The President's Tax Proposals: A Major Step in the Right Direction

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INTRODUCTION

ON May 29, 1985, President Reagan sent Congress a tax program designed, in his words, to achieve "fairness, growth, and simplicity." The program's immediate precursor, a Treasury Department Report ordered by the President in his 1984 State of the Union address, had been released shortly after the 1984 national elections. Although the President's proposals and the Treasury Report differ in important details, both endorse the six principal criteria of sound federal income tax policy: simplicity and practicality, equality, fairness, neutrality, economic growth, and adequacy. The purpose of this Article is to evaluate the success of the President's proposals as they affect individual taxpayers in meeting the basic criteria of income tax policy. Part I presents

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1. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 29, 1985) [hereinafter cited as President's Proposals].


In the late 1970's, the Treasury Department published an earlier report on the Federal tax system requested by then Secretary of the Treasury William E. Simon. See Department of Treasury, Blueprints for Basic Tax Reform (Jan. 17, 1977) [hereinafter cited asBlueprints].


4. For example, the Treasury Report would ultimately limit the deduction for charitable contributions to the excess of the amount of the taxpayer's contributions over 2% of the taxpayer's adjusted gross income for the year. See 2 Treasury Report, supra note 2, at 69. The President's Proposals reject any restrictions on the deductibility of charitable contributions for taxpayers who itemize their personal deductions. See President's Proposals, supra note 1, Summary, at 4.

5. See generally President's Proposals, supra note 1, Summary, at 1; 1 Treasury Report, supra note 2, at 13-20.

6. This Article is not a complete survey of the President's proposals affecting individual taxpayers because to do a complete survey would require a book rather than an article. For example, proposed changes in the tax treatment of employee contributions to tax-deferred plans will not be discussed. See, e.g., President's Proposals, supra note 1, at 366-67 (proposed modifications of limits on employee contributions under I.R.C. § 401(k)). Nor will the effect on individual taxpayers of a number of business tax proposals be considered. See, e.g., President's Proposals, supra note 1, at 76-77 (proposed restrictions on deductions for business meals and entertainment under I.R.C. §§ 162(a), 274). Nevertheless, the proposals that are discussed in this Article are representative of the Administration's entire tax package and of its attitude towards federal income tax policy.

and analyzes the criteria underlying a rational federal tax policy. Parts II and III measure the President's proposals against those criteria and in the process compare the President's program with the Treasury Report.

I. THE CRITERIA OF FEDERAL TAX POLICY

A. Simplicity

An important feature of the federal income tax system is that it relies primarily on self-assessment by citizens of their tax liability. A self-assessment system of taxation may be justified on three grounds. First, self-assessment probably reduces the costs of raising revenue because taxpayers can gather the information necessary to determine accurately their tax liability at less cost than the government. Second, self-assessment encourages citizens in a democracy to participate directly in a fundamental obligation of citizenship. Third, the alternative to self-assessment, direct assessment by the government, may be excessively bureaucratic, intrusive, and inquisitorial.

To be effective, a system of self-assessment must be relatively simple and comprehensible to the average taxpayer. Otherwise, taxpayers may find it difficult or impossible to compute their tax liability correctly. In addition, the more complex the tax rules, the greater is the advantage that results from obtaining sophisticated legal or accounting advice in minimizing one's tax liability. The resultant discrepancies in the tax liabilities of similarly situated taxpayers create morale problems among taxpayers who are unable or unwilling to employ sophisticated tax dodges. A perception that the system is unfair may lead taxpayers to cheat on their returns, with a consequent loss in revenue and a further erosion of taxpayer confidence in the fairness of the system.

Simplicity also produces important economic benefits. A taxpayer engages in tax planning and compliance to position himself for a struggle with the government over externally fixed resources. What the taxpayer gains from the struggle, the rest of society loses. Consequently, resources are consumed without offsetting efficiency gains.

On the government side, practicality of administration is the "mirror image of simplicity for the taxpayer." Like the costs of compliance and planning, the government's expense in administering the law produces no efficiency gains: What the government gains from a successful audit or lawsuit, the taxpayer loses. Thus, the simpler and more practical the

9. See id.
10. See 1 Treasury Report, supra note 2, at 16-17; Yorio, supra note 8, at 49.
11. See Yorio, supra note 8, at 48.
tax system can be made, the lower the amount of resources wasted in planning, compliance and administration.

B. Equality

The criterion of equality demands that income be taxed at approximately the same rate for taxpayers with the same amount of income.\textsuperscript{15} Equality among taxpayers is an important principle of tax policy not only because similarly situated taxpayers ought to bear an equal burden of taxation, but also because a perception among taxpayers of unfair treatment may lead to the problems of disaffection and dishonesty that are ruinous to a self-assessment system.\textsuperscript{16}

Underlying the criterion of equality is an implicit assumption that income can be measured accurately for tax purposes.\textsuperscript{17} The most common approach to defining income,\textsuperscript{18} both in the literature\textsuperscript{19} and in government studies,\textsuperscript{20} is the ideal of a comprehensive tax base, under which all receipts, whether in kind or in cash, are taxed as income and no items of expenditure go untaxed through a deduction unless the exclusion of the receipt or the deduction of the expenditure is necessary to measure taxable income accurately.\textsuperscript{21} Provisions that allow taxpayers to exclude certain types of income or to deduct certain expenses solely to further non-

\begin{itemize}
  \item \textsuperscript{15} See Sneed, supra note 7, at 574.
  \item \textsuperscript{16} See supra text accompanying notes 10-11.
  \item \textsuperscript{17} See Sneed, supra note 7, at 574-80.
  \item \textsuperscript{18} In recent years, a body of literature has appeared advocating the adoption of a consumption, or cash-flow, tax, in lieu of an income tax, on grounds of fairness and efficiency. See, e.g., Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974) [hereinafter cited as Andrews I]. Other scholars have questioned the fairness and efficiency of a consumption-type tax. See, e.g., Gunn, The Case for an Income Tax, 46 U. Chi. L. Rev. 370 (1979); Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L.J. 1081 (1980) [hereinafter cited as Warren I]. Because the Treasury Report carefully considers and ultimately rejects conversion of the federal tax system into a consumption tax, see 1 Treasury Report, supra note 2, at 30-33, this Article will limit its scrutiny to methods of improving the existing tax on income.
  \item \textsuperscript{19} See, e.g., Bittker, A “Comprehensive Tax Base” as a Goal of Income Tax Reform, 80 Harv. L. Rev. 925 (1967); Pechman, Comprehensive Income Taxation: A Comment, 81 Harv. L. Rev. 63 (1967); Sneed, supra note 7, at 577-79.
  \item \textsuperscript{20} See, e.g., House Comm. on Ways and Means, Tax Revision Compendium of Papers on Broadening the Tax Base, 86th Cong., 1st Sess. 256-58 (Comm. Print 1959); 1 Treasury Report, supra note 2, at 25-26; Blueprints, supra note 2, at 3-9.
  \item \textsuperscript{21} The intellectual progenitor of the comprehensive tax base is Henry Simons’ now classic definition of income:

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


    Because Simons’s definition permits no distinctions among items of consumption or accumulation, it leads ineluctably to a comprehensive tax base ideal. See 1 Treasury Report, supra note 2, at 14.
\end{itemize}
tax policy objectives violate the criterion of equality.22

Left unanswered by the comprehensive tax base ideal is the problem of distinguishing between provisions justifiable on grounds intrinsic to the definition of income23 and provisions defensible primarily for reasons—such as social and economic goals—extraneous to the tax itself.24 Although many tax provisions are easily recognized as tax incentives that violate the equality criterion, other provisions may be justified both on definitional and incentive grounds.25 Under current law, for example, long-term capital gains generally receive favorable tax treatment in the form of a deduction for noncorporate taxpayers of 60% of the excess of long-term capital gains over short-term capital losses.26 This deduction is often justified as a means of encouraging investment, innovation, and risk.27 Defended on this ground, the deduction violates the criterion of equality. But the deduction may also be defended for reasons congruent with intrinsic tax policy.28 If, for example, a taxpayer's gain simply matches inflation over time, the taxpayer's ability to pay has not increased. Since the gain is not real, a strong case can be made for excluding it from income.29 Further, even if the gain represents real income, but the gain has accrued over a number of years, taxing the entire amount in the year of realization, as the Internal Revenue Code generally requires,30 may subject the taxpayer to a much higher effective tax rate in


25. See, e.g., id. at 331-43 (medical expense deduction). See infra notes 181-90 and accompanying text.


27. See, e.g., President's Proposals, supra note 1, Summary, at 6.

28. The arguments in the text justifying the capital gains deduction on intrinsic grounds of tax policy would be unpersuasive if two changes in the taxation of capital gains were introduced in the Internal Revenue Code. See infra notes 32-33. Thus, the arguments in the text for the capital gains deduction are in a sense bootstrap arguments that depend on Congress' unwillingness until now to enact theoretically sound reforms in the taxation of capital gains.

29. There is a counterbalancing factor, however, that may justify the taxation of even a gain caused by inflation. The taxpayer is not taxed on a capital gain until it is realized. See I.R.C. §§ 61(a)(3), 1001(a) (1982). In effect, the taxpayer is permitted to compound interest tax free during the period of deferral. See R. Posner, supra note 12, at 380. Allowing the taxpayer to defer tax on the gain as it accrues may offset, in a rough way, the unfairness caused by taxing an inflationary gain. See id. supra.


A taxpayer may, however, average a capital gain realized in one taxable year over the preceding three taxable years. See I.R.C. §§ 1301, 1302(c)(2) (1984). But these provisions are of limited utility because they do not permit averaging over the taxpayer's entire
a progressive tax system than if the gain had been spread out over the years in which it accrued. For these reasons, the capital gains deduction may be viewed not as an incentive to encourage certain activity, but rather as a method, admittedly crude, of measuring income to exclude inflationary gains from income and to alleviate the unfairness of bunching a realized gain in one taxable year.

Even if a tax provision is clearly designed to foster a nontax goal, it may not violate the criterion of equality if the investment favored by the provision produces a return no greater than the after-tax return on an otherwise comparable, fully-taxable investment. If, for example, the rate of interest on a taxable bond is 10\% and the rate of interest on a tax-exempt municipal bond of equivalent risk is 6\%, both bonds produce the same after tax return (6\%) for a taxpayer in the 40\% marginal tax bracket. For taxpayers in that bracket, therefore, the exclusion for interest on municipal bonds does not violate the equality criterion. Still, the exclusion is inequitable among taxpayers in the 50\% marginal tax bracket for whom tax-exempt municipal bonds produce a greater return (6\%) than the after tax return (5\%) on a fully taxable 10\% bond. Indeed, tax-sheltered investments are attractive to certain taxpayers precisely because their after tax return is greater than the after tax return on a comparable, fully taxable investment. To the extent of the spread in rates of after tax return, the equality criterion is violated.

If the opportunity to participate in tax-favored activities were available to all taxpayers on an equal basis, it would not be unfair to tax more heavily those taxpayers who elect, for whatever reason, not to pursue the favored activity. As a practical matter, however, opportunities for tax avoidance are not equally available to all taxpayers. Holders of capital are able to take advantage of the exclusion for interest on state and local holding period for the asset. Moreover, the Code contains other significant restrictions on income-averaging. See, e.g., id. § 1301 (only excess of taxpayer's income over 140\% of average base period income may be averaged for tax purposes).

1. See President's Proposals, supra note 1, at 171.

2. A more precise method of excluding inflationary gains from income would be indexing the basis of a capital asset to the rate of inflation. See President's Proposals, supra note 1, at 166-67. Beginning in 1991, the President's Proposals would allow a taxpayer to elect to index the bases of the taxpayer's capital assets sold during the taxable year in lieu of taking a deduction for capital gains. Id. at 169.

3. A more precise method of alleviating the unfairness of bunching would be taxing the gain as it accrues or allowing the taxpayer to average the gain for tax purposes over the taxable periods during which it accrued. See Andrews I, supra note 18, at 1132-33.


7. See id. at 275.
bonds and of the capital gains deduction; most wage earners are not.38 Members of powerful unions and corporate executives are able to bargain for certain nontaxable fringe benefits;39 many other taxpayers lack comparable leverage. Thus, only if the Internal Revenue Code miraculously spread its various beneficences proportionately among all taxpayers, an unlikely proposition, would the equality criterion be satisfied.

C. Fairness

Where the equality criterion insists that similarly situated taxpayers pay approximately equal amounts of tax, the fairness criterion establishes the proper pattern of effective tax rates across income classes.40 If Congress decides that those with high incomes should pay a greater percentage of their income in tax than those with low or intermediate levels of income, the appropriate tax policy response is to enact a progressive income tax. Conversely, if the existing level of progressivity and consequent redistribution are regarded as too great, steps must be taken to make the system less progressive.41

The level of progressivity of an income tax depends not just on the superficial rate structure, but also on the exclusions, exemptions, deductions, and credits that the tax system allows.42 If, for example, capital gains are afforded a partial deduction43 and if such gains are realized in proportionately greater amounts by upper income taxpayers, the effect of the capital gains deduction is to reduce the average level of progressivity of the tax.44 Conversely, if the deduction for personal exemptions is raised,45 the effect is to make the tax somewhat more progressive.46

Most Americans probably support some degree of progressivity in the income tax, at least to the extent that people with very low income should pay little or no income tax.47 Beyond that minimal concession,

40. Judge (then Professor) Sneed referred to the "fairness criterion" as the criterion of Reduced Economic Inequality, an appellation that assumes that some level of redistribution is appropriate in the federal income tax. See Sneed, supra note 7, at 581-86. Because this Article makes no assumptions about whether progression and consequent redistribution are desirable, the more neutral term, "fairness," is used.
41. Of course, the appropriate degree of progressivity of a particular tax depends on the level of progressivity desired in the tax system as a whole. Thus, the enactment of a progressive income tax has often been justified as an offset to the regressivity of other parts of the tax system. See, e.g., R. Posner, supra note 12, at 382-83; E. Seligman, The Income Tax 30-31 (1911); Blum & Kalven, The Uneasy Case For Progressive Taxation, 19 U. Chi. L. Rev. 417, 421 (1952).
42. See 1 Treasury Report, supra note 2, at 15; H. Simons, supra note 21, at 217-19.
44. See R. Goode, supra note 35, at 194-95.
46. See R. Goode, supra note 35, at 18.
47. See 1 Treasury Report, supra note 2, at 14; R. Goode, supra note 35, at 18.
however, opinions on the appropriate level of progressivity differ widely.\textsuperscript{48} Thus, the exact content of the fairness criterion will vary from individual to individual and from epoch to epoch. Moreover, it is at least plausible that the fairness criterion is satisfied by whatever tax system is in place in a democracy in the sense that the system presumably reflects, through the democratic process, the degree of progressivity that most citizens regard as appropriate.\textsuperscript{49} On the other hand, a plethora of arcane tax shelters tolerated by the tax law makes this contention somewhat dubious if the effect of the shelters on the actual degree of progressivity is not fully understood either by the citizenry or by its elected representatives.\textsuperscript{50}

D. Neutrality

The primary advantage of a free market economy is its tendency to allocate resources to their most productive uses. Businesses generally produce what consumers want in ways that are relatively efficient.\textsuperscript{51} Although any tax is bound to affect the allocation of resources in society—a tax on income, for example, will encourage the substitution of leisure for work\textsuperscript{52}—the neutrality criterion requires that the tax system interfere with private decisions about resource allocation as little as possi-

\textsuperscript{48} Compare H. Simons, supra note 21, at 18-19 (case for progression rests on ethical or aesthetic judgment that inequality is wrong) and Fagan, \textit{Recent and Contemporary Theories of Progressive Taxation}, 46 J. Pol. Econ. 457, 494-98 (1938) (progression justifiable on socio-political theories) with Blum & Kalven, \textit{supra} note 41, \textit{passim} (arguments for progressive taxation seriously flawed).

\textsuperscript{49} See Fagan, \textit{supra} note 48, at 494 (intersubjective agreement among citizens as to socio-political goals will determine the proper level of progressivity of an income tax).

\textsuperscript{50} See H. Simons, \textit{supra} note 21, at 218-19.


\textsuperscript{52} Indeed, a tax might be enacted in order to counteract a misallocation of resources caused by a market failure. Although the analysis in the text of the neutrality criterion assumes a competitive market, market imperfections exist in the real world. See R. Posner, \textit{supra} note 12, at 271; P. Samuelson, \textit{supra} note 51, at 47-48. Government often intervenes in various ways to correct these market failures. See A. Okun, \textit{supra} note 12, at 11-12; R. Posner, \textit{supra} note 12, at 271-86. A polluter, for example, imposes costs on neighboring landowners that would not normally be reflected as a cost by the polluter. To force the polluter to internalize the costs of this negative externality, a tax equal to the estimated costs caused by the pollutant might be imposed on the polluter. \textit{Id.} at 280. For a discussion of negative externalities, see \textit{id.} at 51-52.

\textsuperscript{53} See Sneed, \textit{supra} note 7, at 600.

Some scholars argue that an income tax discriminates against savings and in favor of consumption. See, e.g., Andrews I, \textit{supra} note 18, at 1123-28; Sneed, \textit{supra} note 7, at 590. If so, existing tax subsidies for investment, such as the capital gains deduction, may be defended as a method of making the tax system more neutral between savings and consumption. Andrews I, \textit{supra} note 18, at 1133-34. The view that an income tax discriminates against savings has been challenged, however. See R. Goode, \textit{supra} note 35, at 25-28; Gunn, \textit{supra} note 18, at 371-78. In any event, if the income tax were determined to be discriminatory against savings, the only solution effective to achieve neutrality would be to repeal the income tax and substitute a consumption tax in its place. See Andrews I, \textit{supra} note 18, at 1134-35. Piecemeal tinkering with an income tax by allowing a deduction or exclusion of certain forms of investment income is likely to result in a less neutral income tax. See \textit{id.} at 1128-40.
sible. In a sense, the neutrality criterion is the economic complement of the equality criterion: Where the equality criterion insists on equal tax treatment for reasons of morality, the neutrality criterion demands equal tax treatment for reasons of efficiency.

The neutrality criterion is implemented by three simple rules of tax design. First, all items of income should be taxed equally to prevent excessive resources from being devoted to activities producing income subject to lower taxes. Second, tax liability should not vary depending on how income is spent because preferential tax treatment of certain consumption may overstimulate demand, producing a loss in efficiency and an artificially high price. Third, all forms of doing business and all methods of business finance should be taxed nearly equally to prevent entrepreneurs from adopting, for tax reasons, otherwise inefficient forms of conducting business or of raising capital.

E. Economic Growth

The amount of revenue generated by a tax system will depend in part on the needs of the public sector and in part on society's view of the proper balance in the size of the public and private sectors. The criterion of economic growth insists, however, that rates of marginal taxation not be confiscatory. Otherwise, significant numbers of taxpayers may lose their incentive to work and to take entrepreneurial risks. Consequently, economic growth in the private sector may be lower than necessary to meet the needs of an increasing population and to improve the standard of living for the existing population.

54. See 1 Treasury Report, supra note 2, at 13; Sneed supra note 7, at 587. The discussion in the text must be qualified because it ignores possible moral objections to the distribution of resources in society resulting from a competitive market. See P. Samuelson, supra note 51, at 45-47; Sneed, supra note 7, at 588. See also A. Okun, supra note 12, at 22-23. Of course, the criterion of tax policy that is relevant to this objection is the fairness criterion discussed above. See supra text accompanying notes 40-46. If the distribution of resources in society is regarded as unfair, the most direct method of addressing that problem through the tax system would be to increase the overall progressivity of the tax rates.

55. See Sneed, supra note 7, at 589.

56. See B. Bittker, L. Stone & W. Klein, supra note 36, at 102-04; Sneed, supra note 7, at 587-88.

57. See 1 Treasury Report, supra note 2, at 13.


59. See P. Samuelson, supra note 51, at 163.

60. See H. Simons, supra note 21, at 21-24; Blum & Kalven, supra note 41, at 437-44. The precise effect of high marginal tax rates on the incentive to work, invest, and take risks is debatable, however. See id.

Although Professor Simons conceded that high progressive tax rates would affect the rate of economic growth, he nonetheless justified progressivity on distributional grounds. See H. Simons, supra note 21, at 25 ("something can be said for mitigation of inequality, even at the cost of reduction in the modal real income").

61. A possible solution for a dearth of private investment is budgetary provision for capital investment on the part of the government. See H. Simons, supra note 21, at 26-30.
In addition to affecting the overall level of economic growth in society, the income tax can also be used as a powerful mechanism for achieving specific economic or social objectives. If Congress decides, for example, that private charities perform desirable functions best not left to the public sector, charities may be supported directly by a tax exemption or indirectly by a tax deduction for charitable contributions. Or if the level of private investment in society is regarded as anemic, specific provisions, such as an accelerated depreciation deduction, may be added to the tax law to stimulate private investment. Unlike the criterion of economic growth, however, specific tax incentives are generally disapproved by tax policy scholars. Indeed, the enactment of tax incentives inevitably results in a system of taxation that is more complex, produces more inequality in tax liability among similarly situated taxpayers, requires higher rates of taxation on nonfavored income or consumption, and is more distortive of private economic decisions than a tax system shorn of specific economic or social incentives.

F. Adequacy

The final requisite of a sound tax system is that it provide revenues adequate to meet the needs of the public sector. Precisely how much revenue must be raised at any time to satisfy the adequacy criterion in this general sense will depend on factors such as society's view of the proper balance between the public and private sectors, external threats posed to the society, and society's judgment on the need or advisability of incurring debt or printing money rather than raising revenue as a means of financing government spending.

In its narrower sense, the adequacy criterion refers to the aggregate revenue effect of a particular provision in the tax law. If a proposed change in the Internal Revenue Code will result in a significant loss in revenues, the criterion is badly served. If the proposal will generate additional revenues, the criterion is satisfied.

63. See id. § 170 (West Supp. 1984).
64. See id. § 168 (West Supp. 1984).
66. See, e.g., Andrews II, supra note 24, at 309-11; Sneed, supra note 7, at 602; Surrey, supra note 23, at 734-38.
67. See 1 Treasury Report, supra note 2, at 3.
68. See id.
69. See 1 Treasury Report, supra note 2, at 4; Surrey, supra note 23, at 725-26.
70. See 1 Treasury Report, supra note 2, at 4; Surrey, supra note 23, at 725.
71. See Sneed, supra note 7, at 569-70.
72. See id. at 570.
73. See id. at 571.
G. Compatibility of the Criteria

In many cases, the various criteria of tax policy discussed above are entirely compatible. The elimination of an exclusion not required for the accurate measurement of income, for example, would simplify the tax system, make its administration more practicable, promote equality of tax treatment, allow lower tax rates to stimulate growth, and remove an existing distortion of private economic decisions.

Some tax issues, however, require a choice among competing policy goals. Under current law, for example, psychic and imputed income are not taxed. As a consequence, the tax system encourages some taxpayers to engage in activities that produce psychic income (leisure, for example) or imputed income (household services performed by the taxpayer, for example). Nontaxation of these forms of income creates economic distortions and leads to unequal tax treatment between taxpayers able to generate disproportionately large amounts of imputed income and other taxpayers. Ensuring the neutrality and equity of the tax system in this respect would require, however, that items of psychic or imputed income be discovered and valued for tax purposes. A proposed reform along those lines is almost certain to conflict with the important policy criterion of simplicity and practicability. Accordingly, it is sometimes necessary to strike a balance among the competing criteria of tax policy. How that balance is struck will depend to some extent on value judgments.

1. See 1 Treasury Report, supra note 2, at 18.
3. See id.
4. For a presentation of the conceptual and practical problems created by taxing psychic or imputed income, see H. Simons, supra note 21, at 51-53.
5. The economic distortions and inequality resulting from the failure to tax psychic and imputed income may be mitigated somewhat by indirect methods, however. Earned income may be taxed at a lower rate than unearned income in order to reduce the discrimination against those who have to forego the psychic income from leisure because of work. See E. Seligman, supra note 41, at 23-24; Andrews II, supra note 24, at 316 n.11. Allowing a credit for child-care expenses and a deduction for two-earner couples may reduce the discrimination against taxpayers who do not generate untaxed imputed income by performing household services within their homes. See I.R.C. § 21 (West Supp. 1984) (child-care credit); id. § 221 (two-earner deduction); R. Posner, supra note 12, at 374-75. The imputed income from owner-occupied housing may be indirectly and partially taxed by disallowing deductions for mortgage interest and real estate taxes on owner-occupied housing. Cf. id. at 375. See infra text accompanying notes 172-75. Even with mitigation provisions, however, distortions and inequality will remain unless psychic and imputed income are fully valued and taxed. If the Internal Revenue Code disallowed deductions for owner-occupied housing, for example, the taxpayer would still have untaxed imputed income to the extent that the rental value of the taxpayer’s home exceeded the costs of maintaining the home. Moreover, repeal of the deduction for mortgage interest would not affect the tax benefits of imputed income for taxpayers who are able to purchase a home outright. See infra note 175.
6. For an attempt at a rational ordering of the criteria for purposes of choosing among them, see Sneed, supra note 7, at 601-04.
II. THE PRESIDENT'S TAX PROPOSALS: ADEQUACY AND FAIRNESS

The basic thrust of the President's Tax Proposals is simple and straightforward. First, rates of taxation for individuals and corporations would be substantially reduced. Second, numerous exclusions, deductions and other tax preferences would be either restricted or eliminated. Taken together, the proposals, when fully effective, are intended to raise virtually the same amount of revenue as current law. The proposals are also designed to require each income class to contribute the same percentage of total revenues as is being contributed by that class under current law, with the exception of the poor, who will pay a much smaller percentage. If the President's proposals are in fact essentially revenue neutral and neutral among income classes, they would satisfy the adequacy and fairness criteria of federal income tax policy on the assumption that the amount of revenue currently raised by the income tax and the existing distribution of the tax burden are appropriate. Whether this assumption is correct depends, of course, on the advisability of raising the federal income tax to finance government spending and on the proper degree of progressivity in an income tax, issues that are exceedingly complex and beyond the scope of this Article.

Doubts have been expressed, however, about whether the proposals are indeed revenue neutral and neutral among income classes. Congressional leaders and at least one economist have contended, for example, that the proposals will result in a revenue shortfall because the Administration has not taken into account how taxpayers might alter their behavior in order to pay lower taxes. Others have argued that the proposals give very wealthy taxpayers a greater tax reduction than other taxpayers or that middle-income taxpayers, specifically two-earner couples, will receive a smaller tax cut than other individual taxpayers. Moreover, the proposals deliberately increase the level of progressivity between middle income and poor taxpayers by providing a somewhat

81. See President's Proposals, supra note 1, 1-4, 118-19.
82. See, e.g., id. at 30-31 (exclusion for employer-provided death benefits).
83. See, e.g., id. at 62-69 (deduction for state and local taxes).
84. See, e.g., id. at 160-63 (investment tax credit).
85. See id., Summary, at 7.
86. See id., Summary, at 8. Although the proposals would increase the tax burden for corporations, the Administration does not regard this as an important economic measure. See id. The Administration's position can be justified on the ground that corporate taxes are ultimately paid by individual shareholders, employees, or customers.
87. See supra text accompanying notes 71-72.
88. See supra text accompanying notes 40-50.
89. See N.Y. Times, June 6, 1985, at D5, col. 1 (remarks of Congressman D. Rostenkowski).
90. See id. (remarks of Professor R. Eisner).
91. See id. at D1, col. 4.
92. See N.Y. Times, June 10, 1985, at D1, col. 3 (remarks of Congressman B. Dorgan).
greater percentage reduction of tax for the latter.\textsuperscript{94}

These objections, even if valid, do not appear to be fatal to the President's program. To begin with, the greater percentage reduction for taxpayers below the poverty line results from a decision to exempt these taxpayers from the federal income tax\textsuperscript{95} by increasing the personal exemption,\textsuperscript{96} the zero bracket amount,\textsuperscript{97} and the earned income credit.\textsuperscript{98} These proposals can be justified on three grounds. First, they would simplify greatly the administration of the tax by removing numerous individuals from the tax rolls and by reducing the number of taxpayers who will itemize their personal deductions.\textsuperscript{99} Second, removing taxpayers below the poverty line from the tax rolls arguably makes the tax system more fair by exempting those taxpayers with the least ability to pay.\textsuperscript{100} Third, the exemption of poor taxpayers from income tax liability somewhat counteracts the extreme regressivity of the Social Security tax, the other major levy currently imposed by the federal government on the earnings of poor taxpayers.\textsuperscript{101}

The charge that the President's proposals would produce a revenue shortfall can be addressed, if it is correct, by revising the program somewhat to ensure revenue neutrality.\textsuperscript{102} Similarly, the excessive advantage that the very rich seem to derive from the proposals can virtually be eliminated by the simple expedient of retaining—rather than reducing—the current rate of taxation on realized long-term capital gains.\textsuperscript{103}

\begin{itemize}
  \item 94. See President's Proposals, supra note 1, Summary, at 5.
  \item 95. See id.
  \item 96. I.R.C. § 151 (1982).
  \item 97. Id. § 63(d) (1982).
  \item 98. Id. § 32 (West Supp. 1984).
  \item 99. See President's Proposals, supra note 1, at 6-7. The reduction in the number of taxpayers who would itemize their personal deductions results in part from the fact that only the amount of personal deductions in excess of the zero bracket amount may be deducted in arriving at taxable income. I.R.C. § 63(a), (c) (1982). See infra note 110.
  \item 100. Even opponents of income tax progression are willing to concede the need for exempting taxpayers who are below the minimum subsistence level. See Blum & Kalven, supra note 41, at 506-07.
  \item 101. Under current law, the Social Security tax is a flat tax of 7.05% on a worker's yearly earnings up to $39,600. See I.R.C. §§ 3111(a), (b), 3121(a)(1) (West Supp. 1984); 49 Fed. Reg. 43,775 (1984). Thus, a worker with income of $10,000 pays a tax of $705, an effective rate of 7.05%; a worker with income of $100,000 pays a tax of $2791.80 (7.05% × $39,600), an effective rate of only 2.7918%.
  \item 102. Determining the accuracy of the charge of a revenue shortfall is difficult because of the number of complex and substantial changes that will simultaneously occur if the President's program is enacted. See N.Y. Times, June 6, 1985, at D5, col. 5 (remarks of economist D. Straszheim). Some doubt has been expressed, in any event, about whether a revenue shortfall would be undesirable. See Wall St. J., July 17, 1985, at 28, cols. 1-2.
  \item 103. See Wall St. J., July 8, 1985, at 36, col. 4.
  \item 104. Under current law, the highest marginal tax rate is 50%. See I.R.C. § 1(a), (b), (c), (d) (1982). Noncorporate taxpayers are generally allowed to deduct 60% of long-term capital gains. See id. §§ 1202(a), 1222(11). Thus, the highest marginal tax rate on long-term capital gains is generally 20%. Under the President's proposals, the top marginal tax rate would be 35%. See President's Proposals, supra note 1, at 1. The capital gains deduction would be reduced from 60% to 50%, generally resulting in a top marginal tax
\end{itemize}
Lastly, the alleged bias against two-earner couples in the President's proposals can be alleviated by changing the tax treatment of child-care expenses\(^{104}\) or by providing some other tax relief for two-earner couples.\(^{105}\) With these or similar changes to which the Administration is reported to be receptive,\(^{106}\) the goals of revenue neutrality and neutrality among income classes will be met and the criteria of adequacy and fairness satisfied. How the President's proposals fare against the other criteria of federal income tax policy will be the subject of the remainder of this Article.\(^{107}\)

III. THE PRESIDENT'S PROPOSALS: THE OTHER CRITERIA

A. Simplicity and Practicality

Although the President's proposals complicate the tax system for certain individual taxpayers,\(^{108}\) the proposals generally serve the criterion of rate on long-term capital gains of 17.5%. See *id.* at 168. Thus, the effect of the President's proposals would generally be to reduce the highest tax rate on capital gains from 20% to 17.5%.

104. Current law allows taxpayers with incomes above $30,000 to take a credit of 20% against their tax due for a limited amount of household and dependent care expenses. See I.R.C. § 21(a) (West Supp. 1984). The President has proposed to convert the credit into a deduction. See President's Proposals, *supra* note 1, at 19-20. The tax savings from the deduction will depend on a taxpayer's top bracket. Because most taxpayers will be in the 15% bracket if the President's program is enacted, the tax relief which they receive for household and care expenses will decline from 20% to 15%. See N.Y. Times, June 25, 1985, at D8, cols. 1-2.

105. Current law generally allows families with two wage-earners to take a deduction of the wages of the lesser-earning spouse, up to a maximum deduction of $3000. See I.R.C. § 221(a) (1982). The President has proposed to repeal the deduction primarily because the effects of the so-called "marriage penalty" will be mitigated by the flatter tax schedules incorporated in his program. See President's Proposals, *supra* note 1, at 15-16. Moreover, a decision to retain the two-earner deduction would cost the government between $7 billion and $9 billion in taxes. See N.Y. Times, June 25, 1985, at D8, col. 2. Finally, a leading tax scholar has expressed doubts about whether a tax system could be devised that would be completely neutral among single persons, unmarried couples living together, and married couples. See Bittker, *Federal Income Taxation and the Family*, 27 Stan. L. Rev. 1389, 1416-43 (1975).


107. The effect of the President's proposals on economic growth will not be considered in the remainder of this Article primarily because the forecasts of economists about the effect of the tax plan on growth vary widely. Some economists predict a drop in real growth of the Gross National Product (GNP) because of the President's proposals to repeal or restrict various tax incentives. See B.N.A. Daily Tax Report, July 9, 1985, at LL-3 (comments of economist A. Sinai). Other economists predict that the President's program will produce a rise in the growth of the GNP because of lower tax rates and fewer economic distortions. See B.N.A. Daily Tax Report, June 11, 1985, at LL-4 (remarks of Chase Econometrics).

108. See *infra* text accompanying notes 129, 132.

The President has proposed to require certain firms to change from cash-basis accounting to accrual accounting for tax purposes. See President's Proposals, *supra* note 1, at 212-14. Because cash method accounting is simpler than accrual accounting, this proposal is likely to make tax compliance more difficult for affected taxpayers. See *id.* at 213;
simplicity and practicality extremely well. To begin with, the proposals will reduce both the number of taxpayers required to file tax returns and the number who will itemize their personal deductions. Consequently, the costs of taxpayer compliance and of government administration of the law will be lower. Equally important, the reduction in marginal tax rates is likely to limit the incentive of certain taxpayers to engage tax planners to minimize their tax liability. Tax planning will also be discouraged by the simultaneous elimination or reduction in the benefits flowing from participation in some important tax shelters. Reducing the incentive to plan and the benefits of planning will save transaction costs of planning, compliance, and administration generated under current law. Moreover, as certain taxpayers are weaned from tax avoidance, the perception of other taxpayers about the fairness of the system will improve.

The reduction in marginal tax rates also produces a spin-off benefit by facilitating the repeal of the complex income-averaging provisions of current law because the unfairness of taxing an abnormally high amount of income in one taxable year will be mitigated by a rate structure that peaks at 35%. Viewed from the standpoint of the adequacy criterion, however, rate reduction requires a trade-off, which, in the President’s proposals, takes the form of eliminating or restricting certain exclusions and deductions available to individual taxpayers under current law. The repeal or restriction of an exclusion or deduction usually makes the system simpler and more practical by reducing the number of taxpayers who itemize, by eliminating the need for taxpayers to keep records of the repealed or restricted tax item, or merely by reducing the number of entries that the taxpayer must make—and the government may audit—on the taxpayer’s return.


109. See supra text accompanying notes 95-99.
110. See supra note 99. The number of taxpayers who itemize will also decline because certain personal deductions will be repealed or restricted. See, e.g., President’s Proposals, supra note 1, at 62-69 (repeal of deduction for state and local taxes).
111. See Blum & Kalven, supra note 41, at 430-35; Yorio, supra note 8, at 50-51.
112. See infra text accompanying notes 280-88.
113. See Yorio, supra note 8, at 17-19, 49-51.
114. See President’s Proposals, supra note 1, at 137; Blum & Kalven, supra note 41, at 435.
116. See President’s Proposals, supra note 1, at 110-11; Blum & Kalven, supra note 41, at 433.
117. See, e.g., President’s Proposals, supra note 1, at 32 (proposed repeal of exclusion for employer-provided commuting services under § 124).
118. See, e.g., id. at 62-69 (proposed repeal of deduction for state and local taxes under § 164).
119. See supra note 110 and accompanying text.
120. See President’s Proposals, supra note 1, at 104-05.
121. See id. at 71.
Other, more subtle changes will also make the income tax simpler and more practical for individual taxpayers. Under current law, for example, numerous tax issues require an investigation of all the facts and circumstances surrounding a contested transaction to determine the taxpayer's tax liability. Income tax rules that require analysis of many facts are costly and inefficient. Recognizing this problem, the President's proposals repeal or modify several provisions of current law that employ a multifactor test to determine tax liability. The proposals would also simplify current law by replacing a host of different requirements for nondiscrimination in fringe benefit plans with a generally uniform nondiscrimination rule.

Two of the busiest areas of tax planning for individual taxpayers involve attempts either to shift income from one taxpayer to another or to convert ordinary income into capital gains. Regarding income-splitting, the President's proposals generally succeed in reducing the transaction costs of tax planning and administration by curtailing the tax advantages of certain income-splitting techniques and by reducing the need for complex antitax-avoidance rules. By contrast, requiring the unearned income of certain minor children and of certain trusts to be taxed at the parent's or grantor's marginal tax rate, as the Administration proposes, may increase the costs of compliance for certain taxpayers.

The major omission of the proposals with respect to simplicity and practicality lies in the President's decision to retain a partial deduction for realized long-term capital gains. Because the capital gains deduction may be the most complicating provision of the Code affecting individual taxpayers, it generates considerable transaction costs in planning.

122. See, e.g., Slappey Drive Indus. Park v. United States, 561 F.2d 572, 582 (5th Cir. 1977) (thirteen facts relevant to debt/equity issue); Gault v. Commissioner, 332 F.2d 94, 96 (2d Cir. 1964) (nine facts relevant to capital gain issue).
123. See Yorio, supra note 8, at 19-23, 44-45.
124. See, e.g., President's Proposals, supra note 1, at 47-48 (proposed repeal of exclusion for employee gifts under § 102); id. at 79-81 (proposed limitations on deduction for travel expenses under § 162).
126. See, e.g., Helvering v. Clifford, 309 U.S. 331, 332-33 (1940) (attempt to shift income to trust).
128. See President's Proposals, supra note 1, at 84-98. See infra text accompanying notes 241-46.
129. See President's Proposals, supra note 1, at 84-98. See infra text accompanying notes 241-46.
130. See President's Proposals, supra note 1, at 168 (proposed reduction from 60% to 50% for capital gains deduction under § 1202(a)). See infra text accompanying notes 265-71.
and administration. Thus, failure to repeal the deduction would be a major defeat for tax simplification. Moreover, the proposal to permit individual taxpayers, beginning in 1991, to elect to index for inflation the bases of capital assets sold in a particular taxable year (in lieu of the capital gains deduction) would both complicate the tax system and create additional opportunities for tax avoidance.

B. Equality and Neutrality

Since the criteria of equality and neutrality are complementary, the President's proposals will be measured against both criteria simultaneously as the proposals affect exclusions from gross income, personal deductions, income-splitting, capital gains, and tax-shelters.

1. Exclusions from Gross Income

Under the President's proposals, a number of items excluded from gross income under current law will be wholly or partially taxed. Some of the inclusions will make the tax system more equitable by taxing recipients of previously excluded income like taxpayers whose income does not benefit from the exclusion. Other inclusions will improve both the equity and neutrality of the tax system. The proposal to tax unemployment compensation and disability compensation payments, for example, will eliminate a tax advantage to single taxpayers under current law and will result ultimately in a truer reflection of produc-

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132. The amount of gain that a taxpayer must include in his income on the sale of an asset is the difference between the amount realized on the sale and his adjusted basis in the asset. I.R.C. § 1001(a) (West Supp. 1984). The adjusted basis of an asset is normally its cost with some relatively simple adjustments. I.R.C. §§ 1011-1012, 1016 (West Supp. 1984). Allowing or requiring a taxpayer to adjust the basis of capital assets for inflation would thus complicate the determination of the amount of gain that must be included as income for tax purposes.
133. Under the President's recommendation, a taxpayer beginning in 1991 may elect to index for inflation the bases of capital assets sold in a particular year. See President's Proposals, supra note 1, at 169. This election precludes the taxpayer from taking a capital gains deduction for that year. Id. The proposal would create opportunities for tax avoidance by allowing taxpayers to time their sales of capital assets in order to get the maximum tax advantage from either indexing bases or taking a capital gains deduction for the particular taxable year.
134. See supra text accompanying note 55.
135. See, e.g., President's Proposals, supra note 1, at 59 (proposed repeal of exclusion for prizes and awards under § 74).
136. See, e.g., id. See also id. at 57-58 (proposed restriction of scholarship exclusion under § 117).
137. See id. at 49-56 (proposed repeal of § 85).
138. See id. at 50. Because employment and disability payments are set at the same amount for all recipients, those recipients who would have paid the highest taxes on their lost earnings obtain the greatest relative tax benefit from the exclusion. See id. Single taxpayers with no other dependents tend to pay higher taxes than other taxpayers, and thus generally obtain the maximum tax advantage from the exclusion. See id.
tion costs in industries with high injury or layoff rates. 139

The Administration also proposes to tax the investment income earned by certain life insurance policies 140—often referred to as "inside build-up" 141—as it accrues. Current law provides important advantages to taxpayers who purchase non-term life insurance with inside build-up. 142 First, payment of tax on inside build-up is deferred until the policy is exchanged for its cash surrender value or dividends are paid to the policyholder. 143 Second, payment of tax on inside build-up is entirely forgiven if the beneficiaries of the policy receive the income upon the death of the taxpayer. 144 Third, taxpayers may borrow tax-free against the cash surrender value of the policy, in effect getting the use of the accrued investment income without paying an immediate tax. 145

Proponents of the exclusion for inside build-up argue that inside build-up is simply a type of unrealized capital appreciation because it can only be converted to the taxpayer's use by cashing the policy and thus losing the benefits of the life insurance element of the policy. 146 According to this view, inside build-up should continue to receive the tax benefits outlined above because unrealized capital appreciation in general will continue to receive comparable tax advantages. 147 Although the proponents of the exclusion are correct that inside build-up resembles unrealized capital appreciation in some respects, 148 inside build-up also resembles other items of income that are currently taxable. A taxpayer who purchases a taxable bond at a discount, for example, is taxable on the

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139. See id. at 51.
140. See id. at 254-57.
141. Id. at 254. Premiums paid on any life insurance policy (other than a term insurance policy) are invested by the insurance company between the time the funds are received by the company and the time they are paid out to beneficiaries. The amount of income earned on the premiums paid by a policyholder and invested by the company is often referred to as "inside build-up." See Wall St. J., June 17, 1985, at 1, col. 6.
144. See I.R.C. § 101(a) (1982).
145. Of course, the policyholder may have to pay interest on the amount borrowed, but the interest is likely to be deductible for income tax purposes. See I.R.C. § 163 (1982). Moreover, life insurance companies are now offering policies that allow policyholders to borrow against policies at low interest rates. See Wall St. J., June 17, 1985, at 12, col. 4.
147. Implicitly left untouched by the President's program are several tax advantages for unrealized capital appreciation. First, there is no tax on capital appreciation as it accrues. See I.R.C. §§ 61(a)(3), 1001(a) (1982); see also Eisner v. Macomber, 252 U.S. 189, 211 (1920). Second, tax on any unrealized gain is forgiven at death because property receives a step-up in basis at death. See I.R.C. § 1014(a) (1982) (basis of inherited property generally fair market value at decedent's death). Third, borrowing against the value of appreciated property, even on a nonrecourse basis, does not subject the owner to a tax on the accrued gain. See Woodsam Assocs. v. Commissioner, 198 F.2d 357, 358-59 (2d Cir. 1952).
148. See supra text accompanying note 146.
portion of the discount allocable to the taxable year even though the taxpayer can realize that discount only by selling the bond. 149 Thus, advocates of the exclusion for inside build-up have failed to explain why inside build-up should be treated like unrealized capital appreciation rather than like bond discount and other currently taxable income.

Moreover, the exemption for unrealized capital appreciation causes significant inequities and distortions. 150 Those inequities and distortions are tolerated only because of the impracticality of taxing appreciation as it accrues. 151 For that reason, the exemption for unrealized appreciation should be limited as narrowly as possible and not applied to situations, like inside build-up, where it is feasible to tax income as it accrues. Indeed, unless the exclusion for inside build-up is repealed, as the President has proposed, economic distortions will result from taxpayers’ allocating resources to the purchase of life insurance rather than competing investments, such as certificates of deposit or mutual fund shares, which are taxed as income accrues. 152

The Administration has made a number of recommendations that will reduce, but not eliminate, inequities and distortions caused by other exclusions available under current law. The exemption for interest on state and local obligations used to finance government spending or publicly owned and operated facilities will be preserved. 153 On the other hand, the proposal to repeal substantially the tax exemption for state and local bonds used to finance nongovernmental activities 154 will somewhat reduce the inequities of current law by indirectly lowering interest rates on tax-exempt bonds 155 and will remove a tax subsidy that favors certain nongovernmental persons and activities in the competition for capital. 156

The major defect in the President’s proposals regarding exclusions from gross income results from the failure to tax aggressively the plethora of fringe benefits that are exempt under current law. Because of differences in bargaining leverage among taxpayers, exemption of certain fringe benefits produces discrepancies in the tax liability of otherwise

150. See infra text accompanying notes 255-56, 258, 274.
151. See infra text accompanying note 262.
153. See I.R.C. § 103(a) (1982); President’s Proposals, supra note 1, at 283-88.
154. See id. (proposal substantially to restrict § 103).
155. See B.N.A. Daily Tax Report, June 26, 1985, at G-5 (remarks of Senate Budget Comm. Chairman P. Domenici and economist H. Galper). Since the proposals will eliminate the tax-exempt status of many types of currently exempt bonds, the supply of tax-exempt bonds is likely to decline. A drop in supply will probably result in higher prices and lower interest rates on those bonds that retain their tax-exempt status. As the interest rate on tax-exempt bonds declines, the spread between the yield on tax-exempt bonds and the after-tax yield on taxable bonds will narrow, and the inequities in the treatment of holders of tax-exempt bonds and taxable bonds will be reduced. See supra text accompanying notes 34-36.
similarly situated taxpayers.\textsuperscript{157} Moreover, economic distortions result when the exemption of a fringe benefit induces employers to compensate employees through the fringe benefit rather than in cash.\textsuperscript{158} As a result, demand for resources devoted to producing the fringe benefit increases and the price of the fringe benefit is artificially higher than it would be under a neutral tax system.\textsuperscript{159}

Because the arguments on grounds of equity and neutrality for taxing fringe benefits like other income are strong, the Treasury Report to the President (not surprisingly) recommended the repeal or restriction of a host of currently exempt benefits.\textsuperscript{160} Unfortunately, the President's proposals reject all but four of the Treasury Department's recommendations.\textsuperscript{161}

2. Personal Deductions

a. Interest

Under current law, interest paid or incurred on indebtedness is usually fully deductible from income.\textsuperscript{162} If the income generated by the proceeds of indebtedness will be taxed in full, the deduction for the interest expense is entirely proper.\textsuperscript{163} But inequities and distortions result when taxpayers are able to borrow in order to generate income that either escapes taxation or is taxed at favorable rates.\textsuperscript{164} Current law permits tax-

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\textsuperscript{157} See supra text accompanying notes 37-39.
\textsuperscript{158} See B. Bittker, L. Stone & W. Klein, supra note 142, at 102-04.
\textsuperscript{159} See 2 Treasury Report, supra note 2, at 21.
\textsuperscript{160} See generally id. at 23-50 (recommended repeal or limitations on employer-provided health insurance, group term life insurance, death benefits, legal services, dependent care services, commuting services, educational assistance, cafeteria plans, stock options, employee awards, military allowances, and parsonage allowances).
\textsuperscript{161} See generally President's Proposals, supra note 1, at 24-32, 47-48 (proposed repeal or limitations on employer-provided health insurance, death benefits, commuting services, and employee awards).

Although the President would limit the exclusion for employer-provided health insurance, his proposal differs significantly from the Treasury recommendation. The President would tax an individual employee on the first $120 per year of an employer's contribution to a health plan for his benefit (the first $300 per year for family coverage). See id. at 26. The Treasury Report would tax an employee on the excess of the employer's contribution over $840 per year for individual coverage (the excess over $2100 per year for family coverage). See Treasury Report, supra note 2, at 25. The Treasury recommendation to place a cap on the exclusion seems preferable to the President's proposal because placing a cap on the amount of the exclusion would probably encourage cost containment in the field of health care. See B.N.A. Daily Tax Report, June 3, 1985, at G-2.

\textsuperscript{162} See I.R.C. § 163(a) (1982). There are, however, limitations on the deduction of interest incurred in certain circumstances. Id. § 163(d) (investment indebtedness); id. § 265 (indebtedness relating to tax-exempt income). For an excellent analysis of the interest deduction, see McIntyre, \textit{An Inquiry into the Special Status of Interest Payments}, Duke L.J. 765 (1981).

\textsuperscript{163} If the income generated by the loan is fully taxable, the interest is analogous to an ordinary and necessary business expense or to an expense for the production of income and hence should be deductible. See I.R.C. §§ 162(a), 212(a) (1982). See also R. Posner, supra note 12, at 375 (mortgage expense deducted from rental income).

\textsuperscript{164} See 2 B. Bittker, supra note 143, at 31-38.
payers to accomplish these objectives in essentially two ways. First, indebtedness may be incurred to finance the purchase of an item of consumption that will generate untaxed imputed income.\textsuperscript{165} Second, indebtedness may be incurred to finance investments that produce tax-deferred income or that will ultimately be sold at a gain that is taxed at a rate lower than the rate at which the interest expense was deducted.\textsuperscript{166}

In combination, the interest deduction and the preference for certain forms of income generated by indebtedness produce serious inequities because some taxpayers reduce their tax burden by incurring debt to finance tax-sheltered investments.\textsuperscript{167} Current law also leads to economic distortions by encouraging, for example, the purchase on credit, rather than rental, of consumer goods.\textsuperscript{168} One solution to these problems is to tax fully any income generated by the proceeds of indebtedness.\textsuperscript{169} Where practical, changes of this nature on the income side should be adopted.\textsuperscript{170} But taxing imputed income on consumer goods is likely to be impractical both because of the difficulties of valuation and enforcement and because of the effect of taxing imputed income on the morale of taxpayers and on their comprehension of the tax system.\textsuperscript{171}

An alternative would be to attempt to limit the deduction to interest incurred on indebtedness the proceeds of which will produce fully taxable income—an approach that is incorporated in several provisions of current law.\textsuperscript{172} The President’s proposals would broaden the scope of these provisions by phasing in restrictions on the deductibility of interest on many consumer loans\textsuperscript{173} and on the deductibility of the taxpayer’s distributive share of the interest expense of a limited partnership.\textsuperscript{174} Because taxing imputed income is difficult and further restricting the interest deduction may be unfair,\textsuperscript{175} the President’s program probably rep-

\textsuperscript{166} See 2 B. Bittker, \textit{supra} note 143, at 31-58.
\textsuperscript{167} See generally B. Bittker, L. Stone & W. Klein, \textit{supra} note 36, at 647-57.
\textsuperscript{168} See \textit{id.} at 114-15. This may be inefficient if landlords, being specialists, can provide services at lower cost than owner-occupants. See R. Goode, \textit{supra} note 35, at 127.
\textsuperscript{169} Capital gains income, for example, might be taxed in full rather than afforded a partial deduction. See I.R.C. \S 1202(a) (1982). See \textit{infra} text accompanying notes 264, 272-74.
\textsuperscript{170} See \textit{infra} text accompanying notes 264, 272-75, 285-86.
\textsuperscript{171} See 1 B. Bittker, \textit{supra} note 143, \S 5.3.2, at 5-25; R. Posner, \textit{supra} note 12, at 375. \textit{But see} R. Goode, \textit{supra} note 35, at 120-29 (proposal to tax imputed net rent on owner-occupied housing).
\textsuperscript{172} See, e.g., I.R.C. \S 163(d) (West Supp. 1984) (limitations on investment interest), \textit{id.} \S 265 (disallowance of interest to purchase tax exempts).
\textsuperscript{173} See President’s Proposals, \textit{supra} note 1, at 322-24. The deductibility of mortgage interest on a taxpayer’s principal residence, however, would not be affected. See \textit{id.} at 323. The President has attributed the deduction for home-mortgage interest to “America’s unequivocal commitment to private home-ownership.” \textit{Id.}, Summary, at 4.
\textsuperscript{174} See President’s Proposals, \textit{supra} note 1, at 322-24.
\textsuperscript{175} The deduction for home-mortgage interest may be defended, for example, on the ground that its repeal would create discrimination between those taxpayers who must finance the purchase of a home and those taxpayers who are able to purchase a home for cash. See 2 B. Bittker, \textit{supra} note 143, \S 31.1.1, at 31-2-3. Assume, for example, that A
b. Charitable Contributions

The Treasury Report to the President recommended three major changes in the deduction for charitable contributions. First, repeal of the deduction for taxpayers who do not itemize would be accelerated to begin in 1986.176 Second, taxpayers who itemize would be allowed to deduct only the excess of their contributions over two percent of their adjusted gross income for the taxable year.177 Third, the amount of the deduction for gifts of long-term capital gain property would be reduced below the fair market value of the property in certain circumstances.178 Although the President adopted the Treasury Department recommendation to accelerate repeal of the deduction for nonitemizers,179 he implicitly rejected the Department's recommendations to place a floor on the deduction for itemizers and to reduce the amount of the deduction for contributions of long-term capital gain property.180

Both the Treasury Report and the President's proposals indicate an unwillingness to repeal the charitable deduction in its entirety because of the effect that repeal might have on the amount of charitable giving.181 But viewing the deduction as an incentive to encourage charitable donations leads to insurmountable theoretical objections. First, the incentive is slanted to favor the charities of upper-income taxpayers because of the progressive rate structure.182 For every $20 contributed by a 50%-bracket taxpayer, the government in effect pays $10 of the contribution.183 By contrast, for taxpayers in the 20% bracket, the government only picks up $4 of the contribution; for taxpayers with no tax liability,
the government pays none of the contribution. Thus, to the extent that the deduction works effectively as an incentive, the incentive is skewed to favor the charities of the rich. On the other hand, the deduction may actually be inefficient because it provides the greatest benefits to wealthy taxpayers who often can afford to give without a deduction. Consequently, the deduction may hand windfalls to some wealthy taxpayers for doing what they would do anyway. Finally, the deduction, like most tax incentives, leads to distortions in the allocation of resources by favoring the activities of charities over other activities.

On the other hand, there may be a case for the deduction as a proper refinement of income rather than as a tax incentive. Contributions made by a taxpayer are usually converted by the charity either into alms for the poor or into goods that are available to large segments of the community ("collective goods"), such as museums, orchestras, and libraries. From a tax perspective, it may be significant that after the contribution, the taxpayer no longer controls or consumes the resources acquired by the contribution. The fact that the contribution is no longer available to support the taxpayer's private consumption may justify excluding the amount of the contribution from the income on which the taxpayer must pay a tax, a result that is effected indirectly by the charitable deduction.

Even a leading defender of the deduction concedes that there are telling counterarguments. Although it is true that a contributor generally does not personally consume the resources purchased by his contribution, he has exercised power over the distribution of goods or services in society. That exercise of power may justify the imposition of a tax by denying a deduction for the contribution. Moreover, most philanthropists presumably derive pleasure, satisfaction, or prestige from supporting charitable enterprises. These considerations suggest that sound tax policy requires that the deduction be restricted to take account of the power exercised or the pleasure or prestige derived from the act of mak-

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184. See supra note 183.
185. See Andrews II, supra note 24, at 310.
187. It is arguable, however, that the deduction for charitable contributions may sometimes help to rectify market failures. See supra note 52. For example, consumers are often ignorant about the quality of competing goods available in the market. See R. Dorfman, Prices and Markets 212 (1978). Tax-exempt consumer groups sometimes operate to remedy these market failures by educating consumers or by inducing legislatures to outlaw a defective product. Allowing contributions to these consumer groups to be tax deductible thus may improve the efficiency of the economy by mitigating the market failure caused by consumer ignorance. As far as the author is aware, however, there is no evidence that the deduction generally operates to mitigate market failures.
188. See generally Andrews II, supra note 24, at 344-75.
189. See id. at 346.
190. See id.
191. See id.
192. See id. at 346, 354-55, 363-64.
193. See id. at 355-56, 363-65.
ing the contribution. As a practical matter, it would be impossible to
determine what part of a contribution produces benefits of this nature to
the taxpayer. But some practical restrictions on the deduction are clearly
proper. For that reason, the Treasury Department’s recommendation to
limit the deduction to the excess of contributions over 2% of the tax-
payer’s adjusted gross income for the year seems preferable to the Presi-
dent’s decision to retain a full deduction. 194

c. The Deduction for State and Local Taxes

The most controversial item in the President’s tax reform plan may be
the proposal to repeal the deduction for state and local taxes. 195 Critics
of the proposal have argued that repeal of the deduction would be uncon-
stitutional 196 and would jeopardize the relationship between the federal
and state governments. 197 In the critics’ view, moreover, repeal would
result in an unfair double tax because taxes paid by taxpayers to state and
local governments would again be taxed at the federal level. 198 Because
this Article focuses primarily on tax policy, arguments about the constitu-
tionality of repeal of the deduction and about the effects of repeal on
the federal system will not be addressed.

The Administration has justified its proposed repeal of the deduction
on three principal grounds. First, the deduction is inequitable because it
provides the largest tax benefits to upper-income taxpayers as a result of
the progressive rate structure. 199 Second, the deduction results in an un-
fair subsidy being paid by citizens of low-tax states to citizens of high-tax
states in the form of the higher rates of federal taxation required to com-
penstate for revenues lost because of deduction. 200 Third, the deduction is
unsound from the standpoint of tax policy because taxes are used by state
and local governments to purchase goods and services—such as educa-
tion, police and fire protection, and road maintenance—that are made
available to taxpayers. Because taxpayers ultimately benefit from the
payment of state and local taxes, no federal deduction should be

194. The President also implicitly rejected the recommendation of the Treasury De-
partment to limit the deduction for a contribution of long-term capital gain property to
the lesser of the fair market value of the property or the basis of the property indexed for
inflation. See 2 Treasury Report, supra note 2, at 72-74. Because the deduction of the
fair market value of such property allows taxpayers to deduct a gain that was never taxed
as income, even proponents of the deduction in general would limit the deduction for
contributions of long-term capital gain property to the basis of the property. See An-
drews II, supra note 24, at 371-72. Thus, the Treasury Department recommendation
should have been proposed by the President.
195. See President’s Proposals, supra note 1, at 62-69 (proposed repeal of § 164).
196. See N.Y. Times, June 15, 1985, at A27, col. 4 (constitutional flaws in repeal of
state tax deduction seen by New York Republicans).
197. See N.Y. Times, July 18, 1985, at D1, col. 3 (remarks of Gov. M. Cuomo); N.Y.
Times, June 20, 1985, at D1, cols. 2, 3, D5, cols. 2, 3 (remarks of various public officials).
199. See President’s Proposals, supra note 1, at 62-63.
200. Id. at 63.
allowed.\textsuperscript{201} It should be noted, initially, that the Administration's first rationale for repeal of the deduction for state and local taxes applies with equal force to the charitable contribution deduction, which also bestows its greatest tax benefits on upper-income taxpayers.\textsuperscript{202} In that respect, the President's proposals to retain one deduction and repeal the other are internally inconsistent. Moreover, if the charitable contribution deduction is to be preserved as a tax incentive,\textsuperscript{203} the Administration has not explained why a tax incentive should be provided for activities supported by charitable giving, but not for the activities of state and local governments supported by tax payments.\textsuperscript{204}

On the other hand, the third rationale offered by the Administration, if valid, effectively disposes of the double-tax argument for retention of the deduction. To the extent that taxes paid to state and local governments are used to purchase goods and services consumed by taxpayers, a refusal by the federal government to allow a deduction for these taxes would not be a tax upon a tax, but simply a tax on consumption, which is generally taxable under the Code.\textsuperscript{205} Moreover, the double tax argument is belied by the tax policies of states whose public officials have opposed repeal of the deduction.\textsuperscript{206} New York, for example, does not allow its residents to deduct income taxes paid to the federal government,\textsuperscript{207} nor does it generally allow its residents to deduct income taxes paid to New York municipalities.\textsuperscript{208}

As with the charitable contribution deduction, the real tax policy issue is whether the deduction for state and local taxes represents a refinement in the concept of income that properly reduces the federal tax liability of citizens of high-tax states.\textsuperscript{209} Resolution of that issue in turn depends on the reasons for variations in state and local tax burdens among the fifty

\textsuperscript{201} Id. at 63-64.
\textsuperscript{202} See supra text accompanying notes 167-70.
\textsuperscript{203} See supra text accompanying notes 166-67.
\textsuperscript{204} Cf. N.Y. Times, July 7, 1985, at E9, col. 6 (advertisement by A. Shanker, President, American Federation of Teachers) (President's Proposal favors private sector services over those supported by tax revenue).
\textsuperscript{205} See I.R.C. § 262 (1982). The benefit argument in the text for denying a deduction for state and local taxes is strongest in the case of real property taxes which go to purchase services benefiting the owners of real property—such as police and fire protection and sanitation services. Cf. Turnier, Evaluating Personal Deductions in an Income Tax—The Ideal, 66 Cornell L. Rev. 262, 275-76 (1981) (although property taxes finance societal needs disproportionately to the economic value of consumption by taxpayer, consumption is nevertheless a component of paying taxes on property).
\textsuperscript{207} For New York income tax purposes, the adjusted gross income of a New York resident is defined as his federal adjusted gross income (with modifications that are not here relevant). N.Y. Tax Law § 612(a) (McKinney 1975). Because the Internal Revenue Code does not permit a deduction for federal income taxes in computing federal adjusted gross income, I.R.C. § 275(a)(1) (1982), neither does New York.
\textsuperscript{209} See supra text accompanying notes 188-90.
states. Whenever a state imposes an above-average tax burden on its citizens, the excess may be due to one (or more) of the following factors: (1) the state provides more goods and services to its citizens than do other states; (2) the state is less efficient than other states in the production or distribution of goods or services;\(^{210}\) (3) the cost of living in that state and hence the cost of government goods and services is higher; (4) citizens of that state endorse a higher level of government responsibility for solving social problems than citizens of other states; or (5) the state has been forced—or has chosen—to expend tax monies to alleviate a national social problem.\(^{211}\)

Of these explanations for variations in tax burdens among the states, only the last justifies a deduction for state and local taxes. If a state supplies more goods and services to its citizens, there is no justification for forcing citizens of other states to shoulder part of the resultant tax burden through higher rates of federal taxation.\(^{212}\) Similarly, if a state is inefficient in providing goods and services to its citizens, the costs of that inefficiency should be borne by its own citizens, not by the citizens of other states. Otherwise, the incentive of officials of state government to eliminate the inefficiency would be reduced.\(^{213}\) Because variations in relative costs-of-living among the states receive no federal tax recognition under current law, it would be anomalous to single out state and local taxes for special treatment.\(^{214}\) Lastly, if citizens of one state rely more on state government to solve social problems, it is hard to understand why citizens of another state should be coerced, through the federal tax system, to pay part of the costs of a view of governmental responsibility that they do not share.

On the other hand, the subsidy to high-tax states that results from the deduction for state and local taxes has been analogized by a supporter of the deduction to the direct expenditure of federal tax dollars on a public works project or other program that benefits only one state or region of the country.\(^{215}\) Since the United States is one nation, not 50 states, citizens of one state sometimes contribute tax dollars to federal programs from which they may derive no benefit.\(^{216}\) Whether that contribution results from direct federal spending or from a deduction for the state and local taxes paid by citizens of high-tax states should not matter because

\(^{210}\) There is some evidence that New York, for example, which is a high-tax state, may distribute government goods and services inefficiently. See Wall St. J., July 1, 1985, at 12, col. 3 (article by W. J. Stern, former chairman and chief executive of the New York State Urban Development Corporation).

\(^{211}\) See N.Y. Times, June 25, 1985, at A26, col. 1 (editorial attributing higher New York tax burden to national policies and problems).

\(^{212}\) See President's Proposals, supra note 1, at 62-64.

\(^{213}\) See Wall St. J., July 1, 1985, at 12, col. 3.

\(^{214}\) For an argument that variations in costs-of-living should be given recognition for federal income tax purposes, see Susswein, Extend Tax-Bracket Indexing, N.Y. Times, July 8, 1985, at A17, col. 2.

\(^{215}\) See N.Y. Times, July 18, 1985, at D1, col. 3 (remarks of Gov. M. Cuomo).

\(^{216}\) See id.
in both cases citizens are expected, quite rightly, to sacrifice parochial interests for the national good.

This analogy between direct federal spending and a federal tax subsidy is indeed apt in the sense that both sap the resources of the federal government, either directly or indirectly. But the analogy otherwise breaks down in three critical respects. First, direct federal spending programs are approved by Congress only after full disclosure and analysis of their costs and benefits. Every state and region of the country has the opportunity through their elected representatives in Congress to influence the substance of the program and the amount of the appropriations allocated to it. State and local spending programs, by contrast, are instituted with minimal, if any, disclosure, analysis, or input by Congress. Second, direct expenditure of federal funds is monitored and supervised by the appropriate Congressional committees and executive departments. Monitoring and supervision of state and local spending by the federal government is haphazard at best and in any event would be resisted by state and local governments. Third, direct federal programs are financed by taxes raised in accordance with a rate structure that allocates the tax burden among income classes in a way that is presumably regarded as fair. By contrast, when an indirect federal subsidy is provided through the state and local tax deduction, the tax benefits flow disproportionately to upper-bracket taxpayers.

The possibility remains, however, that above average rates of taxation in a particular state may be due to the state’s assumption of a national burden, such as the costs of providing for an unusually large number of illegal aliens. Where state spending produces spillover benefits for the rest of the nation, the case for a deduction for state taxes is strong because the residents of the state are not the only beneficiaries of the spending. Nevertheless, this hypothesis would justify a deduction only for the portion of state taxes used to finance such spillover benefits. Furthermore, the hypothesis requires empirical evidence of a causal connection between above average rates of state taxation and spillover benefits, and such evidence is apparently unavailable.

Because taxes are imposed on individuals, not states, a citizen of a high-tax state may protest that it would be unfair to repeal the deduction because amounts paid in state and local taxes are involuntary and be-

218. See Andrews II, supra note 24, at 309-11 (charitable contribution as a tax subsidy); Surrey, supra note 23, at 728-31 (discussing differing procedures for direct federal spending program and tax incentive programs).
219. See id.
220. See supra text accompanying notes 47-49.
222. See President’s Proposals, supra note 1, at 64; Wall St. J., July 1, 1985, at 12, col. 3.
cause all citizens do not derive equal benefits from the goods and services provided by the state.\textsuperscript{223} There are several responses to these arguments. To begin with, certain state and local taxes—for example, the real property tax—are in fact voluntary in the sense that taxpayers have a choice about whether to engage in the transaction that gives rise to tax liability.\textsuperscript{224} Moreover, state and local taxpayers have control over the taxes that they pay through the electoral process and through their ability to relocate to states with more acceptable tax and fiscal policies.\textsuperscript{226} Lastly, the Internal Revenue Code currently imposes severe limitations on the deductibility of medical expenses and casualty losses even though the events from which those expenses arise are often at least as involuntary as the payment of state and local taxes.

Although taxpayers indeed derive differential benefits from state and local government spending, the practical problems of apportioning the federal tax liability of individual taxpayers on a precise benefit principle are insoluble.\textsuperscript{229} For federal income tax purposes, it is most practical and not unreasonable to assume that the citizens of a state receive approximately equal benefits, direct or indirect, from state spending. Moreover, to allow taxpayers a complete deduction for state and local taxes would be sound from the perspective of tax policy only if it were assumed, incredibly, that no citizen derives any benefit from state and local spending.\textsuperscript{230}

\begin{itemize}
\item \textsuperscript{223} Cf. Turnier, supra note 205, at 273-74 (individuals should be taxed only to the extent that they obtain a personal benefit from society's resources).
\item \textsuperscript{224} See id. at 275-76, 281.
\item \textsuperscript{225} For a discussion of voter initiatives to reduce tax rates, see Washington Post, Oct. 17, 1984, at A11; Christian Science Monitor, June 6, 1983, at 4.
\item \textsuperscript{226} For evidence that taxpayers migrate to low-tax states to reduce their tax burdens, see Business Week, June 17, 1985, at 132; N.Y. Times, May 16, 1981, at A8, col. 1.
\item \textsuperscript{227} See I.R.C. § 213(a) (1982) (medical expense deduction limited to excess over 5% of taxpayer's adjusted gross income). For an argument that a deduction for medical expenses does not accurately measure the loss caused by an illness, see R. Posner, supra note 12, at 378.
\item \textsuperscript{228} See I.R.C. § 165(h)(2)(A) (1984) (net casualty loss deduction limited to excess over 10% of taxpayer's adjusted gross income). For an argument that a deduction for casualty loss compensates people who lack the foresight to insure, see R. Posner, supra note 12, at 378.
\item \textsuperscript{229} See Turnier, supra note 205, at 274.
\item \textsuperscript{230} The deduction for state and local taxes has also been defended on the ground that state and local taxes, like charitable contributions, are used to purchase public or collective goods that are not available for the taxpayer's private consumption or benefit. See Turnier, supra note 205, at 273-76. See supra text accompanying notes 188-90. But this argument is not persuasive for two reasons. First, certain state and local taxes are converted by governments into goods and services that in fact benefit the taxpayers directly. Real property taxes, for example, are used by municipalities to purchase police and fire protection, road maintenance, sanitation services, and the like. More importantly, tax deductible payments to charities are converted into public goods that are presumably available to taxpayers in all regions of the country. By contrast, public goods purchased by state and local taxes are primarily available only to the citizens of the state or municipality that imposes the taxes (with the exception of possible "spillover" benefits). Thus, a "public goods" defense of the deduction for state and local taxes does not address—and
3. Income-Splitting

For income tax purposes, individual members of the family, other than husband and wife, are treated as separate taxable entities. Viewing the family as a set of discrete taxpayers often diverges from a reality in which members of the family act as an economic unit, sharing resources and assuming mutual responsibilities. This divergence between the income tax world and the real world inspires efforts to reduce taxes by shifting income from members of the family with high income to members with low income or to trusts. Because of personal exemptions and the zero bracket amount and, most importantly, because of the progressive rate structure, successful attempts to shift income often produce considerable tax savings. Because the incentive to shift income arises from the treatment of individuals and trusts as separate taxable entities, elimination of the incentive would require that the income and deductions of family members be aggregated for income purposes. But difficulties in determining exactly which income and deductions should be attributed to the family group have probably deterred lawmakers, at least until now, from enacting an aggregation rule.

Income-splitting exacts a heavy toll. As discussed earlier in this Article, the incentive to shift income among taxpayers leads to a large amount of tax planning and generates significant transaction costs. Moreover, significant inequities exist because opportunities for income-splitting are greater for propertied taxpayers than for wage-earners. Lastly, economic distortions may result whenever taxpayers are induced to transfer property to their children or to trusts not because the transferee values the property more highly, but simply because the transfer will result in income tax savings.

The President's proposals would reduce these inequities and distortions—certainly does not rebut—the fundamental objection to the deduction, which is that the deduction results in an unfair subsidy of government spending, on public or private goods, by high-tax states. See supra text accompanying notes 209-14.

234. Id. at 1197-98.
236. See B. Bittker, L. Stone & W. Klein, supra note 36, at 707-08.
237. See supra text accompanying notes 126-29.
239. Two early Supreme Court decisions effectively precluded wage-earners from assigning income to family members. See Helvering v. Eubank, 311 U.S. 122, 127 (1940) (assignment of future commissions to trustee held ineffective); Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (husband's contractual assignment of income to wife held ineffective). But the Supreme Court held contemporaneously that income from property transferred to family members was taxable to the transferees, not the transferor. Blair v. Commissioner, 300 U.S. 5, 14 (1937). See also M. Chirelstein, supra note 232, at 180-82 (discussing gifts of income producing property).
tions in two primary ways. First, unearned income of children under fourteen years of age that is "attributable to property received from their parents" would generally be taxed to the children but at the marginal tax rate of their parents.\textsuperscript{241} For this purpose, a child's unearned income will be presumed to be attributable to property received from a parent unless the child can meet a strict burden of proving the contrary.\textsuperscript{242} Second, the income of so-called Clifford trusts,\textsuperscript{243} which is currently taxed at the marginal tax rate of the trust or of its beneficiaries,\textsuperscript{244} would generally be taxed to the trust but at the marginal tax rate of the grantor if the grantor is still alive.\textsuperscript{245} These proposals, if enacted, would reduce the income tax incentive to transfer property to minor children or to trusts because the income generated by the property would continue to be taxed at the parent's or grantor's marginal tax rate.\textsuperscript{246} Consequently, many of the inequities and distortions of income-splitting under current law would be eliminated.

4. Capital Gains

Under current law, capital gains are treated more favorably than ordinary income in three important respects. First, gains are not taxed until the underlying property is sold or the gain is otherwise realized by the taxpayer.\textsuperscript{247} This deferral advantage in effect gives the taxpayer the interest on the tax that would have been paid had the appreciation been taxed when it occurred.\textsuperscript{248} Second, income tax on gains unrealized at death is entirely forgiven because property is given a "stepped-up" basis at death.\textsuperscript{249} Third, long-term capital gains, if realized by a noncorporate taxpayer, are generally taxed at only 40% of the rates on ordinary

\textsuperscript{241} See President's Proposals, \textit{supra} note 1, at 84-87.
\textsuperscript{242} Id. at 85. Earnings of a child, property received by the child from someone other than a parent, and property received by reason of the death of a parent could be placed in a qualified segregated account. Unearned income derived from such an account would be taxed at the child's tax rates. Id. at 85-86.
\textsuperscript{243} See \textit{Helvering v. Clifford}, 309 U.S. 331, 335 (1940) (short-term trust held ineffectual to shift income from grantor). Some commentators have criticized the Court for being somewhat vague in \textit{Clifford} about when a trust would be effective to shift income from the grantor to the trust or to its beneficiaries. See M. Chirelstein, \textit{supra} note 232, at 179-80. Consequently, Congress eventually enacted specific statutory provisions designed to prevent income-shifting. See I.R.C. §§ 671-677 (1982). But the very specificity of these provisions made it possible for taxpayers to set up trusts that were not covered by the provisions and thus effective to shift income from the grantor to the trust or to its beneficiaries. See S. Surrey, W. Warren, P. McDaniel & H. Ault, \textit{supra} note 39, at 1344-45. Trusts, the income of which is not taxed to the grantor, are frequently referred to as "Clifford trusts." See President's Proposals, \textit{supra} note 1, at 88.
\textsuperscript{245} See President's Proposals, \textit{supra} note 1, at 92-98.
\textsuperscript{246} See id. at 97.
\textsuperscript{248} See \textit{supra} note 29.
\textsuperscript{249} See I.R.C. § 1014(a) (1982) (basis of inherited property generally fair market value at decedent's death).
The favorable treatment of capital gains obviously creates inequities between taxpayers whose income primarily takes the form of capital appreciation and taxpayers whose income consists primarily of wages, interest, or other currently and fully taxable income. In addition, the favorable treatment leads to subtle, albeit serious, economic distortions because resources are allocated to activities that yield capital gains rather than to activities that yield ordinary income. The special treatment also gives a corporation a strong incentive to retain earnings, thus increasing the value of the corporation’s stock, rather than to pay dividends that are currently taxable as ordinary income to the shareholders. This in turn reduces the discipline and efficiency of capital markets because corporations need not compete on the market to sell equity but instead may raise capital internally by limiting the payment of dividends to their shareholders. The deferral advantage and the forgiveness of tax on gains unrealized at death create their own distortions by inducing taxpayers to retain property that has appreciated in value even if the property would be more valuable in other hands (the so-called “lock-in” problem).

It is easy to recognize these problems, and much harder to design a practical program to solve them. Taxing realized gains as ordinary income, for example, would be the simplest way to reduce the tax benefits afforded capital gains by current law. But this reform would cause its own inequities because of the detrimental effects of bunching income in one year in a progressive tax system and because of the possibility that the gain may be unreal because it merely matches inflation over time. Moreover, full taxation of realized gains would give taxpayers an even greater incentive to cling to appreciated property and would thus exacerbate the distortions caused by deferral and possible forgiveness of tax on unrealized gains.

On the other hand, a complete program to eliminate the inequities and distortions of current law would require three steps, each of which would complicate the tax system: (1) the basis of property would be indexed for inflation; (2) gain would be taxed as it occurs; and (3) relief through

250. See I.R.C. § 1202(a) (1982) (60% deduction for taxpayer’s “net capital gain” for the year); id. § 1222(11) (1982) (“net capital gain” is excess of net long-term capital gain over net short-term capital loss).


253. See id.

254. See id.

255. See id.


257. See supra text accompanying notes 28-33.

258. See R. Goode, supra note 35, at 214; Andrews I, supra note 18, at 1134.

259. Indexing basis would avoid the unfairness of taxing a phantom gain. See supra text accompanying notes 28-29.

260. Taxation of accrued gains and losses would avoid the “lock-in” problem resulting
some sort of averaging across taxable years would be provided to taxpayers who have unusually large gains or losses in a particular taxable year. Although the first and third proposals are feasible, the second would present virtually insuperable practical difficulties of valuation and enforcement because many assets do not have a readily ascertainable market value and would force some taxpayers to liquidate holdings to pay the tax on an accrued gain.

Thus, the ultimate question is what program of reform can be enacted that would be practical to administer and would reduce the inequities and distortions caused by current law? The Treasury Report recommended that the 60% deduction for realized capital gains be repealed and that indexing for inflation be enacted in its place. The President proposed instead to retain a deduction of 50% of realized capital gains as an economic incentive to high-risk ventures, and to allow taxpayers beginning in 1991 to elect to index the bases of capital assets sold during the year in lieu of taking the deduction. But retaining the deduction on incentive grounds is problematic for a number of reasons. First, it leads to the inequities discussed above. Second, the incentive is too broad because it encourages taxpayers to invest in certain assets—for example, land, stamps, coins, masterworks, and antiques—for which a tax incentive is regarded as inappropriate. Third, it is unclear why high-risk venturers should be given a tax incentive denied other investors, even if it were possible to limit capital gains treatment to risky enterprises. Indeed, the consequences of the incentive are economic distortions that a rational tax system should seek to prevent. Moreover, the President's proposals would exacerbate these inequities and distortions by giving taxpayers the option of indexing in lieu of the deduction and thus providing taxpayers with other opportunities to minimize taxes on long-term capital gains.

Though not perfect, the Treasury Department's original recommendation to replace the deduction with indexing is preferable. Taxpayers would still have an incentive to retain appreciated property, but the inequ-

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from the deferral advantage afforded unrealized gains under current law. See supra text accompanying notes 255-56, 258.

261. Averaging would mitigate the unfairness under a progressive rate structure of taxing unusually large gains in one taxable year. See H. Simons, supra note 21, at 169. See supra text accompanying notes 30-31.

262. See Andrews I, supra note 18, at 1141-43.

263. See R. Posner, supra note 12, at 380; Andrews I, supra note 18, at 1143.

264. See 2 Treasury Report, supra note 2, at 178-88.

265. See President's Proposals, supra note 1, Summary, at 6 (proposed reduction of capital gains deduction from 60% to 50% under § 1202(a)).

266. See id. at 169.

267. See supra text accompanying note 251.


270. See supra text accompanying notes 252-54.

271. See supra note 133.
uities and distortions caused by lower tax rates on realized capital gains would be mitigated.272 Furthermore, with indexing and lower overall rates of taxation, the incentive to cling to appreciated property would be somewhat reduced.273 In any event, if the lock-in problem is regarded as serious, it would be better to attack it directly rather than to allow an inequitable and distortive deduction for realized gains.274

5. Tax Shelters

The incentive to form and participate in a tax shelter derives from one or more of three principal tax advantages that the shelter may offer. First, investors may be able to accelerate deductions and thereby obtain the deferral advantage of interest on taxes saved as a result of the deduction.275 Second, deductions taken against fully-taxable, ordinary income may be converted into tax-preferred income, such as long-term capital gains.276 Third, participants in the shelter may be able to take income tax deductions in excess of their actual investment in the shelter by leveraging their investment through nonrecourse financing.277

272. See supra text accompanying notes 251-53.
273. See 2 Treasury Report, supra note 2, at 186-87.
274. Congress might provide, for example, that unrealized gains be taxed, with appropriate averaging, when capital assets are transferred by gift or at death. See R. Goode, supra note 35, at 220-21. Although such a provision would not eliminate the advantages of deferral during the taxpayer's ownership of the capital asset, it would alleviate the lock-in problem by making it impossible to obtain permanent forgiveness of income tax on unrealized gains by retaining the asset until death. See supra text accompanying note 249.
277. See id. at 650-51. Under Crane v. Commissioner, 331 U.S. 1 (1947), a taxpayer's basis in an asset normally includes the amount of cash or other property paid plus the amount of any mortgage on the property. Crane, 331 U.S. at 11. The Crane rule allowing a taxpayer to include a nonrecourse mortgage in basis provides opportunities for tax avoidance. Consider, for example, the facts, modified slightly, of Rev. Rul. 77-110, 1977-1 C.B. 58. X, a limited partnership, purported to buy motion picture rights from M for $2 million with $200,000 in cash and $1.8 million in a nonrecourse promissory note payable out of the proceeds of the film's exploitation. Neither X nor any of its partners was personally liable for payment of the note, which bore interest of 4%. The film rights transferred to X had been purchased a few months before by M for $200,000. Assuming that the motion picture has a useful life of four years, X would be able to deduct depreciation on the film of $500,000 a year if X's basis in the film under Crane is $2 million. See I.R.C. § 167(a) (1982). The partners of X would then be able to deduct their pro rata share of $500,000. See id. §§ 702-703. If all the partners of X are in the 50% marginal tax bracket, this deduction would result in tax savings of $250,000 in the first year, an amount that already exceeds X's cash investment in the motion picture rights.

At the time of the ruling, the Internal Revenue Service had no statutory weapon to combat this abuse. Still, the Service ruled that payment of the note was too speculative for the note to be included in basis because the fair market value of the film was unproven and because neither X, nor any of its partners, was liable on the note. Under current law, X's partners would be allowed a deduction only up to the amount that they are "at risk" in the partnership. See id. § 465(a) (1984). A taxpayer is not at risk with respect to borrowed funds unless the taxpayer is personally liable for repayment of the loan or has
The recent proliferation of tax shelters has undesirable consequences from the standpoint of the equity and neutrality of the tax system. Wealthy taxpayers are afforded an opportunity to shelter income from tax.\textsuperscript{278} Other taxpayers, who may be unable or unwilling to participate in tax shelters, consequently bear a relatively higher tax burden. Preferential tax treatment of certain activities also results in economic distortions by interfering with a market-determined allocation of resources.\textsuperscript{279}

The President's tax proposals contain a number of recommendations designed to reduce the benefits of tax shelters. The investment tax credit and a number of energy tax credits would be repealed.\textsuperscript{280} Because the immediate tax benefits of these credits are available only to investments in certain property, repeal of the credits is likely to improve the overall neutrality of the tax system.\textsuperscript{281} The Administration has recommended, in addition, that recovery periods for depreciation purposes be extended slightly to reflect actual economic depreciation a bit more closely.\textsuperscript{282} The Administration would also require certain preproduction costs that are immediately deductible under current law to be capitalized instead for income tax purposes.\textsuperscript{283}

In addition to these proposals designed to strip certain tax shelters of their deferral advantage, the Administration has made several proposals to limit opportunities to convert ordinary income deductions into tax-preferred income. The deduction of a taxpayer's share of the interest expense of a limited partnership, for example, would be subject to certain limitations.\textsuperscript{284} On the income side, depreciable property\textsuperscript{285} and certain other property\textsuperscript{286} would be denied the benefits of capital gains treatment.

\textsuperscript{279} See 1 Treasury Report, supra note 2, at 139.
\textsuperscript{280} See President's Proposals, supra note 1, at 160-64, 224-27 (proposed repeal of §§ 23, 29, 40, 46-48).
\textsuperscript{281} See President's Proposals, supra note 1, at 108-64, 151-57 (proposed repeal of §§ 23, 29, 40, 46-48).
\textsuperscript{282} See id. at 168 (proposed modification of § 163(d) to include additional categories of interest).
\textsuperscript{283} See id. at 168 (proposal to deny capital gain treatment under § 1231(b)(1) for depreciable property). Depreciable property used in a trade or business would be indexed for inflation, however. See id.
\textsuperscript{284} See id. at 169 (proposal to deny capital gain treatment under § 1231(b)(2), (3), (4) for timber, coal, iron ore, livestock and unharvested crops).
Percentage depletion, one of the linchpins of energy tax shelters, would be phased out over a five-year period (with the exception of percentage depletion on oil and gas "stripper wells"). Finally, the tax benefits from leveraging through nonrecourse financing would be reduced by the President's proposal to subject real estate investments to current law limiting the loss a taxpayer may deduct from investments other than real estate to the amount the taxpayer has at risk in the investment.

The effect of these proposals and of the reduction in marginal tax rates is likely to dim the luster of many popular tax shelters. For that reason, the President's proposals, if enacted, would improve the equity and neutrality of the tax system. But the President has missed a few major opportunities to curtail the activities of tax shelters even further by rejecting a number of recommendations contained in the Treasury Report. Repeal of the capital gains deduction, for example, would eliminate an important mechanism for converting ordinary income deductions into tax-preferred income. Requiring the intangible drilling costs of oil and gas wells to be capitalized, which the Treasury Department recommended, would eliminate one of the most important deferral advantages currently tolerated by the Code. Eliminating that preference and subjecting all minerals, including oil and gas, to the total repeal of percentage depletion would improve the equity of the tax system and ensure that market forces—rather than tax subsidies—would determine the allocation of resources in the development of alternate sources of energy.

CONCLUSION

This Article has focused primarily on the effect of the President's proposals on individual taxpayers. Because the President's program contains equally significant recommendations for reform of business taxation, a final judgment on the merits of his overall program must await a thorough analysis of the program's effect on business taxpayers.

287. See id. at 228-30 (proposed phase-out of virtually all of §§ 611-617). Percentage depletion generally allows a taxpayer to deduct a specified percentage of the gross income from minerals up to a specified maximum percentage of net income. Moreover, percentage depletion continues to be deductible even after the taxpayer has recovered the entire cost of the mineral reserves. See B. Bittker, L. Stone & W. Klein, supra note 36, at 633-34.

288. See President's Proposals, supra note 1, at 325-27 (proposed expansion to include real estate in at-risk rules of § 465). See supra note 277 and accompanying text.

289. See, e.g., 2 Treasury Report, supra note 2, at 178-88 (recommended repeal of capital gains deduction under § 1202(a)).

290. See supra text accompanying notes 247-74.

291. See 2 Treasury Report, supra note 2, at 232-33 (recommended repeal of § 263(c)). In general, intangible drilling costs include labor and materials that are used up in the drilling or development stage of oil and gas production. See Treas. Reg. § 1.612-4 (1965).

292. See Wall St. J., June 18, 1985, at 6, col. 1.

293. See, e.g., President's Proposals, supra note 1, at 192-96 (proposed recapture of depreciation deducted during a period of relatively high tax rates).
From the standpoint of personal taxation, however, the proposals would eliminate or reduce many of the complexities, inequities, and distortions caused by current law.\textsuperscript{294} Although the program is not ideal, its deficiencies generally result not from the changes actually proposed, but from the President's unwillingness to support the even more dramatic recommendations of the Treasury Report.\textsuperscript{295} Perhaps the President was concerned about the risks of suddenly eliminating many important tax incentives. Or perhaps his program represents the limits of what is now politically feasible. If not, Congress should improve on the program in ways suggested by this Article.

The danger, however, is that Congress will be swayed instead by the pleas of interested parties—the real estate industry,\textsuperscript{296} the coal industry,\textsuperscript{297} municipal unions,\textsuperscript{298} state and local public officials,\textsuperscript{299} and others\textsuperscript{300}—to restore tax advantages that would be excised by the President's program. If so, a major opportunity for significant reform of personal income taxation will have been lost. It is better, in general, to take a step in the right direction than not to move at all.\textsuperscript{301}


\textsuperscript{295} See \textit{supra} text accompanying notes 157-61, 194, 264-74, 289-91.

\textsuperscript{296} See B.N.A. Daily Tax Report, July 9, 1985, at G-3 to G-4 (comments of President of National Association of Home Builders).

\textsuperscript{297} See B.N.A. Daily Tax Report, June 6, 1985, at G-4 (comments of President of National Coal Association).

\textsuperscript{298} See \textit{N.Y. Times}, July 3, 1985, at D20, col. 2 (comments of President of National Education Association).


\textsuperscript{300} See B.N.A. Daily Tax Report, July 18, 1985, at G-4 (comments of oil and gas industry representatives).

\textsuperscript{301} It must be recognized, however, that an incomplete tax reform program may actually be worse than no reform at all if the reforms adopted produce a tax system that is less equitable and more distortive than the existing system. Consider, for example, the President's proposal to repeal various energy tax credits. See President's Proposals, \textit{supra} note 1, at 224-27. These credits bestow tax benefits only on certain economic activities, and thus cause both inequities and distortions. See \textit{supra} text accompanying notes 280-81. Repeal of the credits thus appears to be sound tax policy. But repeal of the credits should not be evaluated in isolation. If various tax subsidies to the oil and gas industry are not simultaneously repealed, the resultant discrepancies in the tax treatment of alternate sources of energy may cause economic distortions even more serious than the distortions created by a tax system that bestows some type of subsidy on all forms of energy. See \textit{Wall St. J.}, June 18, 1985, at 6, col. 1. See \textit{supra} text accompanying notes 291-92.

Thus, a strong argument can be made that the President's proposals for reform in the taxation of energy would actually cause greater inequities and distortions than current law.