale.

77 *Id.* at 1157-63. Intangibles will be taxed only on realization. *Id.* at 1119.

78 *Id.* at 1163-67. The Shakow model would exclude increases and decreases in consumer debt (including home mortgages) and possibly small loans (under \$1000), loans with adjustable interest rates, and loans with short maturities.

79 *Id.* at 1174-75. Professor Shakow's data showed that if one assumed a 4.5% annual asset appreciation rate and disregarded groups of individuals who are not expected to have serious liquidity problems, less than 0.9% of the population has liquidity problems. Further, if a 13% appreciation rate is assumed, a rate higher than occurred in any period between 1961-84, only 2% of taxpayers would have liquidity problems. If a rate almost twice the appreciation rate for any period between 1961-84, 25%, is assumed, then only 3.25% would have problems. *Id.*

80 *Id.* at 1167-68, 1196-2000.

81 *But see* Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857 (1982) (discussing the effect a liquidity squeeze would have on a taxpayer holding marketable securities).

82 Shakow, *supra* note 8, at 1167. Estate tax rates can exceed the highest marginal income tax rate, and the estate tax applies to the full value of an asset, rather than the annual increase in the asset's value as under an accrual system. *Id.*

83 *Id.* at 1176. The Shakow model proposed this treatment of illiquidity as a compromise between encouraging taxpayers to create liquidity problems, which provides a new goal for tax lawyers, and penalizing taxpayers with liquidity problems.

interest accruing on the deferred amount.<sup>84</sup> The interest rate would be set at a rate unattractive to most taxpayers in order to discourage persons from borrowing from the government.<sup>85</sup>

#### IV. Analysis of the Shakow Model: Simplification or Complexity?

The Shakow model recognizes that any form of accrual taxation would increase the complexity of the Code, at least to the extent that complexity is caused by requirements of measurement and recordkeeping.<sup>86</sup> He justifies this increased complexity, however, at least in part by what he perceives as a corresponding decrease in complexity caused by interpretive ambiguity and tax-motivated business planning.<sup>87</sup> Professor Shakow thus maintains that a shift to accrual taxation would cause an increase in compliance complexity justified by a corresponding decrease in rule and transactional complexity.<sup>88</sup>

##### A. *Types of Complexity*

Compliance complexity refers to the difficulties faced by taxpayers such as keeping records, choosing forms, and making necessary calculations.<sup>89</sup> An increase in compliance complexity is specifically problematic if it increases recordkeeping requirements of the average taxpayer who might not otherwise need to maintain detailed records. This type of complexity would clearly increase under an accrual system due to the annual valuation requirement.

Transactional complexity arises because economically similar activities may have different tax consequences depending on essentially irrelevant distinctions among the activities.<sup>90</sup> This inconsistent treatment causes taxpayers to base economic decision-making at least in part on tax considerations, as opposed to the underlying economic factors. Tax-minimizing behavior, in turn, breeds additional complexity from tax reformers and legislators who respond with measures designed to circumvent the latest tax maneuvers.<sup>91</sup>

Rule complexity arises from problems in interpreting the written and unwritten rules of the Code.<sup>92</sup> Ambiguity in rules results in frustration and cynicism on the part of the taxpayer, and increases the costs of compliance through the need for professional tax preparers, lawyers, and

84 *Id.*

85 *Id.*

86 *Id.* at 1183-84.

87 *Id.*

88 See generally D. BRADFORD, UNTANGLING THE INCOME TAX 266 (1986).

89 *Id.* at 266-67.

90 *Id.* at 267.

91 One commentator has called this kind of complexity "dynamic complexity." The initial tension is created by preferential taxation. Preferential taxation stimulates new types of transactions as individuals seek to gain the tax benefits created by the preferences. Legislators and administrators concerned with preserving the integrity of "legislative intent" and protecting tax revenues react, in turn, by instituting new measures to stem the tax avoidance. Galper & Kaufman, *Simplification and Comprehensive Tax Reform*, in FEDERAL INCOME TAX SIMPLIFICATION 161, 165 (C. Gustafson ed. 1979).

92 D. BRADFORD, *supra* note 88, at 267.

accountants.<sup>93</sup> Moreover, a law that is understood by only a small band of accountants and tax lawyers breeds suspicion and thus undermines the popular support which is essential to the self-assessment required by the system.<sup>94</sup>

The Shakow model contends that an accrual system would result in net simplification by reducing transactional and rule complexity to such a degree that they would offset an increase in compliance complexity. Although this conclusion may have been complete prior to the recent tax reform, the Tax Reform Act of 1986 has added a new variable to the equation. The 1986 Act eliminated the capital gains preference, and thus reduced the tension between ordinary income and capital gain. This change, in itself, eliminates some of the same rule and transactional complexity a shift to accrual taxation would eliminate. The question thus becomes whether a further move toward accrual taxation is desirable, following the 1986 Act.

### B. *Repeal of the Capital Gains Preference Should Reduce Transactional and Rule Complexity*

By eliminating the preferential rate of taxation on capital gains, the 1986 Act may have reduced both transactional and rule complexity to such an extent that any additional reduction in complexity by a further move toward accrual taxation would not justify the unavoidable increase in compliance complexity. The clearest effect of the elimination of the preferential rate is the reduction in transactional complexity. Because all gains are taxed in full, taxpayers no longer have an incentive to characterize ordinary income as capital gain. The tax rates on realized income from the sale of capital assets and from other sources are the same. Therefore, the 1986 Act significantly reduces transactional complexity.

This reduction in transactional complexity should, in turn, cause a reduction in rule complexity. Obviously, problems in rule interpretation can be reduced simply by deleting the rules. Because the 1986 Act eliminated the incentive to characterize income as capital gain, it may be possible to remove certain complex provisions from the Code. For example, the collapsible corporation<sup>95</sup> and personal holding company provisions,<sup>96</sup> which are primarily aimed at attempts by taxpayers to characterize ordinary income as capital gain, could be deleted. Similarly, the need for recapture provisions,<sup>97</sup> preventing ordinary income created by excess depreciation deductions being taxed as capital gain, is reduced. Recapture would occur automatically, since all gains are now taxed in full.

Unfortunately, the incentive to characterize losses still exists, because the 1986 Act limits the deductibility of capital losses. All reduction

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<sup>93</sup> It is estimated that over 40 to 50% of taxpayers filing returns enlist the help of a professional tax preparer. *Tax Reform and Deficit Reduction Hearings Before the House Comm. on Ways and Means*, 98th Cong., 2d Sess. 200, 214 (1984) (statement of Emil M. Sunley, Director of Tax Analysis for Deloitte, Haskins, & Sells); R. HALL & A. RABUSHKA, *LOW TAX, SIMPLE TAX, FLAT TAX 4* (1983).

<sup>94</sup> D. BRADFORD, *supra* note 88, at 266.

<sup>95</sup> I.R.C. § 341 (1982 & Supp. III 1985).

<sup>96</sup> I.R.C. §§ 541-547 (1982 & Supp. III 1985).

<sup>97</sup> I.R.C. §§ 1239, 1245, 1250, 1255 (1982 & Supp. III 1985).

in rule complexity is not lost, however. While the deletion of whole provisions might be precluded, the rules still could be simplified. Moreover, because the characterization and recapture provisions would apply only to those taxpayers with sufficient capital losses, the provisions would be applied less frequently. Reducing the application of complex provisions could, in itself, result in reduced rule complexity.

Additionally, eliminating rate differentials between ordinary income and capital gain spares taxpayers the need to undertake the complicated netting procedures.<sup>98</sup> Because all capital gain is taxed at the same rate, no need exists to divide gains and losses into separate short- and long-term accounts.

### C. *Accrual Taxation May Further Reduce Transactional and Rule Complexity*

Conceivably, a move towards accrual taxation could sufficiently reduce rule complexity to justify the increased compliance complexity likely to result. A move toward accrual taxation would not only eliminate complexities concerning the distinction between capital gain and ordinary income, but would also eliminate, or at least reduce, complexities over whether a realization event has occurred.<sup>99</sup> Indeed, eliminating the preferential treatment of realized capital gain might increase the tension between realized gain and unrealized appreciation.<sup>100</sup> This tension would manifest itself in greater pressure on the provisions that govern the recognition and nonrecognition of gain. Taxpayers would still have an incentive to organize their affairs so as to minimize their taxes through the benefit of deferral. Thus, a substantial portion of the transactional complexity achieved by reducing pressure on the characterization of gain may be illusory, as it is merely shifted to the recognition event.

A shift toward an accrual tax system would relieve this pressure, because it abandons the realization requirement as well as the preference for capital gains. As a result, a number of significant nonrecognition rules could be deleted from the Code.<sup>101</sup> The deletion of these complex nonrecognition rules would clearly reduce rule complexity. The deletion of these rules also would reduce transactional complexity, because the elimination of rate differentials between classes of realized income would be coupled with the elimination of differentials between realized gain and unrealized appreciation.

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98 See Galper & Kaufman, *supra* note 91, at 180-81 (This conclusion was made in the context of analyzing BLUEPRINTS, *supra* note 7, which had proposed taxing capital gains at ordinary rates).

99 In his article, Professor Shakow noted that abolishing the distinction between ordinary income and capital gain would simplify the income tax system generally, but he also contended that accrual taxation would result in much greater simplification. He based this contention on a review of cases in volume 81 of the Tax Court Reporter. Two of the cases decided in that volume would be moot if the ordinary income-capital gain distinction were eliminated. In contrast, accrual taxation would moot four other cases, eliminate substantial issues in three cases, and substantially reduce the importance of issues in six cases. Shakow, *supra* note 8, at 1119-20.

100 Hickman, *supra* note 1, at 225.

101 I.R.C. § 1031 (1982 and Supp. III 1985) (like-kind exchanges); § 1033 (involuntary conversions); § 302 (distributions in redemption of stock); § 1034 (sales of principle residences); § 361 (corporate reorganizations).



As noted above, the Shakow model retains, to some extent, the realization requirement with an interest deferral charge for small, difficult-to-value assets in order to make accrual taxation administratively feasible.<sup>102</sup> Nevertheless, although taxation of these assets is based on realization events, the Shakow model would still permit the repeal of a number of nonrecognition rules.<sup>103</sup> The interest deferral charge would reduce the tension between realized gain and unrealized appreciation to a degree sufficient to delete these nonrecognition rules, even without eliminating the tension completely.

The interest deferral charge, however, would have to be set at an equilibrium interest rate. If the interest rate were too low, then taxpayers would still benefit from deferral. This time the benefit would take the form of a loan from the government at the interest deferral rate.<sup>104</sup> Conversely, the interest deferral rate should not be set too high because this could create an incentive to categorize assets artificially. Either of these incentives would create an impetus to tax minimizing behavior, thereby increasing transactional complexity.<sup>105</sup>

## V. Conclusion

In the latest round of tax reform, Congress made sweeping changes to overhaul a tax system most viewed as unfair, inefficient, and complex. One change intended to greatly simplify the Code was the repeal of the long-term capital gains exclusion. Unfortunately, in its desire to purge the Code of the complexity caused by the exclusion, Congress failed to consider and remedy the problems that initiated the exclusion originally. As a result, the exclusion's repeal is unstable and will probably be reinstated as soon as marginal tax rates are increased. Reinstatement will not be difficult either, since Congress only repealed the preferential rate, and

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<sup>102</sup> See *supra* notes 71-75 and accompanying text.

<sup>103</sup> I.R.C. § 1031 (1982 and Supp. III 1985) (like-kind exchanges); § 351 (tax-free formation of corporations); § 721 (tax-free formation of partnerships); § 361 (corporate reorganization).

<sup>104</sup> The Shakow model addresses the problems associated with interest rates in its treatment of the liquidity problem. Professor Shakow advocates that the interest rate be set at a level which would be unattractive to most taxpayers. This would discourage persons from borrowing from the government at rates which would be unavailable in the private debt market. By making the interest rate unattractive, the Shakow model ensures that taxpayers will not create liquidity problems for the purpose of obtaining, in effect, a loan from the government at a below market rate. Shakow, *supra* note 8, at 1176. This concern is analogous to the interest deferral charge.

<sup>105</sup> A deferral charge itself, however, could produce additional transactional complexity. In fact, the Treasury Department's 1977 BLUEPRINTS rejected a deferral charge on grounds that such an approach would engender considerable complexity with only small gains in more accurate income measurement. Other commentators have rejected such a practice as well. The problems with interest deferral stem from determining the appropriate rate of interest.

First, in order to compute the charge, a deferral percentage would have to be applied to the tax attributable to the gain for the time period in which the asset producing it was acquired. Thus, computing the charge would be very burdensome and potentially a source of controversy, if numerous transactions or mixed assets are involved. Second, any deferral charge formula would need to make assumptions about the taxpayer's marginal tax rates, the appropriate interest rate, and the rate at which the gain occurred over the period the asset was held. Undoubtedly, rules using generalized and simplifying assumptions could be devised to solve these problems, but these new rules would introduce additional complexity. The rules would be necessarily complex and would create an arbitrage potential requiring complicated tax planning to take advantage of the simplifying assumptions. Hickman, *supra* note 1, at 245-56.

retained the distinction between ordinary income and capital gain in the Code. Realistically, however, Congress could not have eliminated the distinction entirely, because to do so would have meant eliminating all the capital loss restrictions. Congress could not eliminate these restrictions due to the pressure this would put on revenues under the current realization-based tax system.

Congress needed an alternative which would allow it to eliminate the ordinary income-capital gain distinction without the accompanying pressure on revenues. Until recently, however, the only feasible alternative available was a consumption tax system which many already viewed as more inequitable than the system Congress was trying to reform. Now, following Professor Shakow's proposal, a viable alternative may exist in accrual taxation.

The Shakow model moves the goal of a relatively pure accrual tax system from a theoretical construct closer to a more realistic alternative than ever before thought possible. It does so by paying particular attention to the problems of valuation and liquidation. Through a carefully structured categorization of assets and liabilities, the model makes annual valuation a less imposing specter than originally thought. Similarly, Professor Shakow's analysis casts doubt on the importance of the liquidity problem and suggests a compromise solution which neither penalizes taxpayers with liquidity problems nor encourages them to create liquidity problems for the benefits of deferral.

The question remains, however, whether the benefits derived from greater consistency in the measurement of income would outweigh the additional costs in complexity. Professor Shakow, writing before enactment of the 1986 tax reform, suggests that movement from the pre-1986 Code to a full accrual tax system would not only create a more equitable system, but a simpler system as well. Enactment of the 1986 Act helps focus attention on this claim, and underscores the distinction between eliminating preferential treatment of capital gain and the more radical step of eliminating the realization requirement. The question now raised is whether the 1986 Act already has eliminated much of the complexity associated with capital gains so that further movement toward full accrual taxation would involve difficult trade-offs between equity and complexity. It is with this question that further analysis of Professor Shakow's model should begin.

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