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PROVISIONS OF THE TAX POLICY REVIEW BILL OF 1972 AFFECTING INDIVIDUAL TAXPAYERS

DAVID C. JOHNSON*

Reference to a tax provision as 'preferential' or 'special' does not connote opposition to the social or economic objective which Congress has used the tax law to support. It does mean the provision deviates from a norm. Implicit in the reference is the idea that the income tax has an essential integrity; that there is a fundamental standard for determining the tax base and the applicable rates; that maintenance of the standard (restoration where it has been eroded) is important to society, high on its scales of values; that the proponent of a measure which deviates—which creates a preference—has a burden of proof which goes as much to the use of the tax system as the means of accomplishment as to the measure's specific social or economic objective.

Bernard Wolfman[1]

I. INTRODUCTION

Interest in the policy aspects of taxation is no longer limited to tax professionals. The dramatic injection of the tax reform issue into the 1972 presidential campaign stirred a national debate on tax preferences.[2] Not since Phillip Stern's best-seller, *The Great Treasury Raid,*[3] has there been such interest among taxpayers about privileges and tax shelters.

Much of this dialogue concerned itself with the income tax provisions of the Internal Revenue Code. But recognition of growing financial needs of states and cities, problems of state welfare, financing public education, taxation of multistate business, and the

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1. Wolfman, *Federal Tax Policy and the Support of Science,* 114 U. PA. L. REV. 171, 173 (1965). Presently, Bernard Wolfman is the Dean of the University of Pennsylvania School of Law.

2. An example of magazine writings on tax reform is found in SATURDAY REVIEW, Oct. 21, 1972, at 45-52, wherein noted personalities are asked the question, "Do Our Tax Laws Need a Shake-up". As one might expect there is great diversity between the views of Ralph Nader (public interest advocate) and Al Capp (cartoonist, lecturer) as to the direction that tax reform should take.

3. P. STERN, THE GREAT TREASURY RAID (1964). The book held position seven on the non-fiction best seller list for the weeks of April 10, 17, 1964. *See* TIME, April 10, 17, 1964, at 10, 12.

problem of what is the proper mixture of property and sales taxes, have aided in making the public more conscious of needed reforms.[4]

In 1972, in response to this public concern the Joint Economic Committee issued the following statement in their annual report:

> We urge the Administration to provide to the Congress by this summer detailed evaluations of at least one-third of the special provisions in the individual and corporate income tax laws, so that Congress can decide whether the provisions fairly distribute their benefits and efficiently achieve their specific objectives.[5]

This report included a study of federal subsidies and tax subsidies.[6] Such emphasis on tax subsidies encouraged numerous tax reform bills before the ninety-second Congress.[7] And in response to these demands, Congressman Wilbur D. Mills, Chairman of the House Ways and Means Committee, and Senator Mike Mansfield, majority leader of the Senate, introduced on May 31, 1972, the *Tax Policy Review Act of* 1972.[8] This tax proposal would have required Congress to comprehensively and systematically, within the next three and one-half years, review "preferential" tax provisions in the Internal Revenue Code. Under the bill, fifty-four "preference" items[9] would

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4. For a consideration of these broad issues of tax reform where the need for an interrelationship of state and federal revenues is recognized, see Young, *Tax Reform—The Next Stage*, 27 TAX L. REV. 247 (1972). The author analyzes the need for funds; types of federal assistance (direct grants and revenue sharing); and additional revenue at the federal level, with emphasis on the value added tax.

The activities of Congress in 1972 should not be overlooked in its role of increasing national awareness. *See* Matsunaga, *Recent Tax Trends in Congress*, 50 TAXES 683 (1972).

5. HOUSE COMM. ON WAYS AND MEANS, 92d CONG., 2d SESS., REPORT OF THE JOINT ECONOMIC COMMITTEE, 39 (Comm. Print 1972).

6. The committee recommended that "Congress act to eliminate enough of the serious tax loopholes to provide a revenue increase of approximately 10 billion. . . ." *Id.*

7. The major ones were: H.R. 11058 to change 38 provisions, sponsored by California Congressman James C. Corman; and H.R. 13877 which would have made 4 major revisions, sponsored by Wisconsin Congressman Henry S. Reuss.

8. H.R. 15230 and S. 3657, 92d Cong., 2d Sess. (1972).

9. The provisions are grouped under the bill by termination date. The items are both business and nonbusiness in nature. Since this article deals with the provisions affecting individuals, these terms will be italicized.

PROVISIONS TERMINATED ON AND AFTER JANUARY 1, 1974:

1. *The $30,000 exemption for the minimum tax.*
2. *The deduction of ordinary income taxes for the minimum tax.*
3. *The exclusion from gross income of group-term life insurance of employees.*
4. *The $5,000 death benefit exclusion.*
5. *The $100 dividend exclusion.*
6. The guaranteed business bad debt deduction.
7. The provision permitting assets to be written off over a period 20 percent shorter than their class lives under the ADR system.
8. *The capital gain treatment of lump-sum distribution from pension funds.*
9. *Qualified stock options.*
10. The tax exemption for credit unions and certain mutual insurance funds.
11. Special reserves for losses on bad debts of banks, mutual savings banks, etc.
12. Percentage depletion for oil, gas, and other minerals.
13. *Capital gain for timber, coal and iron or royalties.*
14. Exclusion of gross-up on dividends of less developed country corporations.
15. Exclusion of earned income from foreign sources.
16. *The alternate tax on capital gains of* corporations and *individuals.*
17. The recapture rules for real property.

be eliminated automatically from the tax law over the three year period, unless Congress voted to retain them.

Although this specific bill will not be re-introduced in 1973, and Congressman Mills has retreated from the automatic phase-out feature of the bill, the fifty-four preference items will continue to be targets for reform.[10]

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18. The special exemptions for excess deductions account for farm losses.

PROVISIONS TERMINATED ON AND AFTER JANUARY 1, 1975:

19. *The exclusion from gross income of sick pay.*
20. *The deduction for nonbusiness interest.*
21. *The deduction for nonbusiness taxes.*
22. Fast depreciation methods.
23. The deduction of research and experimental expenditures.
24. The deduction of soil and water conservation expenditures.
25. Additional first-year depreciation allowance.
26. The deduction of expenditures for clearing land.
27. Amortization of railroad grading and tunnel bores.
28. The deduction of intangible drilling and development costs.
29. The deduction of development expenditures in case of mines.
30. The exemption of ships under foreign flags.
31. The special deduction for Western Hemisphere trade corporations.
32. The exemption of income from sources within possessions of the United States.
33. The exclusion from Subpart F of shipping profits and certain dividends and interest.
34. The provisions relating to Domestic International Sales Corporations.

*35. *Step-up in tax basis of property acquired from a decedent.* [Not covered in the article].

36. *Capital gain from the sale or exchange of patents.*

PROVISIONS TERMINATED ON AND AFTER JANUARY 1, 1976:

37. The $25,000 corporate surtax exemption.
38. *The retirement income credit.*
39. *The deduction and credit for political contributions.*
40. The investment credit.
41. *The exclusion for interest on State and local bonds.*
42. *The exclusion of the rental value of parsonages.*
43. *The exclusion from gross income of scholarships and fellowships.*
44. *The exclusion from gross income of gain on sale of residence by person over 65.*
45. *Additional personal exemptions for the aged and blind.*

*46. *The exemption for child where income exceeds $750.* [Not covered in the article].

47. *The deduction for nonbusiness casualty losses.*
48. *The charitable contribution deduction.*
49. *The medical expense deduction.*
50. *The child care deduction.*
51. *The moving expense deduction.*
52. Nonrecognition of gain on the use of appreciated property to redeem stock.
53. Nonrecognition of gain in connection with certain liquidations.
54. *The deduction for long-term capital gains.*

10. In a speech before the Securities Industry Association Management Conference in New York, Chairman Mills gave his reasons for the change in approach as follows:

> Some have misconstrued the purpose of the automatic termination dates... with the result that their enactment might create uncertainties and undesirable economic effects. . . . I originally scheduled the 54 items because they lent themselves to an automatic termination procedure. With the deletion of the automatic termination procedure, there is no reason to confine tre review to the 54 items, and it becomes desirable to expand the scope of the review to cover many additional items. . . .

See 59 STD. FED. TAX REPTS. no. 46 (1972). In the press release explaning H.R. 15230 Mills states why he does not feel that past reforms have gone far enough:

> In 1969 we enacted into law what was clearly the most comprehensive tax reform measure in our history. That act made over 75 tightening amendments to the tax laws. . . . There were also many significant tax reforms enacted in 1962 and 1964. Nevertheless, there were many areas in which I, and others, would have liked to see these acts go further than it was possible to go at those times. . . .

See 59 STD. FED. TAX REPTS. no. 31, part II (1972).

The bill is most significant and will continue to have impact in two respects: isolation of preference items and labeling them as such, and the automatic phase-out concept. Although tax dispensations have been thought of by scholars as subsidies and preferences, Congressional labeling first occurred in 1969 when the minimum tax on tax preferences was added to the Code.[11] But the list of preferences subject to the minimum tax is quite limited, whereas Mills has isolated fifty-four items. Tax reformers of the future will find their case easier to make as a result of this "official" recognition. Secondly, the phase-out feature of the bill was an important innovation in the area of reform. If preference items were subject to automatic elimination two desirable features would emerge. First, the subsidy through the tax base would have to be reviewed or it would disappear. This would then make the indirect subsidy more like the over-the-board federal appropriation that is reviewed at regular intervals. This could of course be accomplished without automatic elimination if the sums federally allocated by tax preferences were reflected in the federal budget and accounts,[12] but even with such accounting the prospect of termination would encourage greater focus on the subsidy involved. Second, the phase-out would have the effect of shifting the burden of proof from the tax reformer where it now lies to the advocate urging retention of the subsidy. Not only would he have to make his case for the subsidy, but he would further have to establish that the income tax is the appropriate vehicle for such relief. In any event the innovation by Mills provides a possible mechanism for tax reform bills of the future, and at least suggests to Congress that in adding a new preference item to the Code some consideration as to a time-limit on the subsidy should be made.

Why is there such pressing need for reform in view of the fact that the Tax Reform Act of 1969 made seventy-five amendments to the tax laws?[13] In fact since 1913 there have been approximately fifty major revenue measures, each of which made important changes in the tax laws.[14] The Revenue Act of 1964[15] affected 234 sections

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11. INT. REV. CODE OF 1954, §§ 56-58.
12. *See* Wolfman *supra* note 1, at 186. Therein he states:

> Finally, the darkness should be lifted. The considerations which permit our sacrificing some of the integrity of the tax system for the values of private initiative and freedom do not also require that we be kept in ignorance. . . .

13. *See* Mill's press release, *supra* note 10.
14. Paul, *Directions in Which Tax Policy and Law Have Been Moving,* 30 TAXES 949 (1952) points out that in thirty years between 1913 and 1942 Congress enacted about *forty* pages of revenue legislation a year involving nineteen major revenue measures. In the following ten years Congress enacted ten revenue measures of major importance, which averaged seventy pages a year. He suggests that comparing this with the 1894 Act, which only required eight pages, indicates an alarming trend.

Hambrick, *The Illusion of Tax Reform,* 1963 DUKE L.J. 56, 57, in referring to ap-

and subsections of the Internal Revenue Code of 1954, and two sections of the 1939 Code.[16] All of these measures were "reform" from someone's points of view.

The explanation for steadfast dissatisfaction with reform efforts is quite naturally that people disagree sharply with the meaning of the word "reform." In the next section of this article I will consider generally the conflicting views on tax policy to show how difficult it is to reach agreement in changing the Internal Revenue Code, and set the stage for examination of the provisions of the bill that affect individuals, or perhaps more properly, the non-business items.

II. TAX IDEOLOGIES**

Tax ideologies are the underlying content of our fiscal system—the intellectual and emotional essence on which it rests. When we attempt to meditate upon this essence, we are reaching into the ultimate values and ideals of the system—or, to use a more ponderous phrase, the metaphysics of taxation.

Louis Eisenstein[17]

In looking at the fifty-four items of preference listed by Chairman Mills, it is apparent that our law does not truly tax individuals on "all income from whatever source derived."[18] The existence of exclusions,[19] deductions,[20] exemptions and credits,[21] special treatment for capital gains,[22] and special dispensations,[23] prevent what is the ideal of most scholars: a progressive tax applied to all income of an individual.[24]

Before examining individually how these preference items came into law, and whether or not they should remain, it is necessary to inquire into three areas involving tax policy considerations of a broader nature. First, the politics of taxation: what are the group

proximately thirty revenue acts since 1942 and in considering the then pending legislation (then entitled the Revenue Act of 1963) asks if anything has happened which should inspire renewed hope that the frustrations which plagued previous efforts have passed from the scene.

15. Pub. L. No. 88-272, 88th Cong., 2d Sess. (1964).

16. *Amending* §§ 43, 925 of the 1939 Code.

**In analyzing writings and tax legislation prior to April of 1964 I borrowed on occasion from my master's thesis, *The Revenue Act of* 1964 *and the Prospects for Future Reform,* on file in the law library of the University of Pensylvania School of Law.

17. Eisenstein, *Some Second Thoughts on Tax Ideologgies, N.Y.U.* 23RD INST. ON FED. TAX 1 (1965) [hereinafter cited as *Some Second Thoughts*].

18. INT. REV. CODE OF 1954, § 61 (a).

19. *See* note 9 *supra,* items numbered 3, 4, 5, 19, 41, 42, 43, 44.

20. *See* note 9 *supra,* items numbered 20, 21, 39, 47, 48, 49, 50, 51.

21. *See* note 9 *supra,* items numbered 83, 45, 46.

22. *See* note 9 *supra,* items numbered 8, 9, 13, 16, 36, 54.

23. *See* note 9 *supra,* items numbered 1, 2, 35.

24. This ideal is the theme of House Committee on Ways and Means, 86th Cong., 1st Sess., *Tax Revision Compendium of Papers on Broadening the Tax Base,* (Comm. Print 1959).

arguments which shape our tax laws and make reform difficult? In this analysis I shall rely heavily on the works of the late Louis Eisenstein. Second, what is the proper approach to the elimination of preferences? Should the entire Code be repealed so we may start afresh, as urged by the comprehensive tax base advocates, or should an ad hoc approach be continued, as urged by Professor Bittker? Third, assuming that a tax dispensation or subsidy is justified from the standpoint of the social good it accomplishes, is the tax base the proper vehicle for this relief? In this inquiry I shall be guided by the principles announced by Dean Wolfman.

Although there are many other fruitful lines of inquiry in the area of tax policy, these three categories—group arguments, comprehensive tax base as an ideal, and the propriety of using the Code as a vehicle for subsidies—seem to me to be central to the inquiry of whether or not a preference should be removed.

A. GROUP ARGUMENTS—THE IDEOLOGIES OF EISENSTEIN

In looking at the problem of specific reforms from the standpoint of group arguments which shape our tax laws, one is immensely aided by Louis Eisenstein's book entitled *The Ideologies of Taxation.*[25] He classified his work as

> [A]n essay on the intellectual content of an emotional subject—the distribution of our so-called progressive income tax among the American people. It is concerned with the systems of reason and rhetoric which groups and interests devise in order to obtain a distribution responsive to their pecuniary desires.[26]

He subscribed to the oft repeated statement of Dr. T. S. Adams that

> modern taxation or tax-making in its most characteristic aspect is a group contest in which powerful interests vigorously endeavour to rid themselves of present or proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly to economics, reasons, and justice, will in the end retire beaten and disillusioned. Class politics is of the essence of taxation.[27]

To Eisenstein "[o]ur taxes reflect a continuing struggle among contending interests for the privilege of paying the least."[28] It is

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25. L. EISENSTEIN, THE IDEOLOGIES OF TAXATION (1961) [hereinafter cited as L. EISENSTEIN].
26. *Id.* at Preface iii.
27. Adams, *Ideals and Idealism in Taxation*, 18 AMER. ECON. REV. 1 (1928).
28. L. EISENSTEIN, *supra* note 25, at 3, 4.

perhaps because people aspire to loftier rationales to justify tax dispensations, that the outlook for reform is so dim.

Although the book is satirically written, it contains brilliant analyses, and seems a natural step from other "tax classics." Earlier writings by Vickrey,[29] and Simons[30] spotlighted needed areas of reform. Eisenstein classifies the arguments that prevent reform.

His classification involves three major group arguments: the ideology of ability to pay; the ideology of barriers and deterrents; and the ideology of equity.[31] The argument of equity appears to be more properly a sub-category of each of the other two—a method of argument for persons of either persuasion—rather than being in a separate category by itself.

1. *The Ideology of Ability to Pay*

Since Chairman Mills' list of 54 preferences are primarily items that benefit businessmen and higher bracket taxpayers, advocates of this persuasion would be solidly behind him.

Proponents of ability to pay believe in progression in the income tax; and that a dollar is a dollar regardless of source, whether capital gains or social security income, and that it should be taxed accordingly . . . *but at a progressive rate.* Persons fitting into this category would be low income classes who benefit from progression, and liberals who believe in redistribution of income through the income tax.[32] Rather than to term it redistribution of income, however, the liberals have purified progression by arguing that higher income groups have greater ability to pay. This places the ideology on shaky ground.

Ability to pay advocates have two difficulties. The first is due to their justification for progressive taxes: that one is able to pay a higher percentage of taxes on certain dollars in accord with an artificial bracketing determined by Congress,[33] and that this is the historical reason for a progressive tax. Eisenstein on the other hand concludes that the income tax was born out of class legislation which resulted from the failure of the poor to understand why there should be no tax on savings.[34] But the laborers and the farmers went further by asking for a redistribution of income. Thus, the

29. VICNREY, THE AGENDA FOR PROGRESSIVE TAXATION (1947).
30. SIMONS, FEDERAL TAX REFORM (1950).
31. L. EISENSTEIN, *supra* note 25, at 13.
32. But as L. EISENSTEIN in some *Second Thoughts, supra* note 17, indicates (discussed further below) the effect of economic arguments has moved liberals into the bariers and deterrents camp.
33. Progression must not be confused with a flat rate. Whereas a flat rate of 20% will yield $20 on $100 and $200 on $1,000, a progressive tax extracts an increasing percentage, such as $20 on 100 and $400 on $1,000.
34. L. EISENSTEIN, *supra* note 25, at 18-21.

progressive tax "derived from the pressures of self-interest exerted against a small minority,"[35] and as such is founded on a discrimination against savings. This conclusion is supported by the analyses of Blum and Kalven.[36] Their book, also a "tax classic," suggests that the only justification for progression is the felt need for economic equity through redistribution of income.

The second difficulty faced by these advocates of ability to pay is shown in their arguments which accept income-splitting, charitable contributions,and the medical deducation.[37] Once these distinctions have been accepted a dollar is no longer a dollar regardless of source. Dollars given to publicly recognized charities or given to assist a needy relative in college. This second difficulty spent for medical purposes are treated differently than dollars would be cured if advocates admitted that this was a deviation from ability to pay, but Eisenstein suggested that liberals will not do this; it would admit that in certain cases the end justifies the means, and if this is so then the end result may be supplied by others.[38]

2. *The Ideology of Barriers and Deterrents*

This is the opposite of the preceding ideology. Proponents of the theory of barriers and deterrents oppose progression and high taxes for three reasons: such taxation dangerously diminishes the desire to work; it fatally discourages the incentive to invest; and it irreparably impairs the sources of new capital. "The three precepts merge into a more general perception of impending diasater."[39] Proponents of this ideology may be tentatively classed as Republicans, or high income non-liberals. As will be seen below this is an overly abrupt classification, but in arguing barriers and deterrents, "Republicans are able to do so with a distinguished monotony that the Democrats are unable to acquire."[40] Naturally, advocates of this persuasion oppose progressive rates. In fact if one opposes progression, he would tend to favor "loopholes," since such preferences have the effect of reducing the impact of progressive rates.

Since Eisenstein's book was written in 1961, he could not then comment on the implications of subsequent revenue acts. He did, however, in 1964 have second thoughts[41] based on the Acts of 1962

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35. *Id.* at 21.
36. BLUM & KALVEN, THE UNEASY CASE FOR PROGRESSIVE TAXATION (1952).
37. Stanley S. Surrey is regarded by Eisenstein as a prime adherent of the ability to pay. *See* articles by Surrey, *The Federal Tax Base for Individuals*, 58 COLUM. L. REV. 815 (1958) and *The Congress and the Tax Lobbyist—How Special Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957).
38. L. EISENSTEIN, *supra* note 25, at 48.
39. *Id.* at 13.
40. *Id.* at 67.
41. Eisenstein, *Some Second Thoughts*, *supra* note 17.

and 1964. He recognized in this article that the barriers and deterrents ideology was picking up numerous Democrats.[42] This later piece is much more concerned with the economic aspects of taxation than was the earlier work.

Whereas, tax policy prior to the sixties emphasized equity and the need for subsidies through the income tax base, justified to a large degree by political considerations, the policy of the sixties concerned itself with economic growth. The Treasury in speaking of the Revenue Acts of 1962 and 1964 called these laws "tax reform in the 'economic' sense."[43] It is noted that "in the crucible of intense national debate tax and fiscal policy have finally been accorded a positive role in our political and economic system."[44]

An inconsistent administration economic policy is shown when the Acts of 1962 and 1964 are placed side by side. In the 1962 the investment credit, a direct stimulant to business was heralded by the administration as a partial solution to the problem of unemployment through increased economic growth.[45] Whereas in the Revenue Act of 1964 the administration emphasized the need for additional consumption as a solution to the employment problem.[46] A prime advocate of the barriers and deterrents ideology, Roswell Magill, confirms this inconsistency. In testifying on the 1963 proposals, he refers to the investment credit, noting, "apparently, although the diagnosis remains unchanged, the remedy prescribed has now been reversed and the emphasis is on increased consumer spending."[47] The issue suggested by comparing these two Acts is whether increased real capital formation, and resultant economic growth, will

42. *Id.* at 8.

43. Remarks of the Honorable Henry H. Fowler, then Under Secretary of the Treasury, at the 14th Ann. Midyear Conf. of the Tax Exec. Inst., Mayflower Hotel, Wash., D.C., Mar. 2, 1964, under first part entitled "A Turning Point in Tax Policy."

44. *Id.*

45. In order to minimize unemployment, to satisfy the desires of our people for rising standards of living, to meet our defense and other domestic and international obligations, and to demonstrate the vitality of our free economy, we must achieve a higher rate of growth. This we cannot do unless we achieve a more satisfactory rate of capital formation.

Statement of then Secretary of the Treasury, C. Douglas Dillon found in *Hearings Before the Senate Committee on Finance*, 87th Cong., 2d Sess. 81 (1962).

46. The rationale given by President Kennedy was as follows:

Consumers will convert a major percentage of their personal income tax savings into a higher standard of living, benefiting their own families while generating stronger markets for producers. Even modest increases in take-home pay enable consumers to undertake larger periodic payments on major purchases, as well as to increase purchases of smaller items—and either type of purchase leads to further income and employment.

Investment will be expanded, as the rate of return on capital formation is increased, and as growing consumer markets create a need for new capacity. It is no contradiction to say that the best means of increasing investment today is to increase consumption and market demand—and reductions in tax individual rates will do this.

Hearings Before the Comm. on Ways and Means on the Tax Recommendations of the President, 88th Cong., 1st Sess., pt. 1, at 8 (1963).

47. *Hearings on H.R.* 8363 *Before the Comm. on Finance,* 88th Cong., 1st Sess. 1371 (1963). For classification of Magil's ideology, *see* L. EISENSTEIN, *supra* note 25, at 57, 76.

be better accomplished through the encouragement of consumption or investment. The question of progression in taxation then becomes a problem of tax distribution which will encourage increased consumption or investment depending on current emphasis.

From the standpoint of the ideologies discussed above, the Revenue Act of 1964, under a Democratic administration, was very favorable to conservatives and a triumph for the advocates of the ideology of barriers and deterrents.[48] On the other hand, the Tax Reform Act of 1969,[49] under the Republicans, was favorable to the liberal ideology of ability to pay. Major provisions of this Act included an increase in the maximum standard deduction,[50] a low-income allowance,[51] and an increase in per capita exemptions.[52] Taking these measures into account, the Act had the effect of removing 7.6 million returns from the tax roll.[53] In addition the Act eliminated the preference given to long-term capital gains in excess of $50,000,[54] and the minimum tax[5] was introduced to deal directly with high bracket preferences. Also, the concept of a maximum tax became law, which may be a victory of sorts for both ideologies. Starting in 1972 a fifty per cent ceiling was placed on the marginal tax rate applying to an individual's earned income.[56]

3. *The Ideology of Equity*

This dogma is concerned with equality among equals. Instead

48. Although numerous reforms were urged the administration's major concern was a reduction in rates. *See* B. NOSSITER, THE MYTHMAKERS 34-36 (1964). Prior to the Revenue Act of 1964 individual rates ranged from 20 to 91 percent. The Act reduced rates to 14 to 70 percent. However, in the words of Senator Douglas: "[t]he present tax system is really loaded against the lower income groups. We delude ourselves if we believe that the rates of progression on the upper federal income taxes are actually paid by many taxpayers." 110 CONG. REC. 1943 (daily ed. Feb. 5, 1964). Hence, the recognition that the wealthy do not really pay taxes at the top level, plus the reduction by the Act from 91 to 70 percent combined with the reforms that failed to pass forces one to concede a victory for the ideology of barriers and deterrents.

Although the Revenue Act of 1964 did produce some legislation favorable to the middle and lower income groups such as the minimum standard deduction, the child care deduction, income averaging and the employee moving expense deduction Congress failed to act in major areas favorable to the wealthy: tightening up the tax treatment in the area of natural resources and the treatment of capital gains.

49. Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487. [hereinafter cited as the 1969 Act].

50. Ultimately the scaled increase will reach 15 percent with a $2,000 ceiling in 1973. § 802(b) of the 1969 Act, 83 Stat. 676, *amending* INT. REV. CODE OF 1954, § 141(b).

51. Reaching $1,300 for years after 1971. § 802(c) of the 1969 Act, 83 Stat. 676-77, *amending* INT. REV. CODE OF 1954, § 141(c).

52. Reaching $750 in 1973, § 801 of the 1969 Act, 83 Stat. 675-76, *amending* INT. REV. CODE OF 1954. § 151.

53. *See* Woodworth, *Simplification and the* 1969 *Tax Reform Act,* 34 LAW AND CONTEMP. PROB. 711, 715 (1969).

54. 1969 Act, § 511(b), 83 Stat. 635 *amending* INT. REV. CODE OF 1954 §§ 1201 (b), (c).

55. INT. REV. CODE OF 1954, §§ 56-58. For a complete legislative history of this law, see Note, *The Minimum Tax for Items of Tax Preference,* 41 CINC. L. REV. 365 (1972).

56. 1969 Act, § 804, 83 Stat. 685, *adding* INT. REV. CODE OF 1954, § 1348. Since the maximum on earned income encourages highly paid executives to favor more regular earnings and less compensation in the form of profit sharing plans, the idea is to reduce the demand for preferential treatment of fringe benefits.

of stating it simply as similar situation, similar treatment, Eisenstein makes a logical extension. The ideology of equity "maintains that those who are similarly situated should be similarly treated, and those who are differently situated should be differently treated."[57]

Equity can be granted in two ways: by extending the provision that creates unfairness to one similarly situated,[58] or by removal of the special provision which gives others grounds for equity. Invariably Congress adopts the former approach, making distinctions which create multiple cries for more equity.[59] A mild example of this is the provision for income-splitting, which arose in 1948 to end the inequity between persons living in community property states and others not so favorably situated, from a tax standpoint. This then led through the process of equity to special rates for heads of households in 1951, and further to surviving spouses in 1954.[60] These provisions then in turn created an inequitably excessive differential as between joint and individual rates. The Tax Reform Act of 1969 cured this problem by reducing individual rates.[61] This change had the unforseen effect of making marriage very costly for two employed individuals.[62]

There are of course practical difficulties in considering alternatives to income splitting, but the process does show how our tax laws grow through extension of equity. And when the equity argument is combined with the ideology of barriers and deterrents we see the extension of percentage depletion—starting with oil—to roughly a list of one hundred presently in the Code.[63]

In considering the twenty-eight provisions of the Tax Policy Review Bill of 1972 that affect individuals, it is apparent that the ability to pay advocate would favor the removal of most of the listed preferences. He would certainly urge that the minimum tax on preferences be made more effective, that benefits from capital gains be reduced, and that exclusions and deductions most bene-

57. L. EISENSTEIN, *supra* note 25, at 13.

58. One of the recommendations made by the Treasury in 1963 was that the capital gain treatment of certain ordinary income items be removed. This applied to patents, sale of timber and coal royalties. Instead of restricting these items Congress added iron ore royalties to the preferred list of items entitled to capital gains treatment. *See Hearings Before the Comm. on Ways and Means on the Tax Recommendations of the President*, 88th Cong., 1st Sess., 24, 147 (1963); H.R. REP. No. 749, 88th Cong., 1st Sess., 63, 93 (1963); S. REP. 830, 88th Cong., 2d Sess., 88, 119 (1964).

59. Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955), was alarmed with the trend toward specialized provisions based on source of income which increase the inequality in the tax law.

60. P. STERN, THE GREAT TREASURY RAID 62 (1964) has an amusing chapter on this point entitled "Your Wife May Be Worth a Million."

61. Equity by extension of preferences is humorously analysed in Blum & Johnson, 1913-2013, *A Hundred Years of Income Taxation,* 33 TAXES 41 (1955) and in Johnson, *The Last Taxpayer,* 30 TAXES 181 (1952).

62. 1969 Act, § 803(a), 83 Stat. 678, *amending* INT. REV. CODE OF 1954, § 1(a).

63. INT. REV. CODE OF 1954, § 613.

ficial to higher-bracket taxpayers be eliminated, with the possible exception of the charitable contribution deduction. The advocate of the ideology of barriers and deterrents, on the other hand, would urge the retention of many high-bracket preferences since they mitigate the harsh effect of too progressive a tax rate. Agreement between the camps would arise to an extent in the area of personal deductions based on hardship and in cases of special exemptions and treatment for taxpayers with "reduced ability to pay." Since economic incentives do not play an important role in the area of personal preferences, the two ideologies do not merge as they appear to be doing in the area of business credits and deductions. As to the ideology of equity it will continue to be the most important argument for and against tax reform. To the ability to pay advocate, equity demands a code free of all but the most essential dispensations. To the ideology of barriers and deterrents, fairness can be best accomplished by extending preferential treatment to all who can make their case.

B. METHOD OF REFORM—COMPREHENSIVE TAX BASE (CTB) VERSUS AN AD HOC APPROACH

Without doubt the ideologies of Eisenstein combined with strong economic rhetoric will continue to be urged as arguments for and against tax reform. However, the method in which to approach reform is currently being debated. Chairman Mills' automatic phase-out approach would have meant first isolating the preference item and then eliminating it within a period of time unless Congress acted affirmatively to retain it. As suggested in the Introduction to this article such an approach has a great deal of merit.

The advocate of a comprehensive tax base would go even further. He would seek

> . . . to eliminate 'preferences' ruthlessly, no matter how persuasive or seductive their individual appeals may be, and to impose the tax on the resulting CTB. The broader base will permit rates to be reduced, and with lower rates the benefit to be reaped by the restoration of any one 'preference' will be lessened; this will let some of the steam out of efforts to renew the process of 'eroding' the base.[64]

Professor Bittker takes issue with this approach[65] and advocates tax reform wherein each provision is considered by itself on its particular merits. He argues that defining a preference or a tax

64. Bittker, *A Comprehensive Tax Base as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 926-27 (1967).

system devoid of preferences results in many distinctions that are inequitable, but administratively necessary. One may bring into the tax base certain items that are presently excluded such as social security, railroad retirement, and veterans' benefits, but how does one then exclude other federal, state, and local government benefits? Taxing a student on a scholarship grant would broaden the tax base, but how is this reconciled with the student who attends a public institution free of charge? Other areas where benefits occur would include subsidized housing, welfare services, government guarantee of loans and so on. Hence, as to exclusions from gross income it is impossible to draw the line between subsidies through the reduction of the tax base and other indirect subsidies.

In analyzing exclusions and deductions Bittker recognizes what the proponents of the CTB do not. Equity, treating as equals individuals similarly situated, is not possible within any workable system of income taxation. For one thing it is doubtful that one could find two individuals in exactly the same situation, when account is taken not just of income, but also of possessions and enjoyment derived therefrom. To achieve theoretical equality one must enter the arena of imputed income from taxpayer's assets, an area that even the proponents from the CTB shy away from. Imputed income would bring into the taxpayer's gross income the net rental value of owner-occupied residences, of household furnishings, and of the value of bank services furnished on checking accounts in lieu of interest. Other distinctions that would generally have to be made under the CTB would be between insurance recoveries and personal injury recoveries, and distinctions between the treatment of tax-exempt organizations and those that are not exempt.

An inconsistency Bittker sees in the advocates of the CTB, aside from distinctions they make as to income exclusions and deductions, is in their recognition that the income tax should be used as a flexible fiscal tool. Thus incentives that encourage economic growth such as the investment credit or the allowance of reduced useful life for purposes of depreciation may be justified on economic grounds but otherwise are clearly inequitable preferences to a segment or segments of industry.

1. *The Response of CTB Advocates*

Professor Bittker's article led to a series of retorts by the advocates for a comprehensive tax base. Professor Musgrave rejected Bittker's ad hoc approach.[66] His analysis is to the effect that even if the accretion concept of income does not solve all problems of creat-

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65. *Id.*

ing an equitable income tax, it does point the way to a proper solution of most problems, even though it may have to be qualified by considerations of administrative feasibility, or, in some instances, may have to give way to other policy objectives. Of course this is one of Bittker's main arguments: exclusions because of administrative feasibility and deviation for policy reasons destroy the entire concept of the CTB.

Professor Musgrave's concern is that the ad hoc provision by provision approach deals with the problem of fairness without the guidance of a general principle to which to relate specific provisions. A general principle to which Congress can refer is argued to be necessary because reform in past decades has been disappointing and in most cases has added preferences to the Code rather than taking them out. This, then, is the result of an ad hoc approach to tax legislation.

The automatic phase-out concept of Chairman Mills would of course, have led to ad hoc consideration, but the burden of proof would have shifted to those who urge the preference, rather than being on the reformer as it is now. Although Mills' proposal did not speak in terms of CTB, his list of preference items is the same as those listed by advocates of ability to pay in their justification of the CTB. This is not to suggest that Professor Bittker is not an ability to pay advocate; rather, the method of reform is the issue to which he addresses himself.

Dr. Pechman took issue with the ad hoc approach by arguing that Professor Bittker misunderstood the implications of the Haig-Simons definition of income.[67] The concept according to Dr. Pechman does not concern itself with the time interval over which income is measured, nor the proper unit of taxation, nor personal deductions. Rather it is limited to the question of what receipts are to be counted as income.

From the standpoint of the economist there is a correctness in this but it overlooks the use or mis-use of the concept by tax scholars of the ability to pay persuasion. Their arguments are phrased more in terms of erosion of the tax base, which occurs through exclusions, exemptions, deductions,and timing provisions.

The latest response to Bittker has come from Dean Galvin. His

66. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967).

67. Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967). The concept of a comprehensive tax base is founded on an economic definition of income called by these writers the Haig-Simons definition. Haig defined personal income as the money value of the net accretion to one's economic power between two points of time," THE FEDERAL INCOME TAX 7 (R. Haig ed. 1921), and Simons regarded his definition as interchangeable, being that "personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period of question." H. SIMONS, PERSONAL INCOME TAXATION 61-62, 206 (1938).

article discusses the project initiated by the Section of Taxation of the American Bar Association, which examines and supports the CTB approach.[68] In addition he points out that the Canadian Taxation Commission Report[69] had concluded that a CTB system was workable and equitable.

2. *The Reply of Professor Bittker*

Bittker responded to these challenges[70] by pointing out that the use of tax preferences for economic policy in cases such as the investment credit had not been answered. Whereas, the CTB advocates would argue against percentage depletion because it is a benefit that Congress would not be willing to give in explicit form (direct appropriation), they are suggesting that the investment credit is proper. Yet Bittker doubts that Congress would have been willing in 1964 to appropriate 1.3 billion dollars as direct cash grants to 330,000 corporations making investments as specified by section 48 of the Code.[71] He further takes issue with Musgrave who would allow deductions for disaster expenses (including medical expenses), whereas these items are not allowed in the economic definition and can be insured against. Basically, Bittker returns to his argument that departures from the CTB argued by its proponents are in themselves ad hoc judgments with reasons no different from those given in support of preferences under existing law,[72] which makes it doubtful that we will gain anything by adoption of the concept.

In response to Pechman's definitional argument, Bittker points out that advocates of the CTB are using a broader definition of income than is Pechman. He further points up past inconsistencies in this regard by Pechman himself.[73]

Finally, Bittker argues that the approach of the Canadian Royal Commission on Taxation would, as he had suggested before, require many more sweeping changes in the existing tax structure than have been acknowledged by proponents of the CTB. Among the changes sought by the Canadian approach are:

> integration of the corporate tax into the individual tax, aggregation of family income, taxation of capital gains at regular

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68. 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).
69. 1 REPORT OF THE ROYAL COMM'N OF TAXATION (Canada) 1-2 (1966). Referred to as the Carter Commission Report.
70. Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968).
71. Only about 25% of the 1.4 million active corporations claimed the credit in 1964. U.S. Treasury Dep't. Pub. No. 159, *Statistics of Income*—1964 (Corporation Income Tax Returns, Preliminary), Table C.
72. Bittker, *supra* note 70, at 1036.
73. *Id.* at 1037.

> rates, and the inclusion in income of gifts, bequests, mortality gains on life insurance, patronage refunds, mutual insurance dividends, and recoveries in personal injury cases.[74]

In conclusion to his response Bittker points out

> that a system of countervailing 'preferences' might produce a distribution of the tax burden conforming more closely to the professed ideal of the CTB advocates than an undiscriminating elimination of those 'preferences' that happen to be vulnerable at a particular time. Although I cannot prove that this judgment is correct, it seems to me more plausible than the contrary assumption that the elimination of *any* preference, even if it is enjoyed only by a generally disfavored group, will be an improvement.[75]

Which is the better argument as to the method of reform? In favor of the CTB approach it must be recognized that past "reforms" using ad hoc analyses resulted in addition rather than subtraction of preference items. And, to those of us who seek to understand the ever-increasing volume of tax law there is strong appeal to the idea of starting anew. Yet, how is a more CTB fairer? Without worrying about the rather extreme arguments as to inequality caused by the failure to impute income, is it fair to include benefits such as social security and to exclude others based on administrative feasibility? In examining the twenty-eight individual preference items below, it will be seen that there is strong justification for most of them. Their wholesale elimination, compensated for in theory by a reduction in rates, may create serious inequities in the name of the Haig-Simons definition of income. What seems to be overlooked in the dialogue is that the taxing committees and Congress do operate under a general guiding principle: taxing all income from whatever source derived. Is it perhaps that the problem is not caused so much by the approach to reform, but the fact that in being guided by a general principle Congress reaches conclusions not satisfactory to the CTB advocate?

There are two arguments that can be made in attacking an item of tax preference: 1) that tax relief, a subsidy, cannot be socially or economically justified by the recipient, and, 2) that although the subsidy is justified, it should not take the form of tax relief. The next section of this article will deal with the second argument.

C. SUITABILITY OF THE TAX SYSTEM AS A VEHICLE FOR SUBSIDIES

In determining the nature of the objection of an ability to pay

74. *Id.* at 1040.
75. *Id.* at 1042-43 (footnote omitted).

advocate to an item of preference it must be asked: is his concern with the subsidy itself or is it with the use of the income tax base as a vehicle for the subsidy? Could one assume that a preference in entering the Code was initially justified as a subsidy within our political framework? It must first be recognized that it is easier for Congress to dole out funds by reducing federal income (tax relief) than it is to directly appropriate the funds, a more time consuming and involved process. On the other hand,the expertise of the tax committees should not be overlooked; the members of the House Committee on Ways and Means and of the Senate Finance Committee are well versed in matters of tax policy, and appear to be guided more by concepts of fairness and less by political pressures than are other committees. The central question to be explored in this section, however, is not the initial justification for a preference item, but rather; assuming that it is a valid subsidy, is it proper to use the Internal Revenue Code for its dispensations?

Dean Wolfman deals directly with this problem.[76] His analysis concerning science lends itself to the broader question of when tax relief, rather than direct appropriation, is proper. "Like a subsidy, tax relief shifts the financial burden from the recipient of the benefit to the rest of the population."[77]

A federal expenditure differs from tax relief in that the granting of funds is subject to guidelines, and reporting requirements, for a purpose that is more than speculative. Tax relief, on the other hand, leaves the objectives and control with the individual recipient. Federal direction and supervision is virtually nonexistent.[78] Wolfman would generally disfavor the tax route because it is "less open, not carefully measured, not reflected in the federal budget and not subject to periodic congressional review."[79] He also argues that it is costly in that

> [a]lthough this method avoids a bureaucracy of federal experts to approve and supervise expenditures, it substitutes tax administrators, tax planners and a tradition of protracted administrative controversy and litigation.[80]

It is not surprising that Wolfman would be most restrictive in the area of tax preferences. He is an ideologist of the ability to pay persuasion, and as such defines a tax system with integrity to be one that is geared to the determination of economic net income

76. Wolfman, *Federal Tax Policy and the Support of Science*, 114 U. PA. L. REV. 171 (1965).
77. *Id.* at 172.
78. *Id.*
79. *Id.* at 183.
80. *Id.* at 184.

taxed without regard to its source. When the market does not operate to allocate resources in a desirable way, then direct appropriation and not tax relief should be preferred. He eschews market reallocation through tax preferences because they are "less directed, more likely to be arbitrary, less susceptible to measure and change."[81] Unlike the recipient of a direct grant, the beneficiary of the tax system does not compete for or make his case in the open subsidy arena.[82]

What criteria determines the choice of vehicle? Wolfman suggests that Congress must recognize and accommodate the demands of three interests which may be in tension:

> 1) society's stake in an income tax system with an essential integrity,
>
> 2) society's stake in preserving substantial areas of activity in which private initiative and management are given relatively free reign, and
>
> 3) society's stake in having federally allocated funds reach their objectives as directly and inexpensively as possible.[83]

Although these criteria indicate that there are cases where tax relief is more proper than direct federal expenditure, the preferences allowable by Wolfman are quite limited. He would yield to tax relief as the alternative only "when private decision making, free of government interference, is most compelling."[84] Examples that he gives are the charitable contribution deduction, and with qualifications, the exclusion of scholarships and fellowships (if based on need). He would deny, for example, tax favoritism to the inventor, requiring him to fight his case in the subsidy arena.

Dean Wolfman presents serious and valid objections to the general use of the tax system as a vehicle for subsidies. His criteria do not address themselves to the issue of whether a subsidy in some form is justified, but only if it should occur through the erosion of the tax base. He has, however, as have the scholars cited above, dealt with the issue of whether it is fair to tax a dollar derived from a particular source differently than a dollar of economic gain of an investor (who has turned over his investment within twelve months). If one argues that there should be no difference, as I would tend to do, then the subsidy must be justified

81. *Id.* at 182.

82. *Id.* at 184. "Funds allocated by the tax route may, and often do, go to projects with little merit, at least by comparison with some projects whose claims to funds have succeeded in competition for direct grants."

83. *Id.* at 182.

84. *Id.* at 184.

on a ground that is more important than achieving equity. Finally, if some social good requires a subsidy, is there justification for using the tax base instead of requiring that a case be made for an appropriation? In examining twenty-six of the preference items affecting individuals, that have been isolated by Mills, these questions—fairness, policy justification, tax subsidy—will frequently recur.

III. INDIVIDUAL PREFERENCES***

The present outlook for preferential provisions, which . . . is for more of the same, might be unfortunate but not catastrophic. Most of those who benefit materially from the special dispensations will not be unhappy, while most of those who pay the price will not even be aware that it is their treat. And as the preferences multiply, it will become increasingly difficult for anyone, including the experts, to tell who is paying for whom.

Walter Blum[85]

A. TIGHTENING UP THE MINIMUM TAX (1,2)

Tax reformers made a significant gain when Congress officially recognized the existence of preferential income and deductions within the Internal Revenue Code.[86] The addition of the minimum tax on tax preference items was designed to increase the tax burden for both individuals and corporations who otherwise could keep their tax low through a variety of tax shelters allowed by the Code.[87]

The minimum tax was added as part of the tax reform of 1969.[88] Recognition of the need for special tax treatment of preference items originated in the statement made to the Joint Economic Committee by the then Secretary of the Treasury, Joseph W. Barr.[89] It was pointed out that in 1967 there were 155 tax returns with adjusted gross incomes of over $200,000 a year and 21 returns with adjusted gross incomes of over $1,000,000 on which no federal income taxes were paid. The Treasury analyzed these returns in terms of types of tax preferences to arrive at the major tax reducing factors.[90] President Johnson's Treasury proposed a dual attack on

***Parenthetical references throughout this part will refer by number to the provisions of the Tax Policy Review Bill of 1972 enumerated *supra* note 9.

85. HOUSE COMMITTEE ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 85 (Comm. Print 1959). [hereinafter cited as TAX REV. COMP.].

86. INT. REV. CODE OF 1954, §§ 56-58.

87. *See* Hobbet, *Minimum Tax on Preference Items: An Analysis of a Complex New Concept*, 32 J. TAX. 194 (1970).

88. 1969 Act, § 301(a), 83 Stat. 580.

89. *Hearings on the Economic Report of the President Before the Joint Economic Committee*, 91st Cong., 1st Sess., pt. 1, at 5-6 (1969).

90. *See* HOUSE COMM. ON WAYS AND MEANS AND SENATE COMM. ON FINANCE, 91ST

these tax shelter items—a minimum tax on a recomputed tax base, and an allocation of personal deductions to non-taxable income.[91] President Nixon's Treasury then changed to an approach which would limit the use of preference items as well as using the allocation of deductions approach.[92] The House Bill generally followed the Nixon proposals,[93] whereas, the Senate Bill more generally followed President Johnson's approach. The version of the Joint Conference Committee of the House and Senate, signed into law in December of 1969, was essentially a combination of the provisions of both the Senate and the House Bill.[94]

The Tax Policy Review Bill would have had the effect of tightening up the minimum tax by removing two items that substantially reduce its effectiveness: a $30,000 exemption, and the allowance of a deduction for ordinary income taxes. These items fit into the computation as follows: first, items of tax preference[95] are totaled; the sum obtained is reduced by a $30,000 exemption,[96] and then further reduced by any federal income tax payable. "Unused" federal income taxes that are carried over from the past seven years[97] are allowed as a further reduction, and to any excess that remains a ten per cent tax is imposed. This amount is of course in addition to and apart from ordinary income taxes payable by the individual.

CONG. 1ST SESS., TAX REFORM STUDIES AND PROPALS, U.S. TREAS. DEPT. (Comm. Print 1969). [hereinafter referred to as TAX REFORM STUDIES] and Caplin, *Minimum Tax for Tax Preferences and Related Reforms Affecting High Income Individuals*, 4 IND. LEGAL F. 71, 71-78 (1970) for a detailed analyses of taxpayer abuses in this area.

91. TAX REFORM STUDIES, *supra* note 90, at 136.

92. HOUSE COMM. ON WAYS AND MEANS: 91ST CONG., 1ST SESS., TECHNICAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS, U.S. TREAS. DEPT. 79-100 (Comm. Print 1969). This is undoubtedly where the term "tax preferences" entered the congressional picture.

93. H.R. 13270, 91st Cong., 1st Sess. § 301 (1969).

94. Reprinted in H.R. Rep. No. 782, 91st Cong., 1st Sess. (1969). For a detailed analysis of the legislative history, *see* Caplin, *supra* note 90; Friend, *The Minimum Tax for Items of Tax Preference . . . Movement Toward a Comprehensive Tax Base?* 41 U CIN. L. REV. 365 (1972). Mr. Friend mentions the pressures of special interest groups on this legislation. Real estate called the Limit on Tax Preferences (LTP) a "Let Them Pay" provision. Farm lobbies called it antifarm. Charities appealed invoking equity. And the attempted inclusion of tax-exempt interest "was variously described as unconstitutional, disruptive, and economically short-sighted." *Id.* at 370 (footnotes omitted).

95. INT. REV. CODE OF 1954, § 57 defines tax preferences. There are two income items: one-half of the net long-term capital gain over net short-term capital loss; and the spread between the exercise price and fair market value of qualified stock options. There are five deduction items (excess investment interest disappeared after 1971): amortization of pollution control facilities, the accelerated portion; accelerated depreciation on real property; accelerated depreciation on personal property subject to net lease; depletion in excess of adjusted basis; and amortization of on-the-job training and child care facilities. Two other tax preference items are applicable only to corporations: the excess of the bad debt reserve deduction over that allowed by actual experience; and the excess of the five-year railroad rolling stock amortization deduction over depreciation "otherwise allowable." For in depth analysis of these provisions, *see* Caplin, *supra* note 90; Friend, *supra* note 94; Davenport & Goldman, *The Minimum Tax for Tax Preferences and the Interest Limitation Under the Tax Reform Act of* 1969, 16 WAYNE L. REV. 1223 (1970); Elliott, *The New Minimum Income Tax on Tax Preferences,* 48 TAXES 731 (1970); Schenk, *Minimum Tax for Tax Preferences*, 48 TAXES 201 (1970); Shaw, *Tax Planning for High Bracket Individuals in Light of the New Act,* TUL. 20TH ANN. TAX INST. 370 (1971).

96. $15,000 for married individuals filing a separate return.

97. INT. REV. CODE OF 1954, § 56(c).

The minimum tax has had limited impact because of preferences not included, and because of reductions of preferences allowed by law. One analyst[98] discusses the following as limitations on the impact of the minimum tax: omission of tax-exempt interest from state and municipal bonds, unrealized appreciation in property donated to charity, the deduction for intangible drilling and development expenses, and farm losses, from the list of preference items. Other ameliorations, in addition to the $30,000 exemption and the deduction for ordinary taxes, are deferrals of the tax in the case of net operating loss carryover,[99] and where the preference items do not produce a tax benefit.[100] Furthermore, the tax preference item of capital gains, enjoyed by more individuals than any other preference, is an item given only limited treatment.[101]

It is possible that the minimum tax will have the effect of making the outright removal of preference items more difficult. the provision is not too severe for the higher income groups at which it is aimed, but it does prevent for the most part the complete avoidance of taxes by one with a high income.[102] Thus, a happy compromise is effected: the tax preferences stay in the Code, justified by the ideologies and incentive arguments that put them in initially, but their tax shelter effect is minimized. Since these provisions originated in answer to public concern with the rich paying no taxes, and since this possibility is significantly limited by the minimum tax, Congress may be satisfied to stop at this point. It is also possible that by using this vehicle Congress may have found an easier way to deal with preferences than to deal with them "substantively." If a subsidy through the tax base becomes too unpopular, it may be added to the list of items subject to minimum tax, or if already on the list, the effect of the minimum tax may be increased.

Mortimer Caplin urges that in addition to broadening the list of items subject to the tax the rate should be reconsidered.[103] Instead of the present ten per cent, he suggests one-half the normal rates,

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98. Johnson, *Minimum and Maximum Taxes After Two Years—a Survey and General Evaluation*, 50 TAXES 68 (1972).

99. INT. REV. CODE OF 1954, § 56(b) provides that the minimum tax for the loss year can be deferred to a subsequent year when the net operating loss is used.

100. Proposed Treas. Reg., § 1.57-4(c), 35 Fed. Reg. 19770 (1970).

101. *See* Johnson, *supra* note 98. Capital gains preference has the least actual impact of all preference items because the tax preference floor (regular taxes plus $30,000) automatically increases with recognition of any capital gain. Hence, for 1972 the maximum *effective* minimum tax rate is 1.5%. *See* Elliot, *supra* note 95, at 734-38.

102. According to the latest statistics on individual income tax returns, the amount of tax preference items reported for 1970 totaled roughly 4.4 billion. This involved 74,641 tax returns. Only 18,646 returns paid taxes on preferences, however. Their preferences were roughly 2.8 billion dollars and the revenue produced from the tax was 115.1 million dollars. Internal Revenue Service, Preliminary Report, *Statistics of Income*—1970, Individual Tax Returns, table H, Wash., D.C., 1972.

103. Caplin, *supra* note 90, at 117-18.

namely from seven to thirty-five per cent. He also agrees that the preference floor should be removed ($30,000 plus the deduction of ordinary taxes). And, although the allowance of tax carry-overs to offset tax preferences was passed after Mr. Caplin's article went to press, it is likely that he would urge the removal of this provision also.

Even though the addition of the minimum tax on items of preference has added a great deal of complexity to the Code, which in turn requires more tax planning (converting investments from preference to non-preference shelters) and tax planners, it does provide a major vehicle for reaching the subsidies within the Code. The vehicle will make substantive attacks on dispensations more difficult to sustain and in fact may eliminate any chance for their removal, but it will also be much more difficult for the recipient of an income exclusion or deduction to argue for no tax at all. It appears that if Congress can be persuaded to remove the floor, increase he list of items subject to the tax, and increase the rate to a realistic percentage, ability to pay ideologists will have achieved much that they sought—at the price of a code with increased complexity.

B. CAPITAL GAINS REVISION

1. *Qualified Stock Options* (9)

Although the qualified stock option is an item of preference, it is much less so in light of the restrictive changes of 1964 and the minimum tax of 1969. Before examining the effects of these laws, however, a look at the history of the stock option is in order, since it represents a fine example of judicial and congressional erosion of the income tax base.

Professor Lanning, in an excellent article emphasizing judicial erosion of the tax base,[104] points out that a great deal of the complexity in our tax system stems from the forced use of tax concepts. He suggests that a concept such as "sale" or "reorganization" or "gift" has at least definitionally some ascertainable factual content, either now or when it was originally developed.

> But if it is continually applied to situations not really described by that basic notion, or if it is not applied to situations where it is appropriate, then its use becomes more and more artificial or 'conceptual' and it may come to rationalize special interests in a general context.[105]

104. Lanning, *Some Realities of Tax Reform*, TAX REV. COMP., *supra* note 85, at 19.
105. *Id.* at 33.

Concepts such as "corporate contraction" or "capital asset" are types that are inconsistent with the factual criteria which they purport to embody. He notes that both serve almost exclusively as rationalizations for special tax advantages.[106] The inconsistent concept of capital gain, and the ambiguous concept of property (which may be applied to almost anything) produce the stock option argument. "It is easy to dispose of the stock option problems if you say an option is 'property.' Then if you deal in 'property,' ergo, you get capital gains treatment."[107] But when so simple a solution is abandoned and the problem is analyzed it is found that

> A stock option represents a type of continuing relationship between a corporation and its shareholders or employees. The option holder is given the risk-free, interest-free use of the corporate capital invested in the optioned property so that he may—as dividend or compensation—take advantage of the possible future appreciation of that property. The transaction is not really closed until the option is exercised. At that point the optionholder's receipt of the appreciated property represents a completed dividend or compensation.[108]

Arguing, therefore, that a stock option is property and a closed event ignores the substance of this transaction, replacing it with mechanical form.

Capital gains treatment for stock option entered the law because of this disregard for substance. The lower courts held that the exercise of an option did not produce income, since it was intended to convey a "proprietary" interest.[109] This of course ignores the continuing relationship between the parties. The fact that the company intended to provide incentive through proprietary interests does not change this relationship.

The Supreme Court applied the doctrine of substance over form, and rejected the proprietary notion as a concept without meaning, holding that, generally, the spread between the cost of the option and its value at the time of exercise was taxable.[110] Unfortunately the decision came too late in that by this time Congress felt no hesitancy in codifying the decisions of the lower courts.[111]

This legislation introduced the "restrictive stock option" termi-

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106. *Id.* at 34.
107. *Id.*
108. *Id.*
109. Commissioner v. Straus, 208 F.2d 325 (7th Cir. 1953); Bradner v. Commissioner, 11 T.C.M. 566, *aff'd per curiam* (6th Cir. 1954); R.A. Bowen, 13 T.C.M. 668 (1954).
110. Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177, *rehearing denied* 324 U.S. 695 (1945).
111. INT. REV. CODE OF 1954, § 421, *amending* INT. REV. CODE OF 1939, § 130A. *See* Lyon, *Employee Stock Options Under the Revenue Act of* 1950, 51 COLUM. L. REV. 1 (1951).

nology into the Code, which was replaced by the term "qualified stock option" in 1964. In connection with the 1963 Hearings the Treasury emphasized the Supreme Court decisions as a ground for redefining stock options as compensation.[112] But Congress did not directly confront meaningful issues. In fact, one member of the House Ways and Means Committee took lightly the alleged abuses in this area. He states:

> Regretfully the testimony of others that there aren't these abuses does not receive similar dissemination to the public . . . the Treasury Department has a grave burden on its back in this area as well as others to come forward to tell this committee and the public what they are talking about when they alleged there were abuses here or abuses in the pension program, stock option plan, and so forth. . . . [113]

Nonetheless, Congress did substantially restrict stock option abuses by the Revenue Act of 1964.[114] The qualified stock option approach of 1964 required that the options be at least 100 per cent of the fair market value of the stock at the time of grant, that it must expire within five years from grant, and that the stock must be held at least three years from acquisition to qualify for long-term capital gain treatment.[115]

In addition the minimum tax of 1969 hits qualified stock options very hard. Under these rules the preference arises when the stock option is exercised. The spread between the fair market value of the stock and the exercise price defines the amount of the preference. This item thus arises at a time when the executive has no tax savings, indeed, he may have borrowed money for the exercise of his privilege. But, in addition to this, the sale of the stock after the three year waiting period results in another preference, that on long-term capital gains. Furthermore, the minimum tax paid on exercise of the option does not add to the basis of the stock, nor does it push up the preference floor as do capital gains.[116]

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112. *See Hearings Before the Committee on Ways and Means on the Tax Recommendations of the President,* 88th Cong., 1st Sess. 147 (1963).
113. *Id.* at 1444, remarks of Congressman Thomas Curtis, Mo.).
114. *Adding* §§ 421-425, 6039, 6652(a), 6678 to INT. REV. CODE OF 1954.
115. The comparison between the restricted stock options under the 1950 Act and the qualified stock options under the 1964 Act, plus transitional rules, is analyzed by Persons, *What to Do About Key Employee Stock Options Under the* 1964 *Revenue Act,* 42 TAXES 351 (1964). In addition to the requirement set out above the options must be issued pursuant to a plan approved by stockholders within 12 months before or after the plan is adopted, and must be issued within ten years after plan, and must be non-exercisable so long as there is an earlier qualified or restricted option outstanding at a higher price, and optionee's holdings cannot exceed 10% of outstanding stock, and his employment must be continuous from date of grant of option to within three months before exercise.
For additional in depth analysis, see Frei, *Stock Options in the Light of the* 1964 *Revenue Act,* 42 TAXES 872 (1964).
116. *See* Johnson, *supra* note 98, at 74; Simon, *Proposed Regulations on Tax Prefer-*

Consequently, qualified stock options are severely restricted by the 1964 Act in not only the extended holding period, but more importantly in that the right of purchase must be equal to the fair market value of the stock. In a period where stock prices are rising, it is likely that these rights will never be exercised. When these features are combined with the minimum tax on both exercise and gain when sold, we see that this is much less a preference than formerly.

Although stock options may be traceable to judicial conceptualism it is likely that Congress would have installed them on its own initiative. The arguments for such treatment fall under Eisenstein's ideology of barriers and deterrents, as subclassified in the dogma that progression diminishes desire to work. The theory is that salaries are a clumsy tool to motiviate executives,[117] and without stock options men of higher caliber will seek employment elsewhere, such as in the government or possibly the ministry.[118] The legislation of 1964 and 1969 was a significant victory for the ability to pay ideologists, but it is not likely that they will have further success in this area. Again, the presence of the minimum tax as a vehicle to deal with preference items limits the prospect of this item ever returning to ordinary income treatment.

2. *Timber, Coal and Iron Ore Royalties* (13)

In 1943 timber was no being properly conserved. Small timber owners, in order to receive long-term capital gains treatment, sold their timber holdings outright. These sales were to large lumbering companies who would often move in and strip the land in a wasteful operation which lacked the necessary reforestation steps.[119] Congress, to conserve timber, provided that a taxpayer who either owns timber or has a contractual right to cut timber shall receive capital gains treatment upon its sale in any form where he retains an economic interest. He may further elect to treat the cutting of timber as a sale.[120] This preference for timber in 1944 resulted through the arguments of "equity" in the granting of capital gains treatment for coal royalties in 1951,[121] for Christmas trees in 1954,[122] and for

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ences Give Clues on How to Avoid Them, 36 J. TAX. 92 (1972). *See also* Baker & Rosenbloom, *Tandem Stock Options: Modification Problem Still Clouds the Usefulness of This Tool,* 36 J. Tax 44 (1972).

117. Comments of businessmen in NEWSWEEK, Dec. 21, 1959, at 68. *See also* S. REP. No. 2375, 81st Cong., 2d Sess. 59, 60 (1950); H.R. REP. No. 2087, 80th Cong., 2d Sess. 4-6 (1948).

118. Roswell Magill suggests that men may enter the ministry, *The Impact of Tax Leakages—A Postscript to Randolph Paul,* 12 TAX L. REV. 1, 3-4 (1956).

119. *See* 1963 *House Hearings, supra* note 112, at 3080, (Dr. Kenneth Beggs, Econ. & Mgr. of Forest Industry Studies, Stanford Research Institute, Melo Park, Calif.).

120. INT. REV. CODE OF 1954, §§ 631 (a), (b).

121. This is best shown in the reprint of the 1951 Hearings on the coal arguments in the 1963 *House Hearings, supra* note 112, at 3600 (included in statement of Rolla Camp-

iron ore royalties in 1964.[123]

The reasoning was basically as follows: small owners of timber lands will *not* be encouraged to sell outright to wasteful lumber companies since they can receive the same benefit simply by cutting or retaining an economic interest. Holding on to their land, they will be encouraged to provide for the future by proper reforestation. Therefore timber would be conserved. This may have been a reasonable argument, but it should have been recognized that similar treatment would be demanded by other industries. And, there is no real evidence that timber was conserved, but it is evident that the tax law was not. Ordinary income from the timber business became capital gain.

The Treasury's proposal in 1963[124] would have had the effect of restoring ordinary income treatment as to timber with the exception of the first $5,000 of sales. Ninety-nine per cent of timber owners, who own sixty-five per cent of the timber lands would have been completely protected by this exclusion.[125] By this time, however, inertia had asserted itself and the preference was too deeply embedded within our tax system for either removal or restriction.[126]

The approach throughout ignored alternatives. Alternatives that without doubt, would have accomplished conservation. In 1943 Congress could have required under penalty that proper restoration be conducted by timber companies. It could have subsidized directly to encourage conservation. Direct subsidy would have been least painful, if Congress — acting as a body, rather than as a tax committee — determined that practices were wasteful and that the resource should be protected.

Coal, on the other hand, is an example of subsidization (through the tax base) of a depressed industry. Gain on payments for coal mined on the lessor's land is entitled to capital gains treatment.[127] This provision was originally argued into the law in 1951, with a clarifying amendment in 1954. The rationale was quite simple: a coal lease is a capital asset—this is proven by comparing it with timber.[128]

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bell, Pres., Nat'l Council of Coal Lessors).

122. INT. REV. CODE OF 1954, § 631(a), For purposes of this subsection and subsection (b), the term timber "*includes* . . . 'evergreen trees which are more than 6 years old at the time severd from the roots and are sold for ornamental purposes'." *See* P. STERN, THE GREAT TREASURY RAID 267, 274 (1964) in a chapter entitled "Old 'Loopholes' Never Die. . ."

123. *See* 1963 *House Hearings, supra* note 112, at 151, 3626, *amending* INT. REV. CODE OF 1954, §§ 272, 631(c), 1016(a)(15), 1231(b)(2), and 1402(a)(3)(B).

124. 1963 *House Hearings, supra* note 112, at 151 and exhibit 13 at 388.

125. *Id.* at 151.

126. *See* Smith, *Tax Treatment of Capital Gains,* TAX REV. COMP., *supra* note 85, at 1233, 1237.

127. INT. REV. CODE OF 1954, § 631 (c).

128. This is best shown in the reprint of the 1951 hearings on the coal arguments in 1963 *House Hearings, supra* note 112, at 3600.

This simply states a justification. The need arose because of what is termed "lock-up." Old coal leases which run from twenty-five to one hundred years provided a fixed dollar royalty, unlike oil royalties which operate on a percentage basis. As such, coal royalty payments are confiscated by inflation which discourages all efforts of coal miners to lease coal for development.[129] The 1951 capital gains treatment extended, however, to all leases and not just those that are "locked-up." The reasons were to encourage "the leasing of coal which otherwise would have been left undeveloped" and "make unnecessary the sale of coal lands by small individual holders to large corporations in order to realize capital gains";[130] in addition, relief was given to pre-existing long-term leases.

Unfortunately, removal of capital gains for coal was not pushed by the Treasury in the 1964 Revenue Act.[131] And, as a result of this failure, *iron ore*, on the basis of similar situation, similar treatment, could justify its special dispensation.[132]

There are two aspects to the problem of subsidies for timber, coal and iron ore: Do these industries deserve special treatment in any form, and, if they do, should it be in the form of tax relief? Is this an appropriate issue for a taxing committee? Could these industries have made their arguments in the open subsidy arena? From the standpoint of ideologies, an individual with ownership in timber, coal or iron ore can argue on the one hand the barriers and deterrents that ordinary income treatment would pose for ecol-

129. *Id.* at 3543, (R.L. Hirshberg, Asst. Gen. Counsel, Nat'l. Coal Assoc.).

130. *Id.* at 3543.

131. 1963 *House Hearings*, *supra* note 112, at 611-13. Removal of capital gains for coal would have resulted in annual revenue gain of $2 million, which was apparently considered quite insignificant:

> *Secretary Dillon*: I would like to emphasize again, this [coal] is not a major suggestion. It is probably the smallest suggestion in the whole bill. *Id.* at 611.
>
> *Congressman Baker*: And could well be put in Mr. Byrnes' 'deep-freeze' by unanimous consent. Surely not 2 million—you mean removing the capital gain on the royalty of coal would only net $2 million? *Id.* at 612.
>
> *Secretary Dillon*: On this coal thing, as I said a number of times and will repeat it now, is a very minor item. It is not even mentiond in my statement. It is found in the technical annex just to complete the picture of the various definitional problems. It is only mineral royalty that is treated this way. It is certainly so minor that if there is any feeling about this, I would be the last one to object to forgetting about it. *Id.* at 613.

132. The Ways and Means Committee in adding iron ore royalties to those items entitled to capital gains treatment reasoned:

> The capital gains treatment provided by this bill should encourage domestic leasing of iron ore production relative to foreign production. . . . Your committee recognized, however, that iron ore royalties do not represent income from the sale or exchange of capital assets and for that reason has classified income from the sale or exchange of iron ore royalties as class B capital gains rather than class A gains even though held more than two years. [This breakdown of capital assets dropped out of the Act].

H.R. Rep. 749, 88th Cong., 1st Sess. 93, 94 (1963). For an argument based on equity, supporting the coal need and analogizing it to iron ore see 1963 *House Hearings*, *supra* note 112, at 4385 (J.R. Greenlee, Chm., Nat'l Affairs Committee of Am. Iron Ore Assn.).

ogy, generally, or to the investor specifically. At the same time he can emphasize the depressed industry argument, which results in *reduced* ability to pay.[133] It is easier for this beneficiary to seek his subsidy in the form of tax savings. In making his case before the open Congress he would either have to justify 1) government sharing of costs through direct subsidization or 2) monopoly pricing.

This would appear to be an area where tax relief is most inappropriate. Without opposing the social or economic objective of such legislation, it is an ideal case for the application of Wolfman's criteria. In view of the broad policy questions involved, and since direct appropriation would not deter private initiative in these areas, why use the tax base for the dispensation? Perhaps its because these industries, or the individuals who benefit, could not make a direct case. Chances, however, for reform in these preferences are minimal —the lobbies are too strong.

3. *Lump-sum Distribution from Pension Funds* (8)

Prior to the Revenue Act of 1969, certain lump-sum distributions from qualified retirement plans were taxed in the hands of the recipients at capital gain rates. The reason for this approach was to reduce the effect of the progressive rates on the receipt in one year of bunched income, which had been earned over a period of years.[134] This was but one aspect of favorable treatment for deferred compensation: under qualified plans the employer receives a deduction for contributions to the fund, which accumulates earnings without tax consequences, and only upon distribution is the beneficiary subject to tax. Nor are the contributions to the fund taxable income to the employee at the time they are made.[135] When all of these benefits were combined with long-term capital gain treatment as to lump-sum distributions, serious policy questions arose as to this tax deferral technique.[136]

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133. In Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933), an ineffectual conspiracy by a coal selling agency to maintain prices was allowed. By the time this was decided the "United States had embarked on the vast National Industrial Recovery Act experiment with 'cooperation' in place of competition as the rule of trade." L. SCHWARTZ, FREE ENTERPRISE AND ECONOMIC ORGANIZATION 225 (1959). As the next step in saving the coal industry, Congress passed the Guffey Coal Act, 49 Stat. 991 (1935), and the Bituminous Coal Act of April 26, 1937, 50 Stat. 72 (1973), held constitutional in Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (1940). Under the Guffey Act owners of coal mines were not only permitted but compelled to conspire together to sell below certain minimum prices fixed by the government.

This demonstration of reduced ability to pay is given further commentary by L. EISENSTEIN, *supra* note 25, at 51-52, 144.

134. H.R. REP. NO. 91-413, pt. 1, 91st Cong., 1st Sess. 154 (1969). Requirements are set out in INT. REV. CODE OF 1954, §§ 402(a)(2), 403(a)(2).

135. *See* Sherman, *Deferred Compensation—Qualified and Nonqualified: A Legislative Perspective Through the Tax Reform Act of* 1969, 11 WM. & MARY L. REV. 870 (1970).

136. *See* PRESIDENT'S COMMITTEE ON CORPORATE PENSION FUNDS AND OTHER PRIVATE

The Tax Reform Act of 1969 amended several sections of the Code to limit this preference item.[137] The effect of these changes is to eliminate long-term capital gain treatment as to the portion of the distribution attributable to post-1969 employer contributions. Hence, that portion of the distribution attributable to the employer after 1969 will be treated as ordinary income.[138] Capital gains treatment is still available as to the tax free accumulation of earnings in the plan prior to distribution, and it is this item that Chairman Mills isolated as a tax preference. As to items treated as ordinary income under the 1969 changes, relief for bunching is provided by the use of a constructive seven year averaging formula.[139]

Other features of the 1969 Reform serve to make the lump-sum distribution less attractive. Even though the maximum tax on earned income was added, providing for a fifty per cent limitation,[140] the ordinary income element of a lump-sum distribution is not considered "earned" for this purpose.[141] And, each dollar of "unearned" income is pushed into higher brackets by each dollar of "earned" income.[142] Also, the long-term capital gain element of the distribution (tax free earnings of the fund) is an item of tax preference subject to the minimum tax.[143] Furthermore, as a result of the 1969 changes, the portion of net long-term capital gain in excess of $50,000, no longer qualifies for the twenty-five per cent maximum alternative tax rate.[144] These items can now reach a maximum rate of thirty-five per cent.

In view of all of these factors the need for total elimination of capital gain treatment as to lump-sum distributions is lessened. The minimum tax may be sufficient as a vehicle to control abuses in this area.

4. *Sale or Exchange of Patents* (36)

When all substantial rights to a patent are sold by its holder to

RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS (1965).

137. 1969 Act, § 515(c) 83 Stat. 645, *amending* INT. REV. CODE OF 1954, §§ 402, 403.

138. *See* Slavitt & Brady, *Planning for Distribution from Qualified Plans: a Comparative Analysis*, 3 TAX ADVISER 281 (1972); Finch & Daleiden, Proposed Rgs. Introduce Dual Concept for Computing Tax on Lump-sum Distributions, 34 J. TAX. 322 (1971); Hanson, *Problems in the Taxation of Lump-sum Distributions of Employer Securities*, 34 J. TAX. 325 (1971).

139. INT. REV. CODE OF 1954, § 72 (n) (4). The provisions of § 72 (n) previously applied only to self-imposed individuals under a five-year averaging approach. To qualify for th 7-year averaging the employee must have been a plan participant for a minimum period of five years. *See* Schechter, *Interaction of Maximum, Capital Gain, and 7-year Averaging Taxes*, 3 TAX ADVISER 138 (1972).

140. INT. REV. CODE OF 1954, § 1348.

141. *See* Slavitt & Brady, *supra* note 138. INT. REV. CODE OF 1954, § 1348(b) expressly excludes distributions to which § 72(n) applies.

142. INT. REV. CODE OF 1954, § 1348(a)(3).

143. INT. REV. CODE OF 1954, § 57(a)(9).

144. INT. REV. CODE OF 1954, §§ 1201(b),(c).

a nonrelated person, it is treated as a sale or exchange of an asset held for more than six months and as such qualifies for preferential capital gain treatment. This feature was added to the Code in 1954. It specifically provides for capital gains treatment "regardless of whether or not payments in consideration of such transfer are—

1) payable periodically . . . or
2) contingent on the productivity, use, or disposition of the property transferred.[145]

Consequently, payments that resemble royalties or even rentals do not put the transfer into the ordinary income category.

The justification for so special a preference is one of economic incentives, or as an ideology, the removal of barriers and deterrents.[146] Special treatment under the Code is justified by the same rationale that one uses to justify the monopoly accorded an inventor generally within our patent law:[147] the need for scientific inquiry. A reason other than incentive is that of public welfare. Public disclosure of inventions is in the public interest, and special treatment of patents encourages this.[148] However, a similar justification would seem to exist in the case of the creative individual who develops a copyright. Yet, he gets only ordinary income treatment.[149]

As to copyrights, compositions (literary, musical, or artistic), and similar property, they are expressly precluded from capital gain treatment by the Code.[150] However, prior to the addition of this section in 1950, the tax status of creative works depended upon whether the author was an amateur or a professional. As an amateur his work became "property" entitled to preferential treatment, but as a professional his work was treated the same as a personal service effort and his compensation was simply wages for his labors.[151] This area indicates the difficulty in the concept "property." Since all property is a capital asset (unless excluded) and entitled therefore to long-term capital gains treatment if held for more than six months (not necessary for a patent), Congress and the courts are in a definitional arena. Yet, without difficulty one

145. INT. REV. CODE OF 1954, § 1235.
146. *See* Yater, *The Effect of the Internal Revenue Code of* 1954 *on the Sale or Exclusive License of a Patent,* 37 J.P.O.S. 155 (1955).
147. *See* Rhoades & Wallen, *Section* 1235: *What it Does (and Does Not) Do as to Inventions—Patented and Otherwise,* U. 'F SO. CAL. 20TH TAX. INST. 677 (1968).
148. *Id.* at 689.
149. INT. REV. CODE OF 1954, § 1221(3) expressly excludes it. *See* Wolfman, *supra* note 76; Eulenberg, *Books and Mousetraps,* 54 A.B.A.J. 1187 (1968). For further exploration of the definitional problems in this area on franchising under the 1969 Tax Reform Act see Hall & Smith, *Franchising Under the Tax Reform Act,* 4 IND. LEGAL F. 305 (1970).
150. INT. REV. CODE OF 1954, § 1221 (3).
151. *See* Surrey, *Definitional Problems in Capital Gain Taxation,* TAX REV. COMP. *supra* note 85, at 1203.

can make the argument that any sort of a right is property. The right to future wages under an employment contract, for instance, is the most obvious example of ordinary income. What has been done by the courts, and less so by Congress, is to try to determine the predominant ingredient in the transaction: is it personal effort or more like an investment gain? This then serves as a rough guide to preferential treatment. But doesn't the patent obviously fit into the personal effort category? Yes it does. In the words of Stanley Surrey,

> these aberrations in the patent, stock option, and pension trust situations really involve a congressional tax bounty through the gift of a capital gain status and should not obscure the definitional problem.[152]

But, more broadly reflected, this argument attacks the whole nature of the capital gains treatment itself. What justification exists for reducing the tax of an investor? The arguments as to bunched income have certainly disappeared in light of the comfortable averaging provisions,[153] and even without this the argument for special treatment after only six months is difficult to sustain.[154]

Ignoring the preferential treatment of investors, capital gains for patents should certainly be eliminated. This is an area where "equity" would otherwise seem to require its extension to authors by defining their works as property and to other receiving royalty payments, by defining these receipts as a sale or exchange. In the words of Dean Wolfman,

> Tax favoritism for the successful inventor has not been justified. If he is to seek reward beyond that which the patent monopoly and his achievements in the market place afford him, he should be made to fight his case in the subsidy arena. If the image of the successful inventor pleading in public for a subsidy appears ludicrous, it may suggest that his case for tax relief needs similar exposure.[155]

5. *The Alternate Tax and the Deduction for Long-Term Capital Gains* (16,54)

As to individuals, prior to the Tax Reform Act of 1969, the computation for tax on net long-term capital gains was arrived at by applying the ordinary tax rate to one-half of the net long-term

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152. *Id.* at 1217.
153. INT. REV. CODE OF 1954, §§ 1301-1305.
154. For exhaustive coverage of all sides of the capital gains question see, TAX REV. COMP., *supra* note 85, at 1193-1395.
155. Wolfman, *supra* note 76, at 185.

gain,[156] or, where this rate exceeded fifty per cent, one could apply an alternate tax of twenty-five per cent.[157] The 1969 changes did not disturb these methods, but did increase the tax rate as to gains over $50,000.[158] Ignoring the minimum tax on preference items, gains in excess of $50,000 can reach a maximum tax rate of thirty-five per cent.

The repeal of the alternate tax (applicable only to non-corporate taxpayers) would in effect tax the individual on long-term capital gains at one-half his ordinary income rate. But the repeal of the *deduction* for long-term capital gains would have the effect of subjecting all gains to the ordinary income tax rates.

The proposal would have the effect of eliminating a major problem area in tax law: what kind of income does an item represent? The arguments advanced in favor of special treatment are numerous,[159] but it would appear that the major one is that it is unfair to tax an appreciation that took place over many years entirely in the year of realization at progressive rates. This argument loses much of its force as to gains realized within one year of asset acquisition.[160] Nor does the argument support the rates applied to the gain. Inclusion of only half of net long-term gains at all income levels can result in gains taxes below the current bottom bracket—a reduction in rate not needed to relieve progression.[161] In fact, if this is the major justification for capital gain treatment, and not that gains from capital are inherently different from gains through labor, then the problem can be solved through averaging.[162]

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156. INT. REV. CODE OF 1954, § 1202.
157. INT. REV. CODE OF 1954, § 1201.
158. For a detailed analysis, see Andrews & Freeland, *Capital Gains and Losses of Individuals and Related Matters Under the Tax Reform Act of 1969*, 12 ARIZ. L. REV. 627 (1970). The authors give the following example, at 636, wherein taxpayer has $100,000 of ordinary income plus $100,000 of net section 1201 gain. The tax liability of $83,000 is computed as follows:

Ordinary income	$100,000	
Tax		$53,090
25% of first $50,000		12,500
Tax on ord. inc. plus ½ of 1201 gain ($150,000 times ord. rate)	$ 88,090	
Less tax on ord. inc. + ½ of gain over $50,000 ($100,000 + $25,000 times ord. rate)	—70,590	+17,500
		$83,090

159. These arguments are classified by Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957). A more elaborate treatmnt is given in L. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES (1951).
160. The asset need only be held for more than 6 months. INT. REV. CODE OF 1954, § 1222(4).
161. The Revenue Act of 1964 added the five-year averaging provisions to the Code to
162. The Revenue Act of 1964 added the five-year averaging provisions to the Code to replace prior selective provisions. INT. REV. CODE OF 1954, §§ 1301-1305. A more sensitive system, called cumulative averaging or cumulative assessment, is analyzed by Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 LAW AND CONTEMP. PROB. 736 (1969).

The conflicting opinions in this area vary with ideology. Ignoring administrative difficulties, an ability to pay advocate might recommend taxing capital gain at ordinary income rates even though it is unrealized. At the other extreme the barriers and deterrents enthusiast may argue for "roll-over," that is, not taxing the sale of a capital asset as long as the proceeds are reinvested. But between these extremes one must look at the problem of whether or not the gain of an investor should be preferred over the income of a wage earner. Should the fact that one holds "property" for a period in excess of six months give him a tax subsidy? Surely holdings of property for many years and a turn-over at a large profit merits special treatment, but isn't this problem easily dealt with by a comprehensive averaging provision, using a declining rate scale if it be necessarv?

As rewarding as it is for a tax professor to dream about a world without capital gains (the tax practitioner may not feel rewarded with such change), one must realistically conclude that the elimination of preferential treatment for capital gains is not forseeable. Elimination of the alternate tax, however, presents a real possibility. This seems to follow from the changes in 1969. The establishment of the ceiling on the alternate tax at $50,000 provides an easy mechanism for reducing this by stages to zero. And, since the current maximum is thirty-five per cent versus the alternate tax of twenty-five per cent under $50,000, it would not involve a radical change.

C. EXCLUSIONS

Most of the personal subsidies by way of exclusion have been with us in one form or another since federal income tax began. Normally, these are not thought to be preference items in the same league as percentage depletion, investment credit, or accelerated depreciation. Yet whether the dispensation comes by way of business activity, it has the same effect of narrowing the tax base. An exclusion reduces gross income and is therefore objectionable to the ability to pay advocate pursuing the comprehensive tax base. His concern is with the fact that an exclusion is not "source" oriented, and consequently does not meet the test of taxation of income regardless of source. Pressure on Congress to eliminate these exclusions, however, is slight, with the possible exception of interest on municipal bonds. A reason for this, aside from the rationale for the preference, is that excluded income is not reported, and so meaningful statistics can not be developed as to the amount of the tax base erosion. This latter problem could be

corrected by requiring that recipients of this special relief report the excluded amount, which would then allow the Treasury Department to develop arguments based on loss of revenue. Let us examine those items of exclusion that have been singled out by Chairman Mills as preferences.

1. *The* $5,000 *Death Benefit Exclusion and Exclusion of Group-term Life Insurance of Employees* (3,4)

Since 1913 Congress has provided for the exclusion from gross income of amounts received under a life insurance contract paid by reason of the death of the insured.[163] The policy reasons underlying this exclusion are unclear.[164] However, this exclusion[165] provides the justification for excluding death benefits, not in excess of $5,000, to the beneficiary or the estate of an employee paid by reason of the death of such employee. The purpose of this dispensation was to eliminate the hardship resulting from the fact that the exclusion at that time was limited to life insurance.[166] But what really makes this item a preference is that the compensation in the form of premium is not taxable to the employee.

Perhaps as a consequence of this the comprehensive tax base enthusiasts make war on this special $5,000 benefit, but do not seek the inclusion of life insurance proceeds generally. This distinction is without justification from Professor Bittker's viewpoint. While not advocating the inclusion of life insurance proceeds in taxable income, he recognizes that it is a preference as that term is used by CTB advocates, and one that encourages the purchase of insurance because of tax incentive, and one that invites the exclusion of fundamental substitutes for it.[167]

On the other hand, exclusion of premiums paid by an employer on group-term life insurance for an employee is a fringe benefit of greater consequence. Currently such insurance in force totals approximately $500 billion, and insures in excess of 75 million persons.[168] Prior to 1964 all premiums were excluded from the employee's income. The President's proposal at that time would have taxed employees on benefits from group-term insurance in excess of $5,000 in coverage. In addition an employee's income would have been

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163. INT. REV. CODE OF 1954, § 101(a).
164. *See* Wentz, *An Appraisal of Individual Income Tax Exlusions,* TAX REV. COMP., *supra* note 85, at 337.
165. INT. REV. CODE OF 1954, § 101 (b).
166. *See* S. REP. No. 781, 82d Cong., 1st Sess. (1951).
167. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform,* 80 HARV. L. REV. 925, 943-44 (1967). *See also* Swihart, *Federal Taxation of Life Insurance Wealth,* 37 IND. L.J. 167 (1962).
168. *See* Clarke & Lee, *Employee Life Insurance Benefits: The Inequity of Section 79,* 50 TAXES 120, 120-21 (1972).

taxable on the earnings on the cash surrender value of split-dollar insurance which was applied to reduce his premium.[169]

The taxing committees compromised on this provision. The House Ways and Means Committee raised the proposed $5,000 "exemption" to $30,000,[170] and the Senate Finance Committee further increased this to $70,000.[171] The law as passed covered only group-term insurance and taxed employees on the benefits for coverage, if in excess of $50,000.[172]

Although this constitutes a substantial preference item, particularly in view of the fact that most plans do not provide employees with more than $50,000 in coverage, there are difficulties with taxing this form of compensation. The exclusion has been part of the law since 1920 and although the rationale given for the ruling does not have equal force today—that the benefits flow to dependents and not the employee, and that the policy is dependent on continued employment or death and builds no other benefits—the forfeitability feature of the argument is still a problem.[174] Furthermore, the removal of the all-out exclusion in 1964 and the provision for a maximum exclusion on coverages of $5,000 was met with serious and concerted opposition from business, employers, and insurers.[175] And, both the Senate and the House recognize the desirability of encouraging employers to provide life insurance protection for employees.[176]

It would not be realistic to assume the elimination of these dispensations, although a reduction in the amount excludable would be a possibility. A difficulty in this area is that life insurance contracts represent a form of savings, and therefore it would appear that the return in excess of investment for death benefits not in excess of $5,000 is too much like life insurance, to argue for its inclusion. A difficulty with this argument, of course, is the $5,000 limitation. If the justification is to equate employee death benefits with life insurance treatment under the Code, then there is no reason for the limitation.

This seems to be one more case where the unexplained ex-

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169. *Hearings Before the Committee on Ways and Means on the Tax Recommendations of the President,* 88th Cong., 1st Sess., pt. 1, at 20 (1963).
170. H.R. REP. No. 749, 88th Cong., 1st Sess. 39 (1963).
171. S. REP. No. 830, 88th Cong., 2d Sess. 45 (1964).
172. H.R. REP. No. 1149, 88th Cong., 2d Sess. 21 (1964), *adding* §§ 79 (a), (b), (c), 6052; *amending,* INT. REV. CODE OF 1954, §§ 3401(a)(14), 6678, 7701(a)(20).
173. Law Opinion 1014, 2 CUM. BULL. 88 (1920).
174. For more elaborate history and discussion, see Walker, *Group Life Insurance,* N.Y.U. 23D ANN. INST. ON FED. TAX 153 (1965). The extension of this benefit to permanent group-term is made by Clark and Lee, *supra* note 168.
175. *See Hearings, supra* note 169, at 108.
176. *See* S. REP. No. 830, 88th Cong., 2d Sess. 46 (1964); H.R. REP. No. 749, 88th Cong., 1st Sess. 40 (1963).

> clusion for formal insurance has spawned another exemption because of a subsequently determined discrimination in the tax treatment of similar types of payments.[177]

As to exclusion from gross income of the value of group-term life insurance of employees, removal of this preference requires reconcilement of conflicting policy consideratons. First, the taxing committees do recognize that such amounts are compensation to the employee.[178] The Committee on Ways and Means pointed out that the exclusion was inconsistent with tax treatment of other types of life insurance protection furnished by employers to employees.

> While this complete exclusion might have been considered relatively insignificant when tax rates were low, the present relatively high rates as well as the growing volume of group-term life insurance now provided makes it particularly inequitable to continue this complete exclusion.[179]

On the other hand, exclusion of premiums paid up to a certain amount are desirable because provision "of such a basic amount of insurance does much to keep together family units where the principal breadwinner dies prematurely."[180] The conflict that arises between these two considerations is first the recognition of loss of revenue from the exclusion of what is clearly compensation, and second, the felt need to encourage employers to provide life insurance protection for employees in amounts that will increase in years to come from the standpoint of what is sufficient to keep the family together after the breadwinner is gone. It is most doubtful that this preference will ever be eliminated. In fact if the line can be held at $50,000 it should be considered a victory for the ability to pay advocates.

2. *Sick Pay* (19)

It was proposed in 1964 that the exclusion from income of benefits received under wage continuation plans be repealed. This proposal was rejected by the House Ways and Means Committee.[181] However, the committee did limit the exclusion by denying any deduction for benefits received during the first thirty days of illness. An amendment by the Senate then restored the present rules for

177. Wentz, *supra* note 164, at 338-39.
178. H.R. REP. No. 749, 88th Cong., 1st Sess. 40 (1963); S. REP. No. 830, 88th Cong., 2d Sess. 46 (1964).
179. H.R. REP. No. 749, *supra* note 178, at 39-40.
180. *Id.* at 40.
181. *Id.* at 44.

cases where payments are below seventy-five per cent of regular weekly wages.[182]

Advocates of a comprehensive tax base would seek to include in gross income not only sick pay, but also workmen's compensation and military disability benefits. However, a truly comprehensive base must go further. Existing law also excludes amounts received as damages for personal injuries and for payments under accident and health policies.[183] One concludes that there is a distinction between loss of capital and loss of earnings. Compensation for medical expenses, suffering and loss of limb, are in the nature of capital recovery, whereas, continued payment of an employee's wages under a wage continuation plan is a replacement of earnings. At the same time reduced earning power caused by aging and daily labor does not allow one a depletion allowance. No recognition is made of the fact that earning power is in itself a form of capital, and one that is exhausted by illness.

Unfortunately, neither Congress nor the courts had such subtle distinctions in mind:

> During one period of 15 years, an employee could have received the following treatment with regard to payments made under a plan which was unchanged during the whole time and without any pertinent change in the applicable law. From 1943 to 1950, he would have been taxed. From 1950 to 1952, payments could have been excludable without argument. From 1952 to 1957, the Internal Revenue Service would have claimed a tax which probably could have been recovered in court. In 1957 . . . the exemption was established.[184]

Aside from the obvious inequity created by a tax preference as uncertain as this one, the additional problem of giving equal treatment to two employees—one who finances his own plan for illness, the other employer-financed—creates greater difficulty. One writer suggests that equity could be achieved by allowing a deduction for all persons who pay for a wage-continuation plan, whether employer or employee, and then the benefits from such a plan.[185] The employee under this approach could exclude the employer premiums from his income as he presently does, but in addition an individual who provides for himself out of tax-paid dollars for premiums could take a deduction. They would then both be

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182. S. REP. No. 830, *supra* note 178, at 49.
183. INT. REV. CODE OF 1954, §§ 104, 105. *See* Bittker, *supra* note 167, at 939.
184. Wentz, *supra* note 164, at 331. The exclusion came into effect in 1954, so 1957 is the last year after the running of the statute of limitations for a claim for refund.
185. White, *Consistent Treatment of Items Excluded and Omitted From the Individual Tax Base*, TAX REV. COMP., *supra* note 85, at 320.

taxed on sick-pay benefits, to the extent they are a substitute for wages.

A factor in favor of this argument is the recognition that amounts paid to a person in lieu of wages or salary can hardly be excluded within our concept of gross income. There is no doubt that they represent earnings even if they are paid under a "wage-continuation plan." The combination of this factor with the element of unfairness that results from giving tax advantage to one with a minor injury (hospitalized and must stay at home) over another who is more seriously impaired but who can stay on the job, makes the random discrimination of section 105(d) obvious.

The only possible justification for excluding payments in lieu of wages, because of sickness, is on the grounds that the illness has permanently reduced earning power: a capital impairment that the taxpayer should be allowed at least to amortize over the remaining life of his earning powers. This may strike the reader as being administratively impracticable and the author must agree. It would appear to be an area where the wage earner is in a position to bear the risk of illness, and loss of earnings, through loss-of-profits insurance, if not provided by his employer. The plan suggested above (allowing a deduction for such premiums and an inclusion of benefits) seems most sensible.

As to the prospects for further confinement of this preference, one must look at the policy justifications expressed by the taxing committees. In connection with the Revenue Act of 1964 both the House[186] and the Senate[187] recognized that the exclusion at that time of $100 per week (in the event of seven days of absence or one day hospitalization as to the first week) was not justified in that amounts received by employees were substitutes for wages or salaries which would otherwise be fully taxable. Such payments are unrelated to the costs of injury or sickness, and the hardship is already allowed for by the exclusion of deduction of medical expenses.[188] Furthermore, the exclusion in its present form (1963) "tends to encourage malingering because it treats the employee who stays at home better than another employee. . . ."[189]

Yet, after the 1964 Act, a substantial dispensation remained in the Code. The Committee's reasons for this was to provide for permanently disabled employees or for those who have had a long, continuing illness. In this case there is a true impairment of earn-

186. H.R. REP. No. 749, *supra* note 178, at 44.
187. S. REP. No. 830, *supra* note 178, at 49.
188. INT. REV. CODE OF 1954, §§ 105(b) excluding amounts paid by employer for medical expenses of employee, and 213 allowing deduction in excess of fixed percentage.
189. H.R. REP. No. 749, *supra* note 178, at 44.

ings, plus large medical bills, will family financial requirements continuing at the usual level.

As such we see that the present sick-pay exclusion is an attempt by Congress to deal with the problem of impaired earnings. Perhaps the dollar restrictions and he waiting period required by section 105 do not realistically measure chronic illness, or permanently impaired earnings, but one must admit that the changes in 1964 were a step in the right direction, and possibly more sensitive to the notion of "capital impairment" than the suggestion that all premiums be deductible. The best that can be hoped for in this area is further tightening of requirements toward the more severe hardship cases.

3. *Interest on State and Local Bonds* (41)

Abolition of the exclusion of interest on state and local bonds has been of constant concern. Elimination of this preference was sought in 1922, 1938, 1940, 1942, 1951, 1954 and 1959.[190] In addition the tax reform effort of 1969 considered three aspects of this issue: limitation on deductions; minimum tax; and an optional subsidy.[191] No action was taken on these proposals.

This immunity traces back to the Tariff Act of 1913,[192] wherein concern was expressed with the injection of a constitutional question into the bill for the sake of only a few thousand dollars in taxes.[193] The issue of the constitutionality of the removal of the exclusion would no longer appear to be debatable,[194] and one author concludes that the Supreme Court could treat the immunity as required by the sixteenth amendment only on the ground of concern over the severity of the economic burdens on state and local government.[195]

In addition to causing severe loss of revenues,[196] this represents a preference for the high bracket taxpayer. The classical example is that of Mrs. Horace Dodge who put an inherited fifty-six million dollars all into state and municipal bonds producing income of $1,680,000 per year. She did not even have to file an income tax return.[197] If we were to deal with this subsidy to the states today,

190. *See* Maxwell, *Exclusion from Income of Interest on State and Local Government Obligations*, TAX REV. COMP., *supra* note 85, at 701-703.

191. For a very comprehensive discussion of this area and the 1969 treatment, see Note, *The Taxability of State and Local Bond Interest by the Federal Government*, 38 U. CINC. L. REV. 703 (1969).

192. Act of Oct. 3, 1913, 38 166, 38 Stat. 168.

193. Department of Justice, TAXATION OF GOVERNMENT BONDHOLDERS AND EMPLOYEES 192 (1939).

194. *See* Surrey, *The Federal Income Tax Base for Individuals*, TAX REV. COMP., *supra* note 85, at 3.

195. Note, *supra* note 191, at 708.

196. Since we are talking about an exclusion that is not reported even informationally one can only guess at the loss of revenue. Dr. Pechman estimated that for the year 1956 $500 million was excluded. Pechman, *Erosion of he Individual Income Tax*, 10 NAT'L. TAX J. 1, 17 (1957).

197. *See* P. STERN, THE GREAT TREASURY RAID 190-91 (1964).

explicitly, it is doubtful that the appropriation would be designed to benefit the higher-bracket taxpayers.[198]

Whatever the merits are for removing this preference item, one must realistically conclude that it will be the most difficult to eliminate. Aside from the constitutional argument, however weak, the present federal course of revenue sharing appears to affirm the notion of reciprocal immunity, which is at the heart of the historical argument.[199] This is in addition to the fact that the provison may be too deeply embedded for removal without serious financial problems for the state and local governments dependent upon this subsidy.[200]

Although the public has been alarmed by the showings that the rich benefit from investing in municipal bonds, the benefit to the municipality should not be overlooked. Replacement of this subsidy by explicit appropriation or revenue sharing would substitute additional federal administrators and the other costs of bureaucracy for what is presently an "automatic" subsidy based on state needs and voter demands for state and local functions. One may be bothered by the fact that Mrs. Dodge earned $1,680,000 a year and did not have to file a tax return, but at the same time it must be realized that the investment of fifty-six million dollars in taxable activities would yield an even greater after-tax return. The rate on state and local bonds, as a result of the exclusion, is determined by the market to be as low as possible. If all investors were in the same tax bracket, the rate would be set at a level high enough to attract investment, but low enough to yield minimum tax savings relative to taxable investments. The rate of return is higher than this percentage which would adjust to tax savings because there are not that many wealthy investors, and therefore the interest yield must be set to attract the middle-income group. As such, the tax savings of the wealthy on municipals is only the amount of the differential between the yield they receive based on the need for middle income investors, and the yield they would have received with adjustment for the tax savings. In this light it is difficult to justify the removal of the subsidy.

4. *The* $100 *Dividend Exclusion* (5)

In 1954 Congress adopted an exclusion of fifty dollars of dividend income for individuals ($100 maximum for joint earnings of husband

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198. *See* Surrey, *supra* note 194, at 3.

199. *See* McGee, *Exemption of Interest on State and Municipal Bonds*, TAX REV. COMP. *supra* note 85, at 769.

200. *See* Severson, *An Evaluation of the Effect of the Removal of Tax Exemption of State and Local Bonds*, TAX REV. COMP., *supra* note 85, at 779.

and wife), and also a credit of four per cent against tax for any dividend income remaining after the exclusion. These relief measures were provided to reduce the effects of double taxation, since profits already taxed to a corporation were taxed again to individual shareholders, and also to encourage equity investments in corporations.[201] In 1964 the dividend credit was repealed, but instead of eliminating the exclusion, as recommended by the Treasury, it was increased to $100 ($200 maximum for joint earnings of husband and wife).[202] Justification for repeal of the credit was that corporate rates were reduced by four per cent under the 1964 Act, which would alleviate the problem of double tax, and that the history since 1954 had not shown an increase in the ratio of equity to debt financing.[203]

The increase in the amount of the exclusion, however, was designed to deal with the issue of double taxation while at the same time encouraging a broader stock ownership among those with relatively low incomes.[204]

Based on individual statistics for 1970, the amount of dividends excluded in that year were $922,714,000, involving over 8 million returns. As a result of the exclusion, over 3 million of these returns escaped any taxation of dividends.[205] These statistics indicate that the beneficiaries of this preference include all levels of adjusted gross income. Taxpayers in the $15,000 to $25,000 range are the most numerous (as to returns with dividend income) and therefore account for over one-fourth of all dividends excluded.

To what extent does the present exclusion deal with the problem of double taxation of dividend income? As to the first $100 it eliminates all difficulty. Beyond this amount the investor is fully taxed on an item already taxed at the corporate level.[206]

To what extent is one affected as to equity investment by the exclusion? Obviously, taxpayers who receive dividends in excess of $100 are no longer influenced by this tax consideration. Whether it serves as an inducement for the modest saver to enter the market cannot be determined but it is a possible factor.

To the extent that the exclusion does not serve these objections it should be repealed. The statistics of income indicate who would be most affected by the repeal, and the issue for Congress may

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201. *See* H.R. REP. No. 749, 88th Cong., 1st Sess. 32 (1963).
202. *Id.* S. REP. No. 830, 88th Cong., 2d Sess. 36 (1964). The Act *amended* INT. REV. CODE OF 1954, §§ 34(a),(b)(2), 35(b)(1), 37(a), 46(a)(3), 116(a), (c)(3), 584(c)(2), 642(a)(3)(i), 702(a)(5), 854(a),(b)(1),(2), 857(c), 1375(b), 6014(a).
202. H.R. REP. No. 749, 88th Cong., 1st Sess. 32 (1963.
204. *Id.* at 33.
205. Internal Revenue Service, Preliminary Report, *Statistics of Income*—1970, Individual Tax Returns, table 5, Wash., D.C., 1972.
206. For an in depth analysis on the issue of double taxation, see TAX. REV. COMP., *supra* note 85, at 1537-1610.

be merely whether or not lower and middle income groups should be encouraged toward equity investments. If such is the case then the installation of a credit device rather than the exclusion seems to be the better approach. Although the Treasury argued in 1963 that the 4 per cent credit against taxes had the effect of reducing any double taxation by a much higher percentage for the higher income bracket stockholders than for the lower bracket,[207] this concern was with the unlimited application of a fixed percentage to all dividends in excess of the excluded amount. Under the present exclusion approach, however, a seventy per cent bracket taxpayer saves $70 on his $100, whereas in the twenty per cent bracket the savings is only $20. In view of the large investments of a top bracket taxpayer $70 is not a significant amount, but as to the first $100 the higher the bracket the greater the benefit. On the other hand if an investor were allowed a credit against his tax of 20% up to the first $200 of dividends, the policy of encouraging investment by middle and lower income groups would be furthered and the effective rates would be more progressive.[208]

5. *Scholarships and Fellowships* (43)

Prior to 1954 a scholarship or fellowship was includable in gross income unless it could be established to be a gift. Congress in enacting section 117 was perhaps trying to eliminate the case-by-case approach to this problem, but did not succeed since the issue is essentially the same: is the payment in compensation for services or is it a gift?[209] The gift feature, and the long-standing recognition that gifts are not income, make this exclusion a special one. Repeal of section 117 could do no more than to place the problem under section 102, which excludes gifts and inheritances from gross income.

Aside from these obstacles there is substantial justification for the exclusion. The "compelling reasons" given by one attorney are as follows: revenue is not materially reduced because the recipient is young without other income (he pays on his wife's earnings during this period); he acquires increased earning power for future taxes (unless he becomes a professor); the law provides safeguards for compensatory arrangements, in that only purely educational payments are excluded; higher education, important to the nation, is encouraged; and colleges are benefited in that donors realize that a contribution for scholarships is not diminished by taxes on

207. 10.4 percent in the highest income bracket, and only 4.3 percent for those subject to the first bracket rate. H.R. REP. No. 749, *supra* note 201, at 33.

208. *See* Smith, *Tax Treatment of Dividends*, TAX REV. COMP., *supra* note 85, at 1547-48.

209. *See* Wentz, *An Appraisal of Individual Income Tax Exclusions*, TAX REV. COMP., *supra* note 85, at 333-34.

the recipient.[210] In the words of another author "There is no need to tax those who may add substantially to our ability to survive."[211]

Objections to the exclusion are based on the fact that the benefit is without regard to the financial need of the recipient, and as in the case of other exclusions it encourages litigation. In the words of Dean Wolfman:

> If all such grants were based solely on the recipient's financial need, and if he had no other income of any significance, exemption of the award would be a sensible, efficient way to provide a measure of federal aid to education. . . . [But] [t]he unevenness of the benefit which fellowship exclusion provides, the litigation which it fosters, and the waste and inequity involved when the recipient does not need the support, all suggest that the exclusion be restricted.[212]

He would confine this preference to candidates working toward their degree where the award is made on the basis of need; other awards being provided by subsidy or loan through direct federal aid. This approach would necessitate limiting the concept of excludable gifts within the present framework, which could be accomplished through the modification of section 119.

Although there is merit in limiting a preference to those most needy, it is difficult to define need in this context. The beneficiaries of this preference would normally fall within the age range of 17 to 25, none of whom could normally afford to attend school without working unless they received support from their family. Need then is defined as parental resource, whereas, within this age range there is a strong need to be financially independent. Furthermore, the beneficiary of this subsidy is really the institution granting the fellowship. As a result of the tax savings, the individual can "afford" this activity versus working for compensation at a higher rate. Repeal of the exclusion would force the institution and its donors to increase scholarship and fellowship support without regard, in many cases, to the need of the recipient.

When the policy justifications for this exclusion, not unlike those advanced for the deduction of contributions for education, are totaled, and combined with the embedded notion that the donee of a gift should not be taxed, it would appear that this preference item should be continued.

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210. Ponder, *Individual Income Tax Exclusions*, TAX REV. COMP., *supra* note 85, at 341-44.
211. Strayer, *Individual Income Tax Exclusions*, TAX REV. COMP., *supra* note 85, at 351.
212. Wolfman, *Federal Tax Policy and the Support of Science*, 114 U. PA. L. REV. 171, 186 (1965).

6. *Rental Value of Parsonages* (42)

In the case of a minister of the gospel, gross income does not include the rental value of a home furnished him, or the rental allowance paid him for use in renting or providing a home.[213] This exclusion traces back to the Code of 1921.[214]

The granting of a preference in this area is consistent with the general practice at all levels to exempt from tax, or to give some tax relief to, religious, charitable, and educational institutions.[215] To the extent that such practices and institutions contribute to our well-being, subsidization is desirable. Whether the subsidy should take the form of a preference under the income tax, however, is a separate question. On this issue the tests of Dean Wolfman can be directly applied. Church support should be free of the governmental interference that must be present in a system of direct appropriations.

> If federally allocated funds are to aid religion at all the exemption of church income and the charitable deduction are much less likely to interfere with free religious exercise or tend toward an 'establishment' than is the federal appropriation.[216]

Of course the question here is not the allowance of the charitable contribution to churches, but rather the provision of an indirect subsidy to supplement the salary of ministers of the gospel.

On this narrow question of the rental value of a parsonage, we must recognize that there are other professions inadequately compensated. Is it fair to treat a minister more favorably under the tax law than an elementary school teacher, for example? Ignoring the constitutional problem, would society be willing to make direct appropriations to ministers for purposes of housing? To the extent it would not, the preference may be challenged.

As in the case of the scholarship exclusion, which benefited the educational institution as well as the recipient, the exclusion of parsonage rental value allows a church to pay a lower salary, and therein the church and its congregation are benefited. Furthermore, contributions that would otherwise go toward higher salaries to ministers can be used for other worthy objectives.

Whether justified or not this exclusion appears here to stay.

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213. INT. REV. CODE OF 1954, § 107.

214. INT. REV. CODE OF 1954, § 213(b)(11). The enactment resulted from a Treasury Ruling, O.D. 862, CUM. BUL. 85 (921), which treated the item as income.

215. *See* Zipperstein, *Taxation of Clergymen,* 41 TAXES 219, 234 (1963), wherein the author considers tax treatment of other dispensations to the clergy as well.

216. Wolfman, *supra* note 212, at 184.

The amount of tax base erosion is slight, it has a long history, and the policy justification is strong. It is not likely that the taxing committees will raise the issue on their own accord, which again would suggest that the approach of Chairman Mills, to examine all preferences, has great merit.

7. *Gain on the Sale of a Residence by a Person over 65; Additional Personal Exemption for the Aged and Blind; and the Retirement Income Credit* (44, 38, 45)

In 1963 President Kennedy urged the repeal of section 151(b) which gives an added exemption for persons sixty-five or over, in addition to seeking the repeal of the complex retirement income credit under section 37.[217] The proposal would have substituted for these provisions a credit against tax of $300. This credit would not have exceeded tax liability, and would have reduced taxes payable by an amount equal to one-half of the taxpayer's marginal rate times non-taxable retirement benefits received. The proposal was opposed. A representative of retired policeman argued against elimination of the credit[218] and civil service employees urged that their annuities be added to the list of exclusions from income,[219] with the system otherwise remaining unchanged. It is unfortunate that this approach failed. It would have simplified income tax reporting for the elderly, and, by the substitution of a credit, would have been more in accord with the need of the taxpayer, in that dollar savings would not have been dependent on a bracket.

The retirement income credit can be traced to a Treasury Ruling which excluded social security payments from gross income in 1942.[220] This created an "inequity" against other retirement benefits, which led to the credit device in 1954.[221] In not reducing this dollar benefit (the amount of the credit) by dividends and interest, Congress sought to encourage persons to provide for their own retirement through investment.

On the other hand, the additional exemptions for persons over sixty-five[222] and for the blind[223] derive from a new concept of ability to pay; people in this group have a *reduced prospective* ability to pay.[224] This concept, of course, does not square with the notion of a

217. *Hearings, supra* note 169, at 16.
218. *Id.* at 977.
219. *Id.* at 986.
220. I.T. 3447, 1 CUM. BULL. 191 (1942).
221. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 74 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 7, 8 (1954).
222. INT. REV. CODE OF 1954, § 151(c).
223. INT. REV. CODE OF 1954, § 151(d).
224. *See* EISENSTEIN, *supra* note 25, at 43.

comprehensive tax base. As stressed by Professor Surrey in his comments on the Revenue Act of 1948:

> [a]nd again, it should be apparent that the income tax is not the vehicle for relief to special groups handicapped by physical ailments. . . . To prevent such distortions of the exemption provisions of the income tax, both the old-age and blindness exemptions should be eliminated. But such exemptions, once granted, are difficult to remove and, more likely, breed additional aberrations.[225]

This argument makes no allowance for reduced ability to pay. It suggests that the subsidy required by the aged and the blind be given explicitly rather than through the income tax base. This approach complies with the requirements set forth by Wolfman—such a subsidy through the tax base is not required from the standpoint of individual initiative, nor does it incur administrative difficulties. At the same time, the credit approach of Kennedy would have cost us little in terms of erosion, while at the same time providing a subsidy to those in need with a minimum of paperwork. Of course, such a preference would result, through the sheer force of equity, in relief for others similarly situated, but if it takes the form of highest advantage to those with lowest incomes, it would aid the cause of progression.

An additional benefit to the aged (again, not based on need) was provided by the House Ways and Means Committee under the Revenue Act of 1964. Under this provision a taxpayer who is 65 or over can exclude from gross income gain attributable to the first $20,000 of the sale price of his residence. The property must have been owned and used by the taxpayer for 5 of the 8 year period preceding the sale.[226]

Strangely enough this particular preference creates a problem through the interaction of sections 120 and 1034. The latter section excludes from recognizable taxable income gains on the sale of a residence where a new one is purchased within one year, and where the purchase price of the new exceeds the adjusted sales price of the old. The reason for the anomaly is that under section 121 the greater the profit from the sale, the greater the exclusion. And, under section 1034, the section 121 exclusion is subtracted from the adjusted sales price of the old house.[227]

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225. Surrey, *Federal Taxation of the Family—The Revenue Act of* 1948, 61 HARV. L. REV. 1097, 1103 (1948).

226. H.R. REP. No. 749, 88th Cong., 1st Sess. 45 (1963); S. REP. No. 830, 88th Cong., 2d Sess. 51 (1964). Amending INT. REV. CODE OF 1954, §§ 121, 122, 1033 (h), (k), 6012 (c).

227. *See* Fisher, *Regressive Taxation Under IRC Sections* 121 *and* 1034, 47 TAXES 537

This is an example of a provision that has not been completely thought through. The broader issue is whether the aged or the blind should be allowed special preferences through the tax base. Certainly, the present approach, not based on need, is a definite preference. Should we be as quick to challenge a dispensation based truly on need? For example, would not a credit against taxes limited to a percentage of $5,000 of income be a comfortable device to aid the retired and disabled on a simpler basis than direct appropriation.

Even under our present approach we must recognize that the prime beneficiaries are the lower income groups. Just as the exclusion of social security, railroad retirement, and veteran benefits most directly aids those with reduced ability to pay, so does the added exemption, the retirement income credit, and the special treatment on sale of residences. Consequently, even if the approach toward the elderly and the blind adopted by Congress is a rough one, it is reasonable to the extent it is attuned to need. And in reviewing these it would be more realistic to ask that the taxing committees adjust them based on need, rather than that they abolish them.

D. DEDUCTIONS

The need for Congressional re-examination of personal deductions has been suggested by many writers.[228] Surrey points out that the deduction for taxes entered the law in 1913 without any real consideration; that the basis for interest deductions (1913) rests in the thought that personal and business interest are too difficult to separate; that charitable deductions were installed in 1916 by a Senate Floor amendment designed to encourage philanthropy in light of the wartime tax rates; that casualty (1913) is traceable to the fire and shipwreck allowance in 1867, with "other casualty" and

(1959). The example he gives is as follows, involving two taxpayers aged 65 named Jones and Smith:

	Jones	Smith
Cost—old	$20,000	$30,000
Selling price	60,000	60,000
Gain	$40,000	$30,000
§ 121 exclusion	$13,333	$10,000
Purchase price of new	$35,000	$35,000
Adj. sales price—old	$46,667	$50,000
Rec. gain	$11,667	$15,000

228. *See* C. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX (1960); Pechman, *Erosion of the Individual Income Tax*, 10 NAT'L. TAX J. 6 (1957); TAX REV. COMP., *supra* note 85.

theft added in 1916; whereas, the medical deduction of 1942 and the child care provision in 1954 were given greater scrutiny by Congress.[229] Since 1954 the allowance for child care has been expanded considerably,[230] treatment of moving expense has been codified[231] and special provisions have been added to benefit political contributors.[232]

The difficulty Congress faces in repealing these deductions is illustrated by the Revenue Act of 1964. President Kennedy proposed that itemized deductions be limited to those in excess of five per cent of adjusted gross income.[233] This change would have produced a revenue gain of $2.3 billion annually, and would have simplified tax reporting for individuals by increasing the use of the minimum standard deduction.[234] This proposal was rejected by the House Ways and Means Committee.[235]

The opposition reasoned that a floor *under* itemized deductions was as dangerous as a limitation placed *on top*. Thus it was argued that the proposal would discourage charitable giving,[236] and homeownership.[237] An accountant saw in it a threat to our established American way of life,[238] and the representative for the United States Chamber of Commerce reasoned that it was

> a prime example of an arbitrary provision that ignores the taxpayer attributes and confidence . . . it penalizes the conscientious, public-spirited citizen and favors the selfish taxpayer who is entirely willing to take his standard deduction and contribute nothing to his community needs.[239]

In view of this history it is easy to argue that a change in these areas would upset basic patterns that have been established.[240] Most of the deductions have the sanction of history, becoming a sort of vested right within our system. In this area, therefore, one can look briefly at the policy reasons sustaining the preference, but cannot realistically predict their removal.

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229. Surrey, *The Federal Income Tax Base for Individuals*, TAX REV. COMP., *supra* note 85, at 9, 10.
230. INT. REV. CODE OF 1954, § 214.
231. INT. REV. CODE OF 1954, § 217.
232. INT. REV. CODE OF 1954, §§ 41, 642 (a) (3).
233. *Hearings Before the Committee on Ways and Means on the Tax Recommendations of the President*, 88th Cong., 1st Sess. 19 (1963).
234. *Id.* at 19, 104, 105.
235. *Id.* at 18, 104. The proposal was not reported out by the Committee.
236. *Id.* at 2533, 2551.
237. *Id.* at 1285.
238. *Id.* at 2533, 2551.
239. *Id.* at 2307.
240. Congressman Byrnes notes that:

> To me these deductions are almost as vital a part of the code as are the rates.
> I think that is why we have to be very careful. It is disturbing that we are going to upset these basic patterns that have been established.

Id. at 702.

1. *Charitable and Political Contributions* (48, 39)

Since contributions to charitable organizations are generally deductible, these organizations are financed largely at the expense of the Federal Treasury. The proportion of the federal contribution corresponding to tax revenues lost is based on the income tax brackets of the contributors.[241] Political contributions, on the other hand, which operate on the same principle, are a recent innovation to the Code.[242] This item can be readily understood by all taxpayers to be an item of preference, and one that substracts from tax revenues while subsidizing political campaigns. Since it is of recent innovation, it is not possible to measure the resultant revenue loss. As to contributions generally, however, the loss of revenue is measurable. In 1970 $12.92 billion dollars were claimed as itemized contributions.[243]

To what extent charitable giving patterns are influenced by the tax allowance is uncertain. Apart from the tax incentive, the wealthy taxpayer is influenced by social custom and pressure.[244] And, in spite of changes in rates and the installation of the minimum standard deduction in 1944, those who itemize give a constant average of four per cent of their income to charity.[245]

Yet, in spite of this stability in contributions, Congress in 1969 increased the limitation on charitable deductions from thirty to fifty per cent of adjusted gross income. The justification given, which will continue to be the policy guide in this area, is summed up as follows:

> In order to strengthen the incentive effect of the charitable contributions deduction for taxpayers generally . . . It is believed that the increase in the limitation will benefit taxpayers who donate substantial portions of their income to charity and for whom the incentive effect of the deduction is strong—primarily taxpayers in the middle-and-upper-income ranges.[246]

241. *See* Rea, *Changes in the Internal Revenue Code of* 1954 *Affecting Charitable Organizations*, 27 ROCKY MT. L. REV. 270 (1955). *See also* Baker, *The Tax Treatment of Charitable Contributions Under the Tax Reform Act of* 1969, TUL. TAX INST., 20TH ANN. 327 (1971); Morgan. *Charitable Contributions Under the Revenue Act of* 1964, 19 U. MIAMI L. REV. 283 (1964).

242. Act of Dec. 10, 1971, Pub. L. No. 92-178, 85 Stat. 560, provided three income tax devices designed to provide incentives for aiding the financing of political campaigns. First, an individual can designate that $1 of his income tax liability ($2 for marriage filing jointly) be put into an account for use of presidential candidates. Second, an itemized deduction of up to $50 ($100 jointly) is allowed. And, third, in lieu of the above, an income tax credit ($12.50 and $25.00) can be claimed to offset tax due on the return. INT. REV. CODE OF 1954, §§ 41, 642 (a) (3).

243. *Statistics of Income, supra* note 205, Table F.

244. The most elaborate analysis of tax incentives as to philanthropic contributions is made by C. KAHN, PERSONAL DEDUCTIONS IN THE INCOME TAX 46-91 (1960). For his conclusions as to rate progression and the cost of giving see pages 83-87.

245. Remarks of Stanley S. Surrey, then Asst. Sec. of the Treas. before the Justice Society, Feb. 28, 1963, *reprinted in* 109 CONG. REC. 3681, 3685 (daily ed. Mar. 11, 1963). *See also* C. KAHN, *supra* note 244, at 62.

246. H.R. REP. No. 91-413, 91st Cong., 1st Sess. 51 (1969).

Whether or not the deduction provides incentive for contribution, and ignoring the problem of favoritism to the wealthy contributor,[247] this is an area where some allocation of funds through the tax system is preferable to a system funded entirely by direct appropriation. Church support, mentioned above in connection with the exclusion of rental value of parsonages, is the obvious example given by Wolfman in that the contribution deduction is less likely to interfere with free religious exercise than a direct appropriation. As to colleges, universities, and foundations, stimulation by tax preference "provides a balance, not a perfect one, but one which yields security and direction on the expenditure side, while leaving room for flair, style and creativity on the other."[248]

2. *Taxes* (21)

The deductibility of state and local non-business taxes, currently including most property, sales, income and motor fuel taxes,[249] is justified as a coordinating device between state and federal taxes.[250] Although the allowance for state taxes tends to decrease progression, supporters of this deduction argue that it is a means of moderating inter-area tax differentials, and also that it is a device to induce states to place a greater reliance on an income tax. In addition it has the effect of transferring revenue from the federal to the state level.[251]

Historically, the reasoning behind the deduction was the idea that net income after taxes was the true measure of ability to pay. Hence, in the earliest income tax acts, even federal income taxes were deductible. This treatment was changed during World War I because of the belief that excessive tax rates would result.[252] Today, the preference provided for states taxes is rationalized on the basis of coordination. Without the deduction interstate competition might force a retreat from income taxation by states where the rates are high. And, as to the deductibility of property, sales, and motor taxes, there is the problem of discrimination against states without significant income taxes.[253]

This item is the largest among the itemized deductions. In

247. *See* Vickrey, *One Economist's View of Philanthropy,* in PHILANTHROPY AND PUBLIC POLICY 54 (1962).
248. Wolfman, *supra* note 212, at 184.
249. The Revenue Act of 1964 eliminated deductions for tobacco and alcohol taxes, driver's licenses, and other selective excises.
250. Kahn, *Personal Deductions in the Individual Income Tax,* TAX REV. COMP., *supra* note 85, at 939.
251. *See* Bridges, *Deductibility of State and Local Nonbusiness Taxes under the Federal Individual Income Tax,* 19 NAT'L. TAX J. 1 (1969).
252. C. KAHN, *supra* note 244, at 101.
253. *Id.* VICKREY, AGENDA FOR PROGRESSIVE TAXATION 95 (1945) would encourage such discrimination to promote the state's use of the income tax.

1970 over $32 billion was removed from the tax base by this preference.[254] It has been established that the increase in state and local tax revenue as a result of this deduction is considerably smaller than the resulting revenue loss, but at the same time it does have the effect of increasing the relative role of state income taxes, and decreasing that of the sales tax.[255]

Undoubtedly, removal of this preference would be unpopular from the standpoint of the public. It would be regarded as a tax upon a tax and confiscatory in nature. If states reduced the role of their regressive taxes: sales and property taxes, and increased the personal income tax, it could become confiscatory were it not for the deduction. However, it is apparent that this is not the case, in that states have not utilized the subsidy.

> We have thus the anamolous situation that in the process of trying to save progressive State rate schedules via deductibility they become in effect less progressive than they might be without deductibility.[256]

3. *Interest* (20)

In 1970 non-business interest deductions totaled $23.9 billion.[257] This deduction has been granted since the income tax began, and, as in the case of real property taxes, has the effect of encouraging home ownership.

The argument against the interest deduction is based on equity. The outright owner of a house or personal property is in a better position than is the renter. Up until 1963 Great Britain cured this inequity by imputing income to the outright owner based on net rental value of the owner occupied house.[258] Our approach of allowing an interest deduction to an individual who borrows money to purchase durable goods is designed to put him in the same position as the outright owner, who in effect borrows from himself. The result of the preference, however, is to leave the renter of durable goods in an unfavorable position. He has neither imputed income from ownership consumption, nor the interest deduction of the borrower-purchaser.

In spite of the inequity that may exist, repeal of this provision presents serious difficulties. The historical justification for the provision—that it is difficult to distinguish between personal and busi-

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254. *Statistics of Income*, *supra* note 205, Table F.
255. Bridges, *supra* note 251, at 15.
256. Kahn, *supra* note 250, at 400.
257. *Statistics of Income*, *supra* note 205, Table F.
258. With the Finance Act of 1963 Great Britain abandoned the practice of including the rental value of owner-occupied residences as taxable income.

ness interest—[259]is still significant. In spite of the introduction of the itemized deductions in 1944,[260] which required that business and personal interest be separated, the determination is not really crucial for those who itemize.[261] Nor is it significant for those without business income. However, in the case of a businessman, interest on a residential loan may qualify as a business deduction if the proceeds are used for the production of income and interest on a business loan may be disqualified because the proceeds are used predominantly for personal expenses.[262] Another difficulty would be in the case of an individual whose part-time business is investments. He has the option of withdrawing personal savings for business purposes, or of making a personal-business loan instead. It is doubtful that in these situations true equity could ever be achieved.

Furthermore, the incentive effect of the interest deduction for the mortgagor home-owner cannot be overlooked. This subsidy encourages home ownership over tenancy. Even though Congress has not dealt specifically with this aspect, it is clear that it is a major obstacle to change.[263]

4. *Medical Expenses* (49)

Presently, one may deduct medical expenses in excess of three per cent of adjusted gross income, medical expenses in excess of one per cent, and one-half the cost of medical insurance (not in excess of $150) with no maximum limitation on deductibility.[264]

The medical expense deduction was added in 1942. At that time five per cent of the taxpayer's income was excluded from his medical expense. In addition a ceiling on deductibility was enacted. The Revenue Act of 1954 reduced the percentage exclusion to its present form, and retained a limitation on total deduction. For taxpayers who had reached the age of 65 the percentage limitation was removed in 1951.[265]

In connection with the Revenue Act of 1964 it was proposed that the one per cent floor on drugs be eliminated and that a four per cent general floor take its place, and further, that the dollar limitation be removed. The House also attempted to tax recoveries from medical insurance which exceed expenses (required

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259. *See* Surrey, *supra* note 229, at 9.
260. *See* Kahn, *supra* note 250, at 109.
261. Of course interest deducted from gross income as a business expense reduces adjusted gross income and consequently increases the medical and charitable contribution deductions which are tied into adjusted gross income.
262. *See* Kahn, *supra* note 250, at 124.
263. *Id.*
264. INT. REV. CODE OF 1954, § 213. Medical deductions claimed for 1970 totaled $10.6 billion dollars. *Statistics of Income, supra* note 205, Table F.
265. Kahn, *supra* note 250, at 126-27.

only if a prior deduction had been taken), but this was deleted by the Senate Finance Committee. The only change that came out of the Act of 1964 was the elimination of the one per cent floor for taxpayers 65 or over.[266]

In 1965 special treatment for the elderly was removed,[267] as was the over-all limitation on the amount of the deduction.[268]

The purpose behind the medical deduction may be best understood by reference to the statement of Randolph E. Paul for the Treasury in 1942:

> A deduction should be allowed for extraordinary medical expenses that are in excess of a specified percentage of the family's net income. The amount allowed under such a deduction should, however, be limited to some specified maximum amount.[269]

If the purpose is relief of hardship, why was a ceiling placed on the deduction? On this point the Treasury reasoned as follows:

> We do not want to extend this deduction to families with chronic invalids who spend a great deal of money and perhaps enjoy their illnesses. In other words it seemed to us that $2,500 was a reasonable maximum limitation.[270]

The removal of this maximum limitation for years after 1966 came about through the elimination of the special provisons for the aged. The Senate Finance Committee refused to put the percentage limitations back in for the elderly[271] unless the maximum limitation on deductions was removed.[272] This was accepted by the Joint Conference with reservations as to definitional problems:

> Removing the ceiling . . . may increase the aggregate amount claimed for deductions [for installation of swimming pools, air conditioning and transportation expenses]. Therefore, the conferees . . . recognize the desirability of considering legislation dealing with the definition of allowable medical expense deductions.[273]

266. *Hearings, supra* note 169, at 19, 100; *House Report supra* note 226, at 56: *Senate Report, supra* note 226, at 156; *Conference Report, supra* note 172, at 22; *amending* INT. REV. CODE OF 1954, § 213(b).

267. Act of July 30, 1965, Pub. L. No. 89-97, §§ 106 (a), (b), 79 Stat. 336, *amending* INT. REV. CODE OF 1954, § 213(a),(b).

268. Act of July 30, 1965, Pub. L. No. 89-97, § 106 (d), 79 Stat. 337, *repealing* INT. REV. CODE OF 1954, § 213(c).

269. *Revenue Revision of* 1942, 77th Cong., 2d Sess. 1612 (1942).

270. *Id.* at 1613, 1623.

271. *See* S. REP. No. 904, 89th Cong., 1st Sess. (1965).

272. *See* Sierk, *The Medical-Expense Deduction—Past, Present and Future,* 17 MERCER L .REV. 381, 387 (1967).

273. 111 CONG. REC. 17540 (daily ed. July 26, 1965).

Unlike the other personal deductions, the medical expense one incurs is not regular in nature (unless chronic) nor is it voluntary. And, with the percentage limitations provided, the amount deducted must be substantial. In this respect it may be classified as a hardship dispensation. In fact the allowance may be viewed as a social health insurance scheme, in that in years of illness lower taxes provide benefits, and in years of health higher taxes provide premiums.[274]

As a result of this, a disparity arises between taxpayers who voluntarily insure against illness and those who do not. Since the deduction is limited to unreimbursed medical costs, the uninsured taxpayer is subsidized. However, this person would normally fall into the category of lower-income or aged and so any social benefits provided by the deduction would accrue to those with reduced ability to pay.

Reform in this area should proceed along the lines suggested by the Conference Report. Medical expenses should be defined by Congress to exclude the more elaborate expenditures which provide personal enjoyment to the family generally, such as swimming pools and air-conditioning.

5. *Casualty Losses* (47)

The deduction for loss of property by casualty has been in the Code since its inception. This is a somewhat unique deduction in that investment in non-income producing property if damaged or destroyed may be utilized to offset taxable income, without any allowance for exhaustion through wear and tear.[275]

As an itemized deduction it is closely aligned with the medical allowance in that both provisions contemplate a hardship situation. In addition, the losses claimed in both areas are normally beyond the control of the individual.[276]

Moreover, both areas raise the question of whether or not the risk should be assumed by the taxpayer, since insurance is readily available. In fact this is the strongest argument against the casualty loss deduction: the risk may be insured against.

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274. Kahn, *supra* note 250, at 136.

275. INT. REV. CODE OF 1954, § 165 (c) (3) provides for the deduction. Sections 167 (a) (1), (2) prevent a depreciation allowance for nonbusiness property. *See* Rabin, *Casualties and Disaster Loans are Deductible: The Do's and Don'ts*, U. SO. CAL. 16TH TAX INST. 463 (1964). The inconsistent treatment arises because of lack of imputation of income. The businessman writes off his depreciable business property as an exhaustion of capital. Sale or destruction of the asset then records gain or loss based on an asset adjusted for depreciation. A nonbusiness taxpayer is not charged with imputed income for the use of his asset, nor is he required to adjust his basis for exhaustion. On sale, of course, his loss is personal and non-deductible, but gain is taxable only to the extent it exceeds cost without allowance for the pleasure of consumption.

276. We are dealing of course with an itemized deduction in excess of $100 per casualty, and as such a provision that gives no relief to the lower-income taxpayer.

The answer to this is that there are victims of disasters where insurance is not available. The counter-argument that extreme casualties should be dealt with through direct federal appropriation rather than through the tax base is answered by the recognition that federal relief is available only in the case of area disasters and does not assist the individual loss through fire, flood, or shipwreck.

Richard Epstein[277] points out several inconsistencies in this provision. Although he would favor an expanded casualty treatment, the two major examples that he gives stress the need for insurance on the part of the taxpayer. First, in a contract setting, if a taxpayer negligently loses valuable personal property he would not be entitled to a casualty loss deduction, since losses through neglect are not contemplated by the provision. If he is uninsured he bears the loss. If he is insured, however, he is made whole without tax consequence, and the insurance company gets a deduction as a legitimate business expense. Hence, the shifting of the loss results in a deduction.

In a tort setting, involving sudden and unexpected injury to land, the deduction allows for another questionable result. Assume that A owns a house in a valley below B which is damaged through the run-off of water from B's property. If this is a deductible casualty loss, then either A is made whole through recovery from B or he has a deduction in excess of the $100 floor. But if A does recover from B the deduction disappears. B cannot claim the loss because it is attributable to a judgment and as such does not fall within the enumerated classes of casualty.

In this last example, of course, if B had insured against liability as an owner the loss would have been shifted to the insurance company, and a deduction would have resulted. It would seem that in both examples the injured party should assume the risk through insurance.

This is clearly an area where at least some tightening up should be considered. The $100 floor per item of casualty installed by the Revenue Act of 1964[278] did much to correct minor abuses and to eliminate small losses based on the argument of theft, but it is apparent that a hardship only arises where a costly catastrophe has occurred. In addition, the value of the deduction to the taxpayer increases with his tax bracket and is of no benefit to one in the lower brackets who takes the standard deduction. An alternative to outright repeal would be to use the medical deduction approach:

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277. Epstein, *The Consumption and Loss of Personal Property Under the Internal Revenue Code,* 23 STAN. L. REV. 454 (1971).

278. The House Ways and Means Committee rejected the proposed 4% floor, and substituted the $100 limitation. *Hearings, supra* note 169, at 19, 105; *Report, supra* note 226, at 51; *Senate Report, supra* 226, at 57.

allow the deduction for casualty losses only to the extent that they exceed a percentage of adjusted gross income.

6. *Moving Expenses* (51)

Prior to 1964, an employee, whether being transferred or going with a new employer, had a difficult time deducting his moving expenses.[279] On the other hand, if the employer paid the moving costs involved in transferring an employee, this was not considered compensatory, and hence not includable in income, while reimbursement of the expenses of a *new* employee was considered to be compensatory in character.[280]

The Revenue Act of 1964 added section 217 to the Code to cure these inequities. The House Ways and Means Committee reasoned that treatment at that time discriminated against both new employees and employees who are not reimbursed for moving expenses by their employers. Further, the Committee felt it was important to remove deterrents to the mobility of labor to aid in reducing local structural unemployment.[281] Thus, expenses of moving the employee, members of his household, and household goods became deductible without regard to employment status.[282]

The Tax Reform Act of 1969 then added three additional moving expense deductions: 1) pre-move house hunting trips; 2) temporary living expenses at the new job location; and 3) certain expenses incident to a sale, purchase, or lease of a residence. The reasons given for liberalizing the deduction were identical with those used in 1964: 1) to equate more fully the treatment of new employees with that of reimbursed old employees; and 2) to encourage the mobility of labor. "Moreover, in an important sense, these expenses may be viewed as a cost of earning income."[283]

This latter point emphasizes that this item is an employee business expense. In this respect it differs from an itemized deduction in that it is deducted from gross income as are other business expenses[284] and thus is available to the taxpayer who takes the standard deduction.

To the extent that these expenses can be equated with "costs of earning income" they should continue to be allowed as are other unreimbursed employee business expenses. This provides a strong

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279. Deductions were disallowed by two Revenue Rulings as being personal in nature. Rev. Rul. 54-429, 1954-2, CUM. BULL. 53; Rev. Rul. 55-140, 1955-1, CUM. BULL. 317. *See* Koons v. United States, 315 F.2d 542 (9th Cir. 1963).

280. *See* H.R. 8363, 88th Cong., 1st Sess. 58-59 (1963).

281. *Id.* at 59.

282. INT. REV. CODE OF 1954, § 217.

283. H.R. REP. 91-413, 91st Cong., 1st Sess. 75 (1969).

284. INT. REV. CODE OF 1954, § 162. Note also that § 82 requires inclusion of reimbursed moving expenses, to prevent a windfall to the taxpayer.

justification that is not present in the case of a personal deduction, which is based on other policy considerations. Furthermore, to the extent this dispensation aids in solving the problem of unemployment, it can be separately justified as a needed incentive device.

7. *Child Care* (50)

Section 214 of the Internal Revenue Code allows a deduction for certain household service and dependent care expenses. The deduction is available of the taxpayer maintains a household for a dependent under 15 or any dependent (including spouse) who is disabled. The dollar amount maximum is $400 per month, with a limitation on gross income on a scale starting at $18,000.[285]

The allowance of a deduction for child care entered the Code in 1954.[286] The deduction at that time was limited to $600 for children under twelve and further restricted the deduction on joint returns in excess of $4,500. In the 1964 Act, Congress raised the income limitation to $6,000 and increased the deduction to $900 on care of children under the age of thirteen.[287] These provisions reached their present form under the Revenue Act of 1971, which substantially liberalized the deduction. Dependent age was raised to include 14 year olds, the maximum deduction was increased to a possible $4,800, and the income limitation was increased to the extent that full benefit is available for gross incomes of $18,000 and some benefit available up to $27,600.[288]

The justifications for this preference are so strong that there is no real case for its removal.

First of all, it may be easily argued that child care is a business expense. For the housewife with a job, child care expenses are costs of earning income. This argument, however, was rejected in *Smith v. Commissioner.*[289] The Tax Court reasoned that the expenditure was personal in nature, and further, that a deduction could not be made for an expense that was a substitute for imputed nontaxable income, the value of a housewife's services.

In view of the extremely generous treatment now provided by section 214, it is doubtful that the argument of an ordinary and necessary business expense will ever be judicially re-examined.

285. INT. REV. CODE OF 1954, § 214. To the extent that income exceeds $18,000 the taxpayer loses 50 cents on the dollar, so that at $27,600 there is no deduction.

286. For a discussion of the provision at that time see U.S. CONG. & AD. NEWS 4055 (1954).

287. For jusifications see H.R. REP. 749, 88th Cong., 1st Sess. 57 (1963).

288. This sliding scale has been present since the inception of the provision. As to joint returns the 1954 limitation was $4,500, with a dollar for dollar loss in excess of that level.

289. Smith v. Commissioner, 40 B.T.A. 1038 (1939), *aff'd mem.*, 113 F.2d 114 (2d Cir. 1940).

As such, the dispensation will continue to be subject to congressional scrutiny and will continue as an itemized deduction rather than a deduction from adjusted gross income.

Congress has not equated the deduction with employee business expense. Rather this preference is thought of as a job development deduction:

> This job development deduction meets three major needs. First, it provides a substantial incentive for the employment of qualified individuals in household service. Accordingly, it can be expected to give large numbers of individuals who are now receiving public assistance the opportunity to perform socially desirable services in jobs which are vitally needed. At the same time, it will help to remove these individuals from the welfare rolls and reduce the cost of providing public assistance. Second, the new deduction relieves hardship. . . Third, the new deduction substantially liberalizes present law as it affects married couples. . . .[290]

But whatever the past justification may have been, this is an area which is currently sustained in the name of women's liberation. The reasoning, which is very persuasive, is as follows: American working wives are predominantly secondary family earners, since women earn less than their employed husbands, and since their working is often discretionary. And, in view of the fact that family income is aggregated, the Code furnishes a strong disincentive for potential or actual secondary family earners.[291]

Of course, the central issue is whether or not dependency care is an ordinary and necessary employee business expense. If one concludes that it is, then it should come "off the top" and be available to those who take the standard deduction. If one concludes that it is a personal expenditure, then the value of the incentive as a tool to encourage employment of household servants and to fill certain job shortages must be examined.

IV. CONCLUSION

In examining twenty-six of the income tax provisions isolated by Chairman Mills as preferences for individuals, this article has attempted to explore the history behind the provisions and to test them against the policy considerations suggested by Eisenstein, Bittker, and Wolfman.

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290. S. REP. No. 92-437, 92d Cong., 1st Sess. 14 (1971).

291. *See* Blumber, *Sexism in the Code: A Comparative Study of Income Tajation of Working Wives and Mothers,* 21 BUFF. L. REV. 49 (1971). *See also* Streuling, *The New Household Service Expense and Dependent Care Expense Deduction: Who Will Benefit,* 50 TAXES 589 (1972).

These considerations are: the politics of taxation; the approach to reform; and the issue of the suitability of the tax base as a vehicle for subsidy.

Since the decade of the seventies will see serious examination of preference items granted by the Code, it is hoped that this article will serve as a reference for those following and encouraging the cause of reform.