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AN APPROACH TO INCOME TAX SIMPLIFICATION

**Fred W. Peel*

Income tax simplification is a popular theme. When the present federal income tax was only thirteen years old Congress created the Joint Congressional Committee on Internal Revenue Taxation with the study of income tax simplification as one of its functions.¹ Through the years cries for simplification have increased in number and intensity. In President Carter's 1976 campaign he said the complexity of the tax system was a disgrace, and his administration has said that tax revision proposals are imminent.² The Tax Reform Act of 1976,³ having made its own contributions to complexity, ordered a study of income tax simplification by the Joint Taxation Committee.⁴ The Wall Street Journal, attempting to dramatize the issue, urged veto of the 1976 Act because it did not do away with the present complex system and substitute a simple tax.⁵

Income tax simplification—or, conversely, income tax complexity—can mean a number of different things.⁶ Complexity can be illustrated by the length of the Internal Revenue Code. The first version of the present federal income tax consisted of twenty-seven pages in the Tariff Act of 1913.⁷ The substantive income tax provi-

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1. Revenue Act of 1926, Pub. L. No. 20, § 1203(c)(4), 44 Stat. 127.

2. Remarks by Secretary of the Treasury W. Michael Blumenthal at the City Club of Cleveland (July 20, 1977).

This article was written before any official announcement of the nature and scope of President Carter's income tax revision proposals.

3. Pub. L. No. 94-455, 90 Stat. 1520 (1976) [hereinafter referred to as the 1976 Act].

4. Pub. L. No. 94-455, § 507, 90 Stat. 1569 (1976). A staff study mandated by this provision has been completed and is a comprehensive survey of the issues. Staff of Jt. Comm. on Tax., 95th Cong., 1st Sess., Report, Issues in Simplification of the Income Tax Laws (Comm. Print 1977).

5. Wall St. J., Sept. 14, 1976, at 22.

6. Blum, *Simplification of the Federal Income Tax Law*, 10 Tax L. Rev. 239 (1955).

7. Pub. L. No. 16, § II A, 38 Stat. 166 (1913) [hereinafter referred to as the 1913 Act].

sions in the Code now cover over 1000 pages in the Commerce Clearing House loose leaf Code volume. Another illustration is the growing use of paid tax return preparers. Individual returns signed by tax preparers (*i.e.*, anyone other than the taxpayer) increased from 18.2% in 1954 to 61.6% in 1974.⁸

This article considers some of the reasons why the system is complex. A number of specific areas of complexity are identified. The uncertain future of income tax simplification is discussed. Finally, an integrated set of proposals for radical simplification is presented.

Reasons for Complexity

The primary reason the income tax is complex is that the economic behavior of people in a highly interdependent society is complex.⁹ A complicated income tax is one incident of economies of scale, of skills practiced on the principle of comparative advantage, and of a financial system that permits concentrations of capital. Starting with an economy that is complex, and becoming more so, all a policy of income tax simplification can hope for is to keep complexity to a minimum.

It is difficult for persons not equipped by training or circumstances to comply with any broad-based tax that has its base measured by net income. Even a relatively simple income tax is complicated to people not accustomed to keeping detailed records. Fairness requires that the tax be sufficiently sophisticated to cover non-cash income and cash receipts from other than employers. Fairness also demands that deductions for income-related expenses be permitted in arriving at adjusted gross income. In 1975, 49% of individual income tax returns reported interest income, 10% reported dividends, 9% reported gain or loss on capital assets, and 8% reported rents.¹⁰

Aside from the inevitable consequences of an interdependent economic system, the principal cause of complexity is special or differential treatment of certain categories of income or expense and of certain categories of taxpayers.¹¹

8. Staff of Jt. Comm. on Tax., 95th Cong., 1st Sess., Report, Issues in Simplification of the Income Tax Laws 29 (Comm. Print 1977).

9. See Cohen, *Remarks*, 26 Nat'l Tax J. 311 (1973).

10. Stat. of Income, Individuals 1975—Preliminary 30, Table 7 (1977).

11. *Federal Tax Policy for Economic Growth and Stability: Papers Submitted by Panelists Appearing Before the Subcomm. on Tax Policy, Jt. Comm. on the Economic Report, 84th Cong., 1st Sess. 253 (Jt. Comm. Print 1955) (paper by Walter J. Blum).*

Probably the main force behind this differentiation has been a striving for fairness.¹² Simplification and fairness are not, however, invariably in conflict.¹³ From one point of view it can be argued that removal of at least some of the differences in tax treatment would promote fairness as well as simplification because it would move the tax system toward the goal of treating all similarly situated taxpayers alike.¹⁴ On the other hand, the differences in the situations of taxpayers may be considered so important that fairness requires different tax treatment. In short, the discussion comes down to what is meant by fairness, and to a discouraging degree, "fairness . . . is in the eye of the beholder."¹⁵

For example, extending percentage depletion deductions to taxpayers dredging clam and oyster shells could be defended as treating them fairly in relation to taxpayers mining calcium carbonates from quarries, thereby adding to complexity. Persons who consider the whole percentage depletion system an unfair distinction, however, might view extension to clam and oyster shells as increasing unfairness as well as complexity.

On a broader scale, a progressive individual income tax undeniably is more complex than a flat rate tax.¹⁶ Progressive income tax rates for individuals are fair, however, because, as a general rule, persons with higher incomes can more easily bear higher tax rates.¹⁷ (The further question of whether income tax rates should be progressive to implement a policy of greater equalization of incomes introduces an additional element, independent of both fairness and simplification, that is not discussed here.)

If Congress applies different tax treatment to the special situation of each group and subgroup of taxpayers and each type of income in a quest for fairness, the Code will not be simple. If, on the other hand, Congress should opt for simplification rather than for differences in tax treatment on the theory that simplification is desirable even though the consequences are arbitrary, questions of

12. Mills, *Some Dimensions of Tax Reform*, 23 Ark. L. Rev. 159, 165 (1969).

13. Comm. on Tax Policy, N.Y. State Bar Ass'n, Tax Section, *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325, 334 (1972).

14. *General Tax Reform: Panel Discussions Before the Comm. on Ways and Means*, 93rd Cong., 1st Sess. 12 (1973) (statement of Stanley S. Surrey).

15. *General Tax Reform: Panel Discussions Before the Comm. on Ways and Means*, 93rd Cong., 1st Sess. 154 (1973) (statement of Norman B. Ture).

16. Bittker, *Tax Reform and Tax Simplification*, 29 U. Miami L. Rev. 1, 4 (1974).

17. See C. Galvin & B. Bittker, *The Income Tax: How Progressive Should It Be?* (1969), and E.R.A. Seligman, *Essays in Taxation* 338-42 (1931 ed., 1969 reprint). But see W. Blum & H. Kalven, Jr., *The Uneasy Case for Progressive Taxation* (1953).

whether differential treatment adds to or detracts from fairness would be sidestepped.

Policies designed to achieve specific social or economic results are another source of differences in tax treatment. For example, the investment tax credit is designed to stimulate private investment and modernization of plant and equipment.¹⁸ The new jobs tax credit, on a smaller scale, is designed to stimulate employment—and perhaps to offset the encouragement that the investment tax credit gives to investment in labor-saving machinery and equipment.¹⁹ Deductions allowed for contributions to educational, charitable, and religious organizations are designed to encourage contributions and, thus, to assure that educational, charitable, and religious objectives are achieved.²⁰

Income tax exemption for charitable, educational, religious, and similar organizations does not appear superficially to complicate the tax system. It would seem simpler not to tax an organization than to tax it. Exempt organizations trading in the market place on the dollar leverage from their exemption, however, caused Congress to react with complex provisions taxing their passive investment income financed with borrowed funds and active business income from businesses unrelated to their charitable function.²¹

Some differences in tax treatment have been provided to benefit specific categories of taxpayers considered deserving of special treatment. The additional exemption for blind taxpayers is an example.²² While not complicated at this stage, it is likely to become complicated as other equally deserving groups awaken to the possibility of pressing for the same treatment. Why not an additional exemption for paraplegics or persons on kidney dialysis machines?

The additional exemption for the aged²³ and the tax credit for the elderly also are examples.²⁴ Pressure on Congress to allow either a limited deduction or a tax credit for educational expenses threat-

18. *President's 1961 Tax Recommendations: Hearings Before Comm. on Ways & Means, 87th Cong., 1st Sess. 5 (1961)* (message from President Kennedy).

19. With one econometric model, simulating the effect of a 7% investment tax credit for 1951-1966 resulted in a rise in the unemployment rate for the first three years. Using an alternative assumption that the credit is not passed through in lower prices, the unemployment rate was higher in every year. Coen, *Efficacy of the Investment Credit for Fiscal Purposes*, Nat'l Tax Ass'n—Tax Inst. of Am. Proceedings 33-39 (1975).

20. For discussion, see Andrews, *Personal Deductions In An Ideal Income Tax*, 86 Harv. L. Rev. 309 (1972).

21. S. Rep. No. 2375, 81st Cong., 2d Sess. 31-33 (1950). I.R.C. §§ 511-515.

22. I.R.C. § 151(d).

23. *Id.* § 151(c).

24. *Id.* § 37.

ens an additional complication.²⁵

Some complexities are the result of differences in tax treatment designed to correspond with real or perceived differences in types of income or types of losses. The prime example is the differential treatment of capital gains and losses, which is essentially a duplicate tax system woven into the basic system for the taxation of ordinary income.²⁶

It must be conceded that not all differences in tax treatment are complicating. Postponement of tax on employer contributions to pension and profit-sharing plans until actual distribution is probably simpler than taxing the employees as their rights to the contributions become vested. The tremendous potential for tax avoidance through postponement of tax for highly paid employees, however, resulted in sophisticated provisions to reduce abuse by setting overall ceilings and by placing limits on provisions that discriminate in favor of the highly paid.²⁷ With the passage of the Employee Retirement Income Security Act of 1974 (ERISA) Congress assumed for the Government the added burden of protecting the financial integrity of the pension and profit-sharing plans, introduced a system of mixed Labor Department-Internal Revenue Service jurisdiction, and produced one of the most complex sets of provisions in the Internal Revenue Code.²⁸

Some differences in tax treatment were designed to simplify. The regulation allowing farmers to use the cash method of accounting instead of the accrual method is a good example.²⁹ This exception to the general rule made record keeping and compliance simpler for farmers. In time, the potential for tax postponement by high-bracket taxpayers implicit in this relaxation of normal accrual accounting was developed through syndicated farming operations that made advance payments for farm supplies. Congress countered in the 1976 Act by introducing a set of complex restrictions on the use of the cash method by farmers.³⁰ Farming corporations are now

25. A tax credit for educational expenses was contained in the Senate version of the Tax Reform Bill of 1976 but was deleted in conference. Conf. Rep., Tax Reform Act of 1976, H.R. Rep. No. 94-1515, 94th Cong., 2d Sess. 537 (1976).

26. I.R.C. §§ 1201-1202, 1211-1212.

27. See, e.g., Treas. Reg. § 1.401-3, T.D. 6203, 1956-2 C.B. 219.

28. I.R.C. §§ 401, 402, 408-415, 4971-4975, 6057-6059, 6692, 6693, 7476, 7802, and Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3001-3004, 88 Stat. 829.

29. Treas. Reg. § 1.471-6(a) (1958).

30. Staff of Jt. Comm. on Tax., 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, 40-57 (1976).

generally required to use the accrual method,³¹ and current deductions for feed, seed, and fertilizer by farming "syndicates" are limited to expenditures for amounts used during the year.³²

Some complexities have been introduced into the tax system to protect against tax avoidance techniques. For example, detailed rules were provided limiting a group of closely related corporations to a single \$25,000 surtax exemption as a reaction to wholesale exploitation of the \$25,000 per-corporation exemption by chain stores and small loan companies.³³

Another example of complexities introduced to defend revenues is a provision added by the 1976 Act limiting a partner's deduction of partnership losses to the adjusted basis of the partner's interest, reduced by the partner's share of partnership debts for which he is not liable.³⁴ This provision was in reaction to the technique of deducting partnership losses in excess of cash outlay by having the partnership incur debts for which the partners were not personally liable.³⁵ The correction of this avoidance technique in the 1976 Act is particularly complex because the special basis adjustment of the partnership interest applies only for purposes of computing current partnership losses and not in computing gain or loss on the sale of the partnership interest.³⁶ The result is a two-tier basis—"hard basis" for current loss purposes and a combination of "hard" and "soft" basis for other purposes.

Complexities are also created by rules to circumscribe and rules to administer special tax benefits. An example is the provision for exemption of gain on the sale of a residence for \$35,000 or less by a person who is at least sixty-five years old. The following statutory rules have been provided to govern this exemption:³⁷

1. Rules are provided for jointly owned property;
2. Rules are provided for situations in which only one spouse has reached age sixty-five;
3. The exemption is restricted to one sale per taxpayer;
4. Since it is a once-in-a-lifetime exemption, it is made elective, with the consequent accompanying mechanics of a taxpayer election;

31. I.R.C. § 447.

32. *Id.* § 464.

33. *Id.* §§ 1561, 1563.

34. *Id.* § 704(d). A similar rule was made applicable to four typical forms of tax shelters, whether or not in partnership form. *Id.* § 465.

35. Report: Comm. on Finance, S. Rep. No. 94-938, 94th Cong., 2d Sess. 47 (1976).

36. I.R.C. § 752.

37. *Id.* § 121.

5. To avoid an abrupt cut-off if the sale price of the residence exceeds \$35,000, a rule is provided for exclusion of part of the gain based on the ratio of \$35,000 to the sale price;

6. Apparently to limit the exclusion to deserving cases, the property sold must have been the taxpayer's residence for at least five years out of an eight year period;

7. Having set the eight year qualifying period, provision is made for a surviving spouse to apply the decedent spouse's holding period toward the five-out-of-eight-years test;

8. The exclusion covers the stock investment of tenant-stockholders in cooperative housing corporations;

9. Rules are provided for treating a share of the gain as eligible for exclusion where only part of the premises on the property sold were used as the taxpayer's residence; and

10. Coordination is provided with the gain postponement rules for involuntary conversions and for sales of residences by taxpayers generally.

In some instances the tax law has been complicated by legislative compromises. This is, in part, a consequence of a bicameral legislative body. Sharp conflicts between the House version and the Senate version of a provision in a tax bill frequently are resolved by a conference committee compromise that takes part of the House provision and part of the Senate provision, thus compounding the complexity by retaining the complicated features of each version. For example, the House version of the Tax Reform Act of 1969³⁸ would have limited deductions for additions to bad debt reserves by commercial banks to their own bad debt loss experience but would have allowed the banks a ten year loss carryback. The Senate version would have limited additions to bad debt reserves to 1.8% of eligible loans and would not have allowed the ten year loss carryback. The conference committee settled on six years' additions to reserve at 1.2% of eligible loans, then six years' additions at 0.6%, then additions to reserves based on the banks' own bad debt loss experience. The House provision for a ten year loss carryback was retained.³⁹

Sometimes complexities develop during the course of passage through one legislative body. The minimum tax that evolved in the Senate in the course of consideration of the 1969 Act is an example. As it originated with the Senate Finance Committee, the minimum

38. Pub. L. No. 91-172, 83 Stat. 487 (1969). [hereinafter referred to as the 1969 Act].

39. H. Rep. No. 91-782, 91st Cong., 1st Sess. 310 (1969).

tax was a flat 5% tax on tax preference items in excess of a specified exemption.⁴⁰ On the Senate floor the tax was changed to a 10% tax on preference items after subtracting the taxpayer's regular tax as well as the specified exemption.⁴¹ The two changes substantially offset each other and left the revenue effect approximately the same as before, but the tax was more complex and its effect was more difficult for potential taxpayers to determine.

Perhaps the complexities that develop from the reconciliation of differing views during the legislative process can be ascribed to our system of separation of legislative and executive powers. Under a parliamentary system it would be possible, theoretically, for a government backed by a parliamentary majority to introduce a compact tax program and have it passed intact. In practice, however, political compromises also find their way into the work product of parliamentary systems. Certainly the United Kingdom income tax is not notably simple.⁴²

A special breed of complexities results from transitional rules that phase in or phase out tax provisions. There are grandfather clauses that protect persons who relied on the tax law as it was before a change was made, and both stricter and more liberal provisions are sometimes put into effect a little bit at a time. For example, the repeal of the Western Hemisphere trade corporation deduction in the 1976 Act is achieved by scaling down the tax benefit percentage from an initial 14% to 11% in 1976, 8% in 1977, 5% in 1978, 2% in 1979, and zero thereafter.⁴³

On occasion a complicated provision is introduced in an attempt to achieve certainty. An example is the provision that ties allowance of exemption for dependents in the case of children of divorced or separated parents to, first, the parent having custody most of the year; second, the terms of the divorce decree or the agreement of the parents as to who is entitled to the deduction; or, third, the expenditure of specified minimum amounts for the child's support.⁴⁴ The terms of the provision are complicated, but the result is to reduce the number of even more complicated factual disputes as to who provided over half the child's support.⁴⁵

To some degree, Congress and its technicians are criticized for

40. S. Rep. No. 91-552, 91st Cong., 1st Sess. 113 (1969).

41. H. Rep. No. 91-782, 91st Cong., 1st Sess. 301-02 (1969).

42. World Tax Series, Taxation in the United Kingdom, 4-116 (1957).

43. I.R.C. § 922(b).

44. *Id.* § 152(e).

45. For other examples, see Van Horn, *The Need for More Objective Tax Laws*, 51 Taxes 589 (1973).

writing Code provisions in complicated language. Section 341(e), detailing a Congressionally provided escape route from unintended consequences of the collapsible corporation rules, is frequently given as an example of a complex Code provision.⁴⁶ Section 341(e) illustrates one of the reasons for complexity; it provides a comprehensive set of rules for a wide range of conduct by taxpayers engaged in complicated affairs.⁴⁷

Some of the complexity is caused by tax provisions with obscure meanings. These are not necessarily long Code or regulation provisions with complicated wording. Some of the shortest and most easily read Code provisions are the most cryptic. For example, section 162(a) provides for deduction of "all the ordinary and necessary expenses . . . in carrying on any trade or business" The complexities are in the gloss of judicial and regulatory interpretation and not in the language. The operator of an illegal horsebook is denied a deduction for the expense of bribes for protection from police⁴⁸—ordinary and necessary as such bribes may be—but is permitted to deduct rent on the premises used for the illegal business.⁴⁹ A person who reads the simple words of section 162(a) has no appreciation of the requirements for deductible business expenses. In contrast, a person who struggles through section 341(e) will know exactly what that provision does.

Qualification requirements add complexity. These are rules that may or may not be clearly written, but they are difficult to comply with in either case. A good example, which was prompted by years of taxpayer abuse, is the substantiation required by section 274(d) and supporting regulations of deductions for travel and entertainment expenses.⁵⁰

Mere passage of time makes the income tax system more complex. There are accretions of complications, like barnacles on a ship's hull, as new rules are developed to respond to new factual situations. This feature can be overstated, however, because some complications that seem to appear for the first time really have been present all along; they merely have gone unrecognized, or at least

46. Comm. on Tax Policy, N.Y. State Bar Ass'n, Tax Section, *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325, 340 (1972).

47. Cf. *General Tax Reform: Panel Discussions Before the Comm. on Ways and Means*, 93rd Cong., 1st Sess. 117 (1973) (statement by Boris I. Bittker).

48. Charles E. Rank, 12 T.C.M. (CCH) 1161, 22 T.C.M. (P-H) ¶ 53,331 (1953).

49. *United States v. Sullivan*, 356 U.S. 27 (1958).

50. Treas. Reg. § 1.274-1 to 7, T.D. 6659, 1963-2 C.B. 113. See *General Tax Reform: Panel Discussions Before the Comm. on Ways and Means*, 93rd Cong., 1st Sess. 126 (1973) (statement of Boris I. Bittker).

uncodified, for a time. Thus, the potential for divergence between a partner's basis in a partnership interest and the partner's share of the aggregate basis of the partnership's assets existed prior to 1954. Only with the enactment of the 1954 Code did the tax law face the problem and provide rules to deal with it;⁵¹ the complexities were not created but were only recognized and provided for in the 1954 Code.

High income tax rates put added pressure on most of the factors that generate complexity.⁵² A 1% income tax rate would be unlikely to inspire the inventive and often economically wasteful tax shelter devices that developed during the 1960's and 1970's under the pressure of marginal income tax rates ranging up to 70%.⁵³ Similarly, it is unlikely that Congress would be moved to correct a perceived inequity in a 1% tax—whether it was an inequity by which some persons escaped liability or an inequity by which some persons were liable for tax on more than their true income. In fact, Congress apparently has taken the position that a 15% minimum tax rate is not high enough to justify the complexity of carrybacks and carryovers of regular income tax that cannot be used to offset tax preference items in the year of liability, because the 1976 Act eliminated the carryover of such unused regular tax while raising the minimum tax rate to 15%.⁵⁴

Areas of Complexity

As an aid in discovering where simplification might be possible the following major areas of complexity in the Code are identified:

—Differential tax rates on long term capital gains and restrictions on deduction of capital losses.

—Taxation of corporate income and its relationship to taxation of shareholders.

—Finely graduated and varying tax rate schedules.

—Special treatment of contributions to, income earned by, and distributions from pension and profit-sharing plans.

—Travel and entertainment expense deductions.

—Depreciation and depletion deductions.

—Business expense deductions generally.

—Deduction of losses.

51. I.R.C. §§ 743, 754.

52. See Wiegner, *Tax Simplification*, 26 Nat'l Tax J. 337 (1973).

53. The 1913 Act imposed on individual incomes a normal tax of 1% and a surtax at rates ranging from 1% up to 6%. 1913 Act, *supra* note 7.

54. I.R.C. § 56, Pub. L. No. 94-455, § 301(b), 90 Stat. 1549 (1976).

—Deduction of contributions and exemption of the organizations eligible to receive them.

—Personal deductions.

—The investment tax credit.

—The minimum tax.

—Tax consequences of divorce and separation.

—Tax treatment of income from foreign sources.

—The organization, reorganization, and liquidation of corporations.

—Consolidated corporate tax returns.

—Income of trusts.

—Tax treatment of partnerships.

—Timing and measurement of income generally.

—Deductions and exclusions for special situations.

Some of the special provisions in the Code, such as treatment of capital gains and losses, are so broad-based that they are listed separately. Others affect smaller numbers of taxpayers but are, nonetheless, complicated. No attempt is made to provide a comprehensive list; the following partial list illustrates the range and complexity of the special provisions:

a. Deduction of moving expenses;⁵⁵

b. Postponement of gain on the sale of personal residences;⁵⁶

c. Permanent exclusion of all or part of the gain on sale of one residence by a person sixty-five or older;⁵⁷

d. Exclusion of some types of prizes and awards;⁵⁸

e. Exclusion of some scholarships and fellowship grants;⁵⁹

f. Exclusion of death benefits of up to \$5000 paid by a decedent's employer;⁶⁰

g. Exclusion of disability payments for injuries received by Government employees in attacks by terrorists outside the United States;⁶¹

55. I.R.C. § 217.

56. *Id.* § 1034.

57. *Id.* § 121.

58. *Id.* § 74.

59. *Id.* § 117.

60. *Id.* § 101(b).

61. *Id.* § 104(a)(5).

h. Exclusion of employer contributions to qualified group legal service plans for the benefit of employees and exclusion of the value of legal services received under the plans;⁶²

i. Exclusion of certain earnings of shipbuilding contractors if placed in special construction reserve funds;⁶³ and

j. Exclusion of benefits paid by the Veterans Administration.⁶⁴

—Special credits against tax.

In addition to the investment tax credit, the following tax credits, some of which have broad impact on the taxpayer population, have been added to the Code in recent years:

a. The credit for the elderly;⁶⁵

b. The work incentive programs (or WIN) credit;⁶⁶

c. The campaign contributions credit;⁶⁷

d. The earned income credit;⁶⁸

e. The dependent care credit;⁶⁹

f. The new jobs credit;⁷⁰ and

g. The possessions credit.⁷¹

—Procedures for litigating tax disputes.

The Future for Simplification

Given all the reasons why complexities develop, why is there not sufficient pressure for simplification to keep down the proliferation of complications? Pressure for simplification has accompanied the growth of complexity from the beginning.⁷² There have been

62. *Id.* § 120.

63. 46 U.S.C. § 1161 (1970).

64. 38 U.S.C. § 3101 (1970).

65. I.R.C. § 37.

66. *Id.* §§ 40, 50A, 50B.

67. *Id.* § 41.

68. *Id.* § 43. Not applicable to taxable years beginning after 1978. Pub. L. No. 95-30, § 103(b), 91 Stat. 139 (1977).

69. I.R.C. § 44A.

70. *Id.* §§ 44B, 51-53.

71. *Id.* §§ 33(b), 936.

72. See, e.g., the statement in Staff of Jt. Comm. on Tax., 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 (1976), "Tax simplification is the second major goal of the Act."

simplification measures taken in recent years. The eventual phasing out of multiple corporate surtax exemptions makes the law simpler, though a complex provision was applied to implement it.⁷³ The deadwood provisions included in the 1976 Act deleted obsolete provisions and excess verbiage throughout the Code.⁷⁴ In the same Act substitution of the credit for the elderly in place of the retirement income credit was a move toward simplification.⁷⁵ Perhaps the change to a flat zero rate bracket in lieu of the percentage standard deduction in the Tax Reduction and Simplification Act of 1977⁷⁶ simplified computation for low and middle income taxpayers,⁷⁷ though it lacks flexibility in responding to increasing price levels and thus is unlikely to make it attractive for taxpayers to refrain from itemizing personal deductions in future years. The 1977 Act was also designed to broaden the use of tax tables (in lieu of individual computations from rate tables).⁷⁸

Offsetting these simplification measures in the same period have been new sources of complication. Notably, the 1969 Act imposed a new set of regulatory taxes on private foundations⁷⁹ and enacted the minimum tax;⁸⁰ ERISA in 1974 increased the complexity of rules governing pension and profit-sharing plans;⁸¹ the Tax Reduction Act of 1975⁸² enacted the general tax credit⁸³ and the earned income credit⁸⁴ and put into effect complex rules to define persons eligible for oil and gas percentage depletion deductions;⁸⁵ the 1976 Act made the Domestic International Sales Corporation (DISC) provisions more complicated⁸⁶ and enacted complex measures to discourage tax shelters⁸⁷ and to govern disclosure of infor-

73. I.R.C. § 1564.

74. Pub. L. No. 94-455, §§ 1901-1908, 1951-1952, 90 Stat. 1764 (1976).

75. I.R.C. § 37, as amended by Pub. L. No. 94-455, § 503, 90 Stat. 1559 (1976).

76. Pub. L. No. 95-30, 91 Stat. 126 (1977) [hereinafter referred to as the 1977 Act].

77. I.R.C. § 63(d), as amended by Pub. L. No. 95-30, § 102, 91 Stat. 135 (1977).

78. I.R.C. § 3, as amended by Pub. L. No. 95-30, § 101(b), 91 Stat. 131 (1977).

79. I.R.C. §§ 507(c), 4941-4945, as enacted by Pub. L. No. 91-172, § 101(a), (b), 83 Stat. 492 (1969).

80. I.R.C. §§ 56-58, as enacted by Pub. L. No. 91-172, § 301, 83 Stat. 580 (1969).

81. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

82. Pub. L. No. 94-12, 89 Stat. 26 (1975) [hereinafter referred to as the 1975 Act].

83. I.R.C. § 42.

84. *Id.*, § 43.

85. *Id.*, § 613A.

86. *Id.*, §§ 992-993, 995-996, as amended by Pub. L. No. 94-455, § 1101, 90 Stat. 1655 (1976).

87. I.R.C. §§ 163(d), 189, 278, 464-465, 704(b), (d), 1056, 1254, as amended or enacted by Pub. L. No. 94-455, §§ 201-214, 90 Stat. 1524 (1976).

mation in individual files;⁸⁸ and the 1977 Act introduced the new jobs tax credit.⁸⁹

Every indication from past experience points to a further increase in the complexity of the income tax system. Both Congress and the public, when confronted with a choice between simplicity and what they conceive as fairness, choose fairness.

Although they may not like its complexity, the beneficiaries of a complex tax provision invariably will opt for the complexity in preference to the simple alternative of losing their tax benefit.⁹⁰ No one wants the income tax to be more complicated—even the accountants and lawyers who are accused sometimes of being the beneficiaries of the complexity⁹¹—but they will settle for more complexity to get, or keep, a benefit. For example, corporations with literally hundreds of subsidiaries operating in separate locations preferred a complex election to be subject to an additional tax as the price for keeping their multiple corporate surtax benefits. This tax was imposed by the Revenue Act of 1964⁹² as a compromise in lieu of outright repeal of multiple surtax exemptions.⁹³ In the 1969 Act, this provision was phased out over five years, finally culminating in complete repeal of the multiple surtax exemptions after 1974.⁹⁴

Pressure from public opinion for simplification is generalized. Pressure for differential treatment of a particular category of income or of a particular bloc of taxpayers, with its attendant complexity, is specific. Such specific pressure exerts a stronger force on Congress and on the executive branch with respect to a narrow provision than does generalized pressure.⁹⁵ The general public annoyance at a complex income tax law and a complex income tax return has not been brought to bear on specific causes of complexity.⁹⁶

88. I.R.C. §§ 6103, 6110, as enacted by Pub. L. No. 94-455, §§ 1201-1202, 90 Stat. 1660 (1976).

89. I.R.C. §§ 44B, 51-53, as enacted by Pub. L. No. 95-30, § 202, 91 Stat. 141 (1977).

90. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 Law and Contemp. Prob. 673, 691 (1969).

91. See the reference by Ass't Sec'y of Treas. Edwin Cohen to the "Lawyers and Accountants Relief Act of 1969," Wall St. J., Apr. 13, 1970, at 16, col. 4.

92. Pub. L. No. 88-272, 78 Stat. 19 (1964).

93. Pub. L. No. 88-272, § 235, 78 Stat. 116 (1964).

94. I.R.C. § 1564.

95. *Federal Tax Policy For Economic Growth and Stability: Papers Submitted by Panelists Appearing Before the Subcomm. on Tax Policy, Jt. Comm. on the Economic Report, 84th Cong., 1st Sess.* 260 (Jt. Comm. Print 1955) (paper by William L. Cary).

96. A study of public attitudes by the Roper Organization, Inc. indicates the public would not support simplification. When presented with two specific alternative tax plans that would broaden the tax base and lower tax rates while simplifying return forms and instructions, the sample interviewed rejected them in favor of the current tax system by a margin

The prospects for gradually simplifying the income tax are bleak. Even if public opinion for simplification could be mobilized, the public's interest is unlikely to be sustained through years of arcane technical disputes over step-by-step moves toward simplification.⁹⁷

The conventional wisdom on how to achieve success with Congress is to concentrate on small, attainable goals and to avoid stirring up any more opposing pressure groups than is absolutely necessary. The history of the federal income tax since 1913 and an analysis of the reasons why the tax is complex indicate, however, that working for small moderate goals will not result in a materially simpler tax system.⁹⁸ At best, it might slow the rate of increase in complexity. In time, the public may come to abandon even the goal of tax simplification and shift to "controlling" the rate of increase in the complexity of the tax system.

A Program For Income Tax Simplification

If substantial simplification can be achieved—and perhaps it cannot—the only hope appears to be through a radical revision put through as a single revenue bill that could be a focus for the public's generalized interest in simplification.

The purpose here is to present a set of proposals for simplification of the federal income tax that is sufficiently radical to do most of the job in one tax bill. Perhaps the proposals will be sufficiently attractive, as a whole, to succeed in being enacted by overcoming the objections of enough taxpayers who benefit, or think they benefit, from the present complex system.

These proposals are consistent with the principles of a progressive income tax. Although marginal rates on individuals would not range up to 70% as they do now, the program well might achieve higher effective rates on the economic income of high-income indi-

of two to one. I Roper Organization, Inc., *The American Public and the Income Tax System* 30 (1977) (commissioned by H & R Block, Inc.).

97. "Our present political process is incapable of achieving meaningful, overall tax reform." John S. Nolan, "A New Tax Structure for the United States," Remarks delivered in Univ. of Mich. Key Issues Lecture Series (Mar. 30, 1977). Nolan suggested a Hoover-type commission to make detailed tax revision recommendations to Congress over a six-year period, the recommended legislation to become effective at the end of the six-year period with generous transition rules.

For a more optimistic view of the prospects for income tax simplification, see Cohen, *Substantive Federal Tax Reform*, 50 Va. L. Rev. 628 (1964).

98. S. Surrey, *Pathways to Tax Reform* 34 (1973): "[T]he income tax system becomes increasingly more complex as each revision or reform passes into tax history."

viduals than are achieved at present.⁹⁹

The proposals are an integrated package. Many of them would not be feasible unless other parts of the program were enacted. These proposals would not make the federal income tax simple. In this complex economy a tax could not be made simple without sacrificing basic principles of fairness. What the proposals would do is eliminate what are believed to be unnecessary complexities. In some instances, however, the system would be fairer than it is now.¹⁰⁰ Almost certainly taxpayers would be able to anticipate the impact of the tax more accurately which, if the taxpayers are economic beings, should lead to a more economic allocation of resources.

PROPOSAL 1. REVISE THE INDIVIDUAL TAX RATE SCHEDULES BY DROPPING THE PRESENT SYSTEM OF 25 OR MORE RATE BRACKETS AND SUBSTITUTING THREE RATE BRACKETS—LOW, MEDIUM, AND HIGH.¹⁰¹

As an example, the tax on married individuals filing joint returns might be 20% on the first \$20,000, 35% of the next \$20,000, and 50% on the excess over \$40,000. The rates mentioned are only for illustration. Actual rates could be set consistent with revenue needs. The only constraint is that Proposals 7 through 10 require that the tax rate on income of corporations, trusts, and some estates be equal to the highest rate for individuals. A top rate for individuals of 50% would be feasible in this context.¹⁰² In a sense, 50% as a

99. Using an expanded definition of adjusted gross income, Pechman estimated present law effective tax rates for 1972 at 23.5% for incomes of \$50,000 to \$100,000, ranging up to 32.1% for incomes of \$1,000,000 and over. *General Tax Reform: Panel Discussion Before the Comm. on Ways and Means*, 93rd Cong., 1st Sess. 152 (1973) (statement of Joseph A. Pechman).

For discussion of flaws in the assumptions behind calculations of effective tax rates based on "real" income, see Bittker, *Effective Tax Rates: Fact or Fancy?*, 122 U. Pa. L. Rev. 780 (1974).

100. "The tax expenditure measures are the items that have led to the greatest amount of tax complexity, and are clearly the provisions whose elimination would have little or no cost in decreased equity." Address by Comm'r Kurtz before Assembly of the Inter-American Center of Tax Administrators (May 9, 1977), reprinted in 123 Cong. Rec. S. 8349 (daily ed. May 23, 1977).

101. See Treasury Department, *Blueprints for Basic Tax Reform 8* (1977), and Klein, *A Proposal to Simplify the Income Tax Rate Structure*, 1964 Wis. L. Rev. 539.

102. Secretary of the Treasury Michael Blumenthal has said, "As for marginal rates, no taxpayer, in my judgment, should be forced to turn over more than half of each additional dollar he acquires through effort or investment." Remarks, Oct. 19, 1977, Treasury Department News Release 4 (Oct. 19, 1977).

Congressman Corman's bill, The Tax Equity Act of 1977, H.R. 1040, § 301, 95th Cong.,

top rate for individuals already has been accepted in principle by the adoption of the 50% ceiling on the tax on personal service income.¹⁰³ A 50% maximum rate on investment income of individuals would not be a windfall when taken together with Proposal 4 which would tax capital gains as ordinary income.

Rates below the maximum rate and the size of the brackets could be varied to accommodate the four rate schedules in present law for individuals filing joint returns, heads of households, unmarried individuals not eligible for the first two schedules, and married individuals filing separate returns.

Further simplification could be achieved if Congress would be willing to impose the tax without regard to the assignment of income imposed by statute in the community property states.¹⁰⁴ This would have the additional advantage of solving the nagging problems of tax rate discrimination against unmarried individuals and against married couples when both husband and wife have substantial income. In other words, earned income could be taxed to the spouse who earns it in community property states as well as in common law states (as is already done in the case of the tax on self-employment income)¹⁰⁵ and the spouse who owns an investment could be taxed on the investment income. Married couples in community property states would have some advantage over those in common law states under such a system because of the splitting of investment income from community property, but couples in common law states could be permitted to redress the balance by equalizing their ownership of investment assets by interspousal gifts. Joint returns still could be permitted as a convenience to married taxpayers, but they would be practical only in cases where combining the incomes would not result in a higher marginal tax rate.

1st Sess., provides a 50% maximum tax rate for individuals. The Canadian Carter Commission recommended a top marginal tax rate on personal income of 50%. The 50% marginal rate was recommended to be consistent with the 50% corporate tax rate, which the Commission recommended retaining, because individuals should not be able to postpone their taxes by retaining profits in their corporations. The Commission also proposed that resident shareholders be given credit for corporation taxes. 1 Report of the Royal Commission on Taxation 20 (1966). *Contra*, S. Surrey, P. McDaniel, & J. Pechman, Eds., *Federal Tax Reform for 1976* (1976).

103. I.R.C. § 1348.

104. *Poe v. Seaborn*, 282 U.S. 101 (1930), holding that the Revenue Act of 1926 did not tax all income to the spouse who earned it in a community property state, involved a question of statutory construction. The Court did not hold that it would be unconstitutional to tax income to the earner before it became property of the marital community. *Cf. Lucas v. Earl*, 281 U.S. 111, (1930).

105. I.R.C. § 1402(a)(5).

Given the lack of precision in measuring taxable income and the numerous exceptions in the tax law, the present sets of narrow rate brackets give a false illusion of precision. Rates that vary by one, two, or three percentage points from bracket to bracket do not reflect with such precision the marginal tax rates on economic income for most taxpayers. For example, even a low-income taxpayer who owns his own home is taxed on a significantly lower marginal rate on real income than a renter with the same salary.¹⁰⁶

With only three tax brackets, most individuals would know what their marginal tax rates would be for the year and could make informed economic decisions accordingly. Also, if the present differential rate schedules for married persons and single persons were retained, the wide brackets would reduce substantially the number of instances in which marital status affects the marginal rate.

PROPOSAL 2. REPEAL THE GENERAL TAX CREDIT.

Whatever the relative merits are of a tax credit as contrasted with taxpayer and dependent exemptions, simplification dictates the choice of one or the other rather than the present system of both exemptions and a small tax credit.¹⁰⁷ There is a general impression among proponents of a progressive income tax that a credit against tax is more progressive than a personal exemption applied to reduce taxable income.¹⁰⁸ As Gerard Brannon and Elliott Morss have pointed out, however, it is not necessary to shift from exemptions to credits to satisfy whatever rate of progressiveness is desired; the rate schedule itself can be used to adjust for the fact that exemptions are worth more to taxpayers with high marginal tax rates.¹⁰⁹

PROPOSAL 3. ELIMINATE THE ZERO BRACKET AMOUNT AND REINSTATE THE OPTIONAL STANDARD DEDUCTION AS A PERCENTAGE OF ADJUSTED GROSS INCOME.

The zero bracket amount¹¹⁰ attempts to accomplish two things. First, it sets a floor on taxed income for low-income taxpaying units and, second, it provides a substitute for itemizing personal deductions from adjusted gross income.¹¹¹ The considerations that dictate

106. See R. Goode, *The Individual Income Tax* 117-25 (rev. ed. 1976).

107. I.R.C. § 42. The general tax credit is scheduled to cease to apply after 1978. Pub. L. No. 95-30, § 103, 91 Stat. 139 (1977).

108. 123 Cong. Rec. E1206 (daily ed. Mar. 3, 1977) (remarks of Rep. Corman).

109. Brannon & Morss, *The Tax Allowance for Dependents: Deductions Versus Credits*, 26 Nat'l Tax J. 599 (1973).

110. I.R.C. § 63(d).

111. S. Rep. No. 95-66, 95th Cong., 1st Sess., 48-49 (1977). A minimum lump-sum

the size of a low-income floor on taxable income are not the same as the considerations for an optional deduction in lieu of itemized personal deductions. The optional standard deduction was designed to relieve taxpayers and the Revenue Service from the complexities of calculating, substantiating, and auditing small personal deduction items such as charitable contributions and non-business interest deductions.¹¹² If the amount of the optional standard deduction is held down to an amount considered appropriate for outright exemption of low-income earners, it will not simplify the returns of middle-income taxpayers. Rather than dispensing with the optional standard deduction as a percentage of adjusted gross income, it would be advisable to increase drastically the previous ceiling—perhaps to \$5000.¹¹³ The standard deduction percentage could be relatively low if Proposal 12 is accepted.

Because the zero bracket amount is a flat amount for the tax reporting unit, it widens the area of discrimination between single persons and married persons. Two zero bracket amounts for single persons total \$1200 more than the zero bracket amount for a joint return, thus adding to the rate bracket discrimination against married couples with approximately equal incomes. On the other hand, the zero bracket amount is \$1000 higher for a married couple with only one income producer than it is for a single taxpayer, thus adding to the rate bracket discrimination against the single person compared to the one-income married couple. Two trends make it advisable to deal with this problem before it gets worse. First, more wives are working and, with less pay discrimination against them, they are coming increasingly into situations in which their incomes approximate the incomes of their husbands. The second trend relates to social change: there is increasing willingness to forego the formality of marriage, so a perceived tax discrimination against married couples if each has income may have a significant effect on the number of marriages.

PROPOSAL 4. ELIMINATE THE DIFFERENTIAL TAX TREATMENT OF GAINS AND LOSSES ON CAPITAL ASSETS.

It is proposed that gains from sale or exchange of capital assets

deduction was suggested as early as January, 1944. Hulse, *Minimum Lump-Sum Deduction for Individuals*, 22 *Taxes* 20 (1944).

112. Woodworth, *Tax Simplification and the Tax Reform Act of 1969*, 34 *Law & Contemp. Prob.* 711, 713 (1969).

113. The highest optional standard deduction for 1976, before its repeal, was \$2,800 in the case of a joint return. I.R.C. § 141(b)(1) (repealed by Pub. L. No. 95-30, § 101(d)(1)).

and section 1231 assets be treated as ordinary income¹¹⁴ and that losses from sale or exchange of capital assets and section 1231 assets be treated as ordinary losses, eligible to offset ordinary income in full.¹¹⁵

Adoption of this proposal would permit sweeping simplification measures. The present treatment of capital gains and losses has been called "perhaps the single most complicating aspect of existing law."¹¹⁶ The complex alternative tax provisions would be eliminated.¹¹⁷ Separate capital loss carryover rules would no longer be necessary. Separate computations for section 1231 assets would be dispensed with.¹¹⁸ Section 1245 and section 1250 depreciation recapture rules could be eliminated because recapture of excess depreciation on recognized gains as ordinary income would be automatic. Problems of defining capital assets would be eliminated, including the complex statutory rules for distinguishing capital investments both of stockbrokers and of real estate subdividers.¹¹⁹ There would no longer be need for treating part of capital gains as tax preference items.¹²⁰ In the area of corporation-stockholder relations, the collapsible corporation provisions could be repealed.¹²¹ The rules distinguishing business and capital losses would become unnecessary.¹²² The taxpayer-Revenue Service conflict over tax-avoidance efforts to transmute ordinary income into capital gains would be eliminated.

The one essential difference between capital gains and losses and ordinary income and losses is the control the taxpayer usually has over realization of capital gains and losses in contrast to his inability to postpone indefinitely ordinary income and losses. Con-

114. Full inclusion of capital gains in ordinary income has been suggested frequently, most recently by Secretary of the Treasury William E. Simon in the model comprehensive income tax described in Treasury Department, *Blueprints for Basic Tax Reform 17* (1977).

For a presentation of the arguments pro and con, see Blum, *A Handy Summary of the Capital Gains Arguments*, 35 *Taxes* 247 (1957).

115. *Blueprints for Basic Tax Reform*, *supra* note 114, at 5.

116. *General Tax Reform: Panel Discussions before the Comm. on Ways and Means*, 93rd Cong., 1st Sess. 118 (1973) (statement by Boris I. Bittker).

"Failure to tax capital gains as ordinary income is an all-pervasive source of trouble in the Internal Revenue Code." *Id.* 284 (statement of Richard A. Musgrave).

See Surrey, *Definitional Problems in Capital Gains Taxation*, 69 *Harv. L. Rev.* 985 (1956).

117. I.R.C. § 1201.

118. *Id.* § 1212.

119. *Id.* §§ 1236, 1237.

120. *Id.* § 57(a)(9).

121. *Id.* § 341.

122. *Id.* §§ 165, 166.

sequently, as long as the tax is based upon the present concept of realization, there will be a potential for taxpayers to realize capital losses to offset ordinary income while postponing realization of capital gains. This behavior by taxpayers led to enactment in 1932 and 1934 of restrictions on deduction of capital losses.¹²³ The logic and the concept of fairness that support taxing gains on capital assets at the same rate as other income, however, dictates with equal force that losses on capital assets be allowed in full when realized. The effect on revenue of full allowance of capital losses might be reduced by requiring realized losses in excess of gains to be applied first against the taxpayer's unrealized, or "paper" gains on marketable securities. To the extent the losses were offset by such unrealized gains the taxpayer would increase the basis of the appreciated securities rather than deducting the losses against current income.

PROPOSAL 5. REPEAL THE TAX CREDITS DESIGNED AS BUSINESS INCENTIVES AND REPLACE THEM WITH DIRECT TRANSFER PAYMENTS OUTSIDE THE TAX SYSTEM.

Neither the investment credit, the WIN credit, nor the new jobs credit is relevant to the measurement of taxable income or the determination of tax liability. Recent proposals that the investment credit be made "refundable"¹²⁴ recognize that the credit has no necessary connection with the income tax. The "refundable" credit would be remitted to an eligible investor as a direct payment in cases where the credit exceeds current income tax liability.

The "refundable" credit is logical. There is no more reason to reward a business for investment in depreciable property if the business has taxable income than to reward a business that makes an identical investment but has a net operating loss. The same principle applies equally to the other business incentive tax credits. The policy objective of increasing employment is equally well served regardless of whether the employer has incurred income tax liability.

In moving from tax credits to refundable credits congressional thinking has come almost full circle back to direct subsidies. In the course of debate on H.R. 8444, the Energy Tax Bill of 1977,¹²⁵ the

123. Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 Nat'l Tax J. 12, 18-22 (1949).

124. S. Surrey, P. McDaniel, & J. Pechman, Eds., *Federal Tax Reform for 1976* 126 (1976); and 123 Cong. Rec. S11,411 (daily ed. July 1, 1977) (remarks of Sen. Kennedy).

125. Passed by the House on Aug. 5, 1977.

Senate, to comply with its own rules for appropriation authorizations, ordered the bill referred to the Appropriations Committee and ordered the Appropriations Committee to report back immediately with an amendment to strike out two of the refundable credits that were in the bill as reported by the Finance Committee. The Appropriations Committee's proposed amendment then was defeated on the Senate floor.¹²⁶

Incorporating the business incentive tax credits in the income tax structure has added additional complexities for which the income tax should not be blamed. Administration of these credits is necessarily complex, and the proposal made here will not make it any simpler. Instead, the proposal would merely shift the blame for these complexities away from the tax system.

Converting the business incentive tax credits to direct payments, regardless of tax liability, should help put the incentives in better perspective for judging their cost and their desirability. These tax credits are the clearest examples of the "tax expenditure" concept that conferring a special tax benefit is equivalent to spending Government funds.¹²⁷ Converting them to direct payments—administered, perhaps by the Department of Commerce instead of by the Treasury Department—would bring them under the annual appropriations mechanism and focus attention on their cost effectiveness.¹²⁸

In the absence of specific exclusions, the business incentive transfer payments that are proposed would be included in the gross income of the recipients.¹²⁹ Such inclusion would reduce their effectiveness as incentives, but this could be adjusted easily by increasing the amounts of the payments. In the case of the investment credit, taxpayers, as an alternative to direct inclusion in income, could be permitted to reduce the adjusted basis of the assets acquired to earn the payments. Such treatment would be analogous to the election under section 108 to reduce basis in lieu of inclusion of forgiveness of indebtedness income.¹³⁰ This would mean, essen-

126. 123 Cong. Rec. S18,044-52 (daily ed. Oct. 28, 1977).

127. Cf. Congressional Budget Act of 1974, Pub. L. No. 93-344, § 202(f)(1)(B), 88 Stat. 304.

128. For a general discussion of tax incentives compared to direct expenditures, see S. Surrey, *Pathways to Tax Reform* 129-54 (1973). Professor Surrey did not recommend replacing the investment tax credit with direct grants.

129. See *General Tax Reform: Panel Discussions Before the Comm. on Ways and Means*, 93rd Cong., 1st Sess. 713 (1973) (statement of Paul R. McDaniel).

130. See Sunley, *Towards a More Neutral Investment Tax Credit*, 26 Nat'l Tax J. 209 (1973). Under the investment tax credit as originally enacted, the basis of eligible assets was reduced by the tax credit. I.R.C. § 48(g)(1) (repealed by Pub. L. No. 88-272, § 203(a)(1)).

tially, that the payment by the Government would be treated as a discount on the purchase price of the asset that generates the incentive reward. Such treatment would be more consistent with the basic principles of the income tax than is the present system under which the investment credit is a tax-free reward.

In any event, the objectives of the investment credit, to the extent they can be achieved at all, can be achieved more fairly and efficiently by shortening the period for recovery of the investment through depreciation. Proposal 6 suggests a substitute for the present system of depreciation deductions that would make shortening of the recovery period a feasible substitute for either the investment credit or the direct incentive payment suggested here.

PROPOSAL 6. SUBSTITUTE A SCHEDULE OF MAXIMUM ANNUAL CAPITAL COST RECOVERY ALLOWANCES IN LIEU OF PRESENT DEPRECIATION DEDUCTIONS.¹³¹

The provision in the Code for depreciation deductions has been gradually liberalized by overlaying one provision after another on a basic structure that, in theory, still is keyed to allowing depreciation deductions over the useful life of the asset to the taxpayer. Liberalization has come successively through provisions for the double declining balance and sum-of-the-years-digits methods,¹³² automatic exclusion of 10% of the cost of personal property assets from disputes as to salvage value,¹³³ liberal class lives limited by a reserve ratio test,¹³⁴ and, finally, the Asset Depreciation Range (ADR) system for using class lives within a range of 20% of those prescribed by regulation.¹³⁵

What is suggested here is scrapping everything except the ADR lives and expressing these lives (or different lives if desired) in terms of annual, maximum cost recovery allowance rates. Taxpayers would be permitted to use in each year any cost recovery rate from zero up to the maximum rate for each category of assets.

The rate would be applied to the entire basis of the depreciable asset with no allowance made for salvage. The rate would be applied each year on the declining balance of undepreciated basis. This

131. For a similar proposal, see Williams, *Simplification of the Federal Tax Laws for Corporations*, 26 Nat'l Tax J. 331, 332-34 (1973).

132. I.R.C. § 167(b).

133. *Id.* § 167(f).

134. Rev. Proc. 62-21, 1962-2 C.B. 418.

135. I.R.C. § 167(m), authorizing and modifying the ADR system adopted by the Treasury Department earlier in 1971.

system would be quite similar to the Canadian system.¹³⁶

Increasing the maximum annual cost recovery allowance rates would be a feasible substitute for the investment credit.¹³⁷ As originally proposed by President Kennedy, the investment tax credit would have been allowed primarily on incremental investment.¹³⁸ This aspect of the original proposal soon was dropped, however, and instead, Congress enacted a smaller credit on gross investment. In contrast, any system of depreciation, or cost recovery, that allows recovery of the full cost of depreciable assets while they are still useful to the business eventually evolves to the point that the reward through accelerated deductions is available only for additional investments above the original investment rate, so that the incentive element will become a reward for incremental investment.¹³⁹

Also, the present investment credit is a clumsy tool because it has only one rate for rewarding all assets with a useful life of seven years or more. Thus, a taxpayer investing in assets with seven year lives is rewarded three times as often as a taxpayer with assets that are replaced only after twenty-one years. And, because the credit is not limited to incremental investment, the reward has to be paid for investments that needed no incentive and would have been made to replace old assets in any event.

PROPOSAL 7. IMPOSE A FLAT-RATE CORPORATE INCOME TAX AT THE MAXIMUM INDIVIDUAL INCOME TAX RATE.

This proposal assumes a substantial reduction in the maximum individual income tax rate. As stated under Proposal 1, for purposes of discussion it is assumed that the maximum individual rate will be set at 50%. Using a single corporate tax rate and linking it to the

136. Couzin, *Business Operations in Canada*, 45-5th Tax Mngm't (BNA) A-23 (1975).

137. For discussion of the alternatives of investment tax credit or accelerated depreciation, see Brannon, *A Requiem for the Investment Tax Credit*, Tax Incentives 175, 189-93 (1969). Professor Brannon chose the investment credit alternative. (The requiem proved to be premature.)

138. *President's 1961 Tax Recommendations: Hearings Before Comm. on Ways and Means*, 87th Cong., 1st Sess. 6 (1961) (message from President Kennedy).

139. Depreciation deductions based on lives shorter than useful lives postpone payment of tax. For a taxpayer replacing depreciable assets continuously at a level rate the effect is indefinite postponement (in practical effect, permanent postponement) of payment of tax on an amount equivalent to the excess of the speeded-up depreciation deductions on the initial investment cycle over whatever the depreciation deductions otherwise would have been for the same period. Once this postponement has been achieved, however, any additional tax benefit can be achieved only by increasing the dollar volume of investment in depreciable assets. See J. Brittain, *Corporate Dividend Policy* 44, 45 (1966).

maximum individual rate would permit full integration of the corporate and individual income taxes under Proposal 8.

Elimination of the corporate surtax exemption is proposed for three reasons. First, the present provision against abuse of the surtax exemption by multiple corporations with the same owners is complex.¹⁴⁰ Second, taxing all corporate income at the full corporate rate permits an assumption that the income has been fully taxed and need not be taxed again at the shareholder level. This point is developed further in Proposal 8. Third, the corporate surtax exemption is an illogical application of the ability-to-pay principle.

The size of a corporation or the amount of its income bears no necessary relation to the ability of its shareholders to pay. If the corporate tax rate is less than an individual shareholder's marginal tax rate, the stockholder has been given an opportunity to split income and save tax that is not available to other persons.

If one focuses on the taxable corporate entity and ignores the tax status of the stockholders, there still is no basis for a progressive corporate income tax. The income after tax either will be reinvested or distributed to stockholders, so there is no basis for saying the corporate tax rate is a heavier burden on a corporate taxpayer with a small income.

Full integration and complete avoidance of double taxation of corporate earnings would not be possible under Proposal 8 if some corporate income is taxed at less than the highest individual income tax rate. Elimination of double taxation (or the threat of double taxation) should be of more long-term benefit to the owners of a small corporation than a surtax exemption.

Large businesses have no real alternative to the corporate form of doing business. Ordinarily they remain in existence indefinitely with ample opportunity to reinvest retained earnings so that the second tax imposed on dividends applies to only a part of their earnings and profits. In contrast, small and medium size businesses are confronted with the dilemma of choosing between the corporate and noncorporate forms for doing business and are largely at the mercy of future events that determine the degree of impact of the double tax on the owners.

140. I.R.C. §§ 1561, 1563.

PROPOSAL 8. INTEGRATE CORPORATE AND INDIVIDUAL INCOME TAXES BY EXCLUDING DIVIDENDS PAID BY DOMESTIC CORPORATIONS FROM GROSS INCOME.¹⁴¹

This proposal is based on the premise that corporations should properly be treated as taxable entities. If a corporation generates net income it is logical to tax that income regardless of the status of the stockholders. A business corporation operates in the market place as a business entity competing with other businesses, corporate and noncorporate, and taking advantage of a corporation's continuity of existence and facility in assembling capital and managing operations. As such, it is a logical and viable taxpayer in its own right.

Starting with the foregoing premise, if relief from double taxation is to be provided, it must be provided by relieving shareholders from the second tax when dividends are received.

The proposed dividend exclusion would be limited to dividends paid from corporate income earned after the effective date of the change. Allowing the exclusion to apply to distributions of previously accumulated earnings and profits would produce an unjustifiable windfall because business decisions of corporations, their shareholders, and their former shareholders during the period the earnings were accumulated were based on the assumption that the dividends would be taxed. Also, it would be unfair to distribute previously accumulated corporate earnings and profits on the assumption that they had been fully taxed at the corporate level when, in fact, they may have been only partially taxed (because of the surtax exemption) or untaxed (because of inclusion of various untaxed items—such as accelerated depreciation—in accumulated earnings and profits accounts).¹⁴²

In addition to limiting the proposed exclusion to dividends paid out of earnings and profits earned after the effective date of the change, the present presumption in section 316(a) of the sequence

141. For a summary of an array of alternative proposals for complete or partial integration of corporate and individual taxes, see Staff of Jt. Comm. on Tax., 95th Cong., 1st Sess., Tax Policy and Capital Formation 10-17 (Comm. Print 1977).

The Canadian Carter Commission recommended full integration by taxing corporations at a flat 50% rate, taxing individuals at progressive rates with a top marginal rate of 50%, including dividends grossed up by corporate tax paid in resident shareholders' incomes, and allowing resident shareholders credit for the corporate tax paid. 4 Report of the Royal Commission on Taxation 7 (1966). The Carter Commission rejected the alternative of imposing no further tax on dividends to resident shareholders, however, because the Commission started from the premise that it was not proper in principle to tax corporations or other organizations. *Id.* at 4, 45. See Van Sickle, *Reform of the Federal Taxes on Personal and Corporate Income*, 34 Am. Econ. Rev. 848 (1944).

142. Staff of Jt. Comm. on Tax., *supra* note 141, at 11.

in which earnings and profits are distributed would be reversed. In other words, each dividend distribution would be presumed to be from the earliest post-March 1, 1913 earnings remaining in the corporation's accumulated earnings and profits account. Dividends would be paid from current earnings and profits only after the post-March 1, 1913 accumulated earnings and profits account had been exhausted.

Reversing the sequence of distribution of earnings and profits would accomplish several things. First, it would minimize the wind-fall benefits to stockholders in publicly held corporations as a result of eliminating the double tax on dividends. Second, it would reduce greatly the initial revenue loss from integrating the two taxes. Third, it would equate the treatment of corporations that have accumulated income in past years with the treatment of corporations that have paid out their earnings as dividends in past years. Fourth, it would give an advantage in the capital markets to new publicly held corporations over established corporations with substantial accumulated earnings and profits.

Reversing the sequence of distribution from earnings and profits accounts admittedly adds a complication. Although corporations are supposed to know what their accumulated earnings and profits accounts contain, some do not. Not knowing the precise amount in the accumulated earnings and profits account was not a practical problem for many corporations as long as they did not attempt to compute excess profit tax credits based on invested capital during the World War I, World War II, or Korean War excess-profits tax periods or to distribute more than current earnings and profits and more than they were certain was contained in accumulated earnings and profits. Under the proposal, if a corporation wanted to clear out its accumulated earnings and profits account so that subsequent distributions could be excluded by the shareholders, it would be necessary to determine the precise amount in the account. For many corporations the question would still be of no practical consequence for many years, however, because they will feel that they cannot afford to distribute enough to eliminate the accumulated accounts quickly and it will take years of dividend payments in the regular course to distribute the earnings and profits accumulated before the effective date of the change.

The difference in treatment of distributions out of prior accumulations would make it necessary for corporations to notify dividend recipients as to whether or not the dividends were excludable. Except in marginal cases, however, this would be a simpler determination than the determination that is now made by corporations

whose distributions are paid out of capital.

Under the proposal the corporate tax would not be considered an advance payment of shareholders' tax that had been withheld at the corporate level. Therefore, there would be no refunds of the corporate tax to dividend recipients who are untaxed individuals or exempt organizations. The integration proposal is consistent with the taxation of active business income of exempt organizations and the taxation of feeder corporations owned by exempt organizations.¹⁴³

The definition of earnings and profits earned in years after the effective date of the change would have to be modified to match the definition of taxable income, with four exceptions:

(a) Earnings and profits would be reduced, as at present, by the income tax paid by the corporation.

(b) Earnings and profits would include intercorporate dividends received if paid out of earnings after the effective date of the integrated system. (Such dividends would be excluded from taxable income of corporations just as they would be excluded from the taxable income of individual shareholders).

(c) Intercorporate dividends that are paid out of earnings and profits accumulated prior to the effective date of the integrated system would be treated by the recipient corporation as though they were earnings and profits accumulated by it before the effective date.

(d) Tax exempt interest would not be included in current earnings and profits, but would be added to the account for earnings and profits accumulated before the effective date.

Corporations no longer would be allowed net operating loss carrybacks, capital loss carrybacks, unused foreign tax credit carrybacks, or other carrybacks because such carrybacks could invalidate the basis for tax-free dividends previously paid.

The proposal would not affect the treatment of distributions that are not out of earnings and profits. Such distributions would continue to be applied against the basis of the stock and distributions in excess of the basis of the stock would be treated as gain to the shareholders.¹⁴⁴ Under Proposal 4 this gain would be taxed as ordinary income. Gain on redemptions or on complete or partial liquidations would be recognized as at present. Under Proposal 4 such gain would be taxed as ordinary income.

The proposed dividend exclusion would not apply to dividends

143. I.R.C. §§ 511, 502.

144. *Id.* § 301(c)(2), (3).

received from foreign corporations. Although many foreign corporations paying dividends will have borne an income tax equivalent to the United States income tax, others will have borne lesser foreign income taxes. Since the central purpose of the proposal is simplification, the possibility of determining whether a particular distribution of earnings and profits by a foreign corporation was out of income taxed as heavily as if it had been fully taxed at the corporate level in the United States has been rejected as too complex. Similarly, dividends from domestic corporations that have elected the section 936 possessions tax credit would not be eligible for exclusion.

This proposal in combination with Proposal 7 would achieve complete integration of corporate and individual income taxes for future operations, except for shareholders who sell or buy stock in corporations that have earned income and have paid tax on it under the integration system but have not yet distributed the earnings as dividends.

This proposal in combination with Proposal 7 would eliminate the need for the tax on unreasonable accumulations and the personal holding company tax. Taken together with Proposal 9, it should, for the first time, provide new businesses with a rational basis for the decision whether to operate in corporate form.

PROPOSAL 9. REPEAL SUBCHAPTER S¹⁴⁵ AND GIVE ALL BUSINESS CORPORATIONS AN OPPORTUNITY TO ELECT TO BE TREATED AS PARTNERSHIPS.¹⁴⁶

Since it is proposed that corporations be taxed at the highest rate applicable to individuals, it is appropriate that they and their shareholders be permitted to sidestep the corporation tax entirely. This would be permitted by an election to be treated as a partnership. The election would be exercisable one time only by each corporation.

The simplest approach would be to limit the partnership treatment to corporations organized after the effective date of the proposed integration of the corporate and individual taxes.¹⁴⁷ Short of that, partnership treatment could be opened to corporations with an earlier history of Subchapter S treatment on condition that they

145. *Id.* §§ 1371-1379.

146. See Pennell, *Subchapter S—The Need for Legislation*, 24 *Tax Law.* 249 (1971).

147. See *Income Tax Revision: Panel Discussions Before the Comm. on Ways and Means*, 86th Cong., 1st Sess. 923 (1959) (statement of Mortimer M. Caplin). *Id.* at 930 (statement of Frederick A. Nicholson).

make an actual or constructive distribution of accumulated earnings and profits.

No earnings or profits account would be maintained by a corporation during the period of its election to be taxed as a partnership.

The complexities of Subchapter S appear, in large part, to be the result of a system that permits corporations to come in and out of Subchapter S without changing their essential nature as corporations. Consequently, it has been necessary to maintain earnings and profits accounts for Subchapter S corporations and to tax the shareholders, not on items of distributive income and deductions, but on constructive dividends out of current earnings and profits. On the other hand, if a corporation could elect partnership status only once during its corporate lifetime, and then only after clearing out its earnings and profits account, it would be feasible to treat it exactly like a partnership and to treat the stockholders as partners while the election is in effect.

A corporation that elected partnership treatment would be free to terminate the election at any time. The consequences of termination would be the same as a section 351 transaction in which partners contribute partnership assets to a new corporation. Once the partnership treatment had been terminated and the corporation commenced, or resumed, life as a taxable corporation, it would not be permitted to revert to partnership treatment.

There would appear to be no need for the complexities engendered by the present Subchapter S provisions that restrict ownership to ten (or fifteen) stockholders, limit ownership by trusts, and prohibit ownership by other corporations.

The tax treatment of partnerships is not simple. Its rudiments are generally understood, however, and the tax law would be simplified by removing the complex in-between status of Subchapter S corporations.

The objective of this proposal is to reduce the instances of quixotic differences in tax consequences between proprietorships and partnerships on the one hand, and corporations on the other.

This proposal would make unnecessary the elaborate and roundabout procedures that groups of investors now go through to prevent their associations from being taxed as corporations and preserve for themselves the right to current deductions. These procedures have become stylized and formalistic to the point that the Tax Court has virtually invited a revision of the distinction between partnerships and associations taxable as corporations in the

regulations under section 7701 of the Code.¹⁴⁸

The solution proposed here is not to force these associations into the corporate mold, but to permit them to avail themselves of partnership tax treatment while using the corporate form as a matter of business convenience. This approach is followed because tax shelter deduction benefits—to the extent they should be permitted at all—are as appropriate for small- and medium-size investors as for large investors. The small investors must band together to finance economically feasible projects. There is no reason why the investor who has enough funds to finance a tax shelter investment singlehandedly, or with only a few associates who can operate together closely enough to fit the popular image of a partnership, should be allowed the benefits of tax shelter deductions while small investors who must form larger, more impersonal associations should be denied these benefits. As long as a group is willing to have the corporate form of organization ignored for tax purposes and to pick up distributive shares of the items of income and deductions, there would appear to be no serious policy objections.

PROPOSAL 10. TAX UNDISTRIBUTED INCOME OF TRUSTS (AND OF ESTATES THAT HAVE NOT BEEN DISTRIBUTED WITHIN A SPECIFIED PERIOD) AT THE SAME RATE AS THE CORPORATE TAX RATE.

A decedent's estate may be viewed, for a time, as a quasi-extension of the deceased individual. On that theory it is reasonable to tax the estate as an individual. The same logic is not applicable to a trust, and it is not applicable to an estate that continues so long without winding up as, in effect, to be administered as a continuing trust.

A trust is not an individual. Trustees need not be individuals and, even if they are, the tax on the income of the trust is not imposed on them in their capacity as individual taxpayers. A trust is a separate legal entity, an artificial creation of the law, more akin to a corporation than to an individual taxpayer. Taxing undistributed trust income at the corporate rate, with the corporate rate equal to the highest individual rate pursuant to Proposal 7, would eliminate a whole area of complexities engendered by individuals attempting to split investment income to avoid progressive rates.¹⁴⁹

148. Phillip G. Larson, 66 T.C. 159 (1976).

149. The complexities prompted one commentator to suggest taxing trusts on all their income, whether accumulated or distributed, and taxing them like corporations. Sutter,

The proposal would not change the essential principle of the taxation of trust and estate income. These entities would continue to occupy a status between corporations and partnerships. Like corporations, they would be taxable entities, but only for income accumulated. Like partnerships, they would be conduits, but only for income currently distributed to beneficiaries.

Taxing trusts on accumulated income at the corporate tax rate would remove the need for complex throwback rules for income earned after the effective date of the change.¹⁵⁰ Income earned by a trust and taxed to the trust because it is not distributed currently would then be excluded from income by the beneficiaries when distributed in a subsequent year. It would be necessary, however, to retain throwback rules to govern future distributions of undistributed income accumulated prior to the effective date of the change.

PROPOSAL 11. REVIEW EACH OF THE TAX PREFERENCE ITEMS IN THE BASE OF THE MINIMUM TAX, MAKE ANY CHANGES CONSIDERED APPROPRIATE, AND REPEAL THE MINIMUM TAX.¹⁵¹

The minimum tax,¹⁵² enacted in the Tax Reform Act of 1969, adds an additional layer of complexity to the income tax. Also, it is erratic in its application because of the fortuitous nature of the regular income tax deduction from the tax preference items, thus complicating the problems taxpayers have in forecasting their marginal tax rates.¹⁵³

The minimum tax is imposed on tax preference items. The tax preference items are not the result of inadvertent loopholes; all were enacted with the deliberate object of making them tax preferences. Thus, it seems incongruous to have the minimum tax imposed by Congress to reduce benefits Congress has provided.¹⁵⁴ Senator Haskell has called the minimum tax a confession of failure.¹⁵⁵ It is an

Selected Areas for Simplification of Income Taxation of Estates and Trusts, 98 Tr. & Est. 964, 968 (1959).

150. I.R.C. § 667.

151. See 123 Cong. Rec. S11,411 (daily ed. July 1, 1977) (remarks of Sen. Kennedy) and Johnson, *Minimum and Maximum Taxes After Two Years—A Survey and General Evaluation*, 50 Taxes 68, 84 (1972).

152. I.R.C. §§ 56-58.

153. Peel, *Corporations and the 10% "Minimum" Tax*, 23 Tax Exec. 588, 592-93 (1971).

154. In the Tax Reform Act of 1969 Congress enacted provisions for liberal amortization deductions for railroad rolling stock and for pollution control facilities and simultaneously put the resulting increases in deductions in the minimum tax base.

155. 123 Cong. Rec. S13,435 (daily ed. Aug. 3, 1977) (remarks of Sen. Haskell).

admission by Congress of dissatisfaction with the tax preferences it has created. Ironically, the minimum tax fails to reach the most spectacular example of untaxed income—municipal bond interest.

Proposal 4 would eliminate the reason for inclusion of one of the major items in the minimum tax base, long-term capital gains. The other items can be reviewed. It would be much simpler to cut back directly on the benefits from the tax preference provisions, if Congress considers that desirable, than to retain the present complex minimum tax.

PROPOSAL 12. REPEAL DEDUCTIONS THAT ARE DESIGNED TO RELIEVE TAXPAYERS PERSONALLY AND ARE NOT RELATED TO THE MEASUREMENT OF INCOME.¹⁵⁶

Several categories of deductions under the Code are not necessary to determine profits, or net income. Some of these deductions are of expenditures that are direct benefits to the taxpayers, and their only apparent relation to the income tax is that they reflect expenditures or losses that may have some impact on taxpaying capacity. It is proposed that the following deductions that reflect expenditures for the taxpayer's personal benefit be eliminated:

a. Property taxes on the taxpayer's personal residence and vacation home.¹⁵⁷

These taxes are personal expenses. Denial of deduction would still leave the homeowner with the benefit of untaxed imputed income equivalent to the rental value of the property, or a personal expense interest deduction, or some combination of the two. Treatment of the imputed income or the interest deduction could not be changed without introducing additional complications,¹⁵⁸ but repeal of the deduction for property taxes on personal residences and vacation homes¹⁵⁹ would simplify the tax and also be a step toward equating the treatment of home owners and renters.

156. One commentator has raised the possibility of repealing all itemized deductions from adjusted gross income and providing a *mandatory* standard deduction. Trammell, *Personal Deductions and the Federal Income Tax—Some Suggestions for Revision*, 14 Ark. L. Rev. 26, 28 (1959).

157. The tax revenue cost of deduction of property taxes on owner-occupied homes has been estimated at \$3,690,000,000 for 1976. Surrey & Sunley, General Report, LXIa Cahiers De Droit Fiscal International, International Fiscal Association 46 (1976).

158. *Federal Tax Policy For Economic Growth and Stability: Papers submitted by Panelists Appearing before the Subcomm. on Tax Policy, Jt. Comm. on the Economic Report, 84th Cong., 1st Sess. 359 (Jt. Comm. Print 1955) (paper by Melvin I. White).*

159. I.R.C. § 164.

b. State and local gasoline taxes (except as business expenses).¹⁶⁰

The deductions taken for personal expenditures for gasoline taxes are only approximations at best because, in a commendable move for simplification, the Revenue Service provides an optional formula keyed to mileage and the gasoline tax in the state of residence.¹⁶¹ Furthermore, deduction of personal expenditures for gasoline taxes appear to be contrary to any rational policy for coping with energy scarcity.¹⁶²

c. Medical expenses.¹⁶³

The medical expense deduction originated as an attempt to take into consideration the effect on taxpaying capacity of "unusual" medical expenses.¹⁶⁴ Now it has degenerated into a complex set of provisions with separate limitations on deduction of expenses of medicine and drugs and of hospital and doctor expenses, subject to percentage of income limitations and dollar limitations, and capped with a deduction of half of a maximum amount of health insurance premium payments. The deduction system is further complicated by provision for exclusion of proceeds from medical insurance, requiring correlation with the medical expense deduction to prevent double benefits.¹⁶⁵

d. Personal casualty losses.¹⁶⁶

This deduction presumably was designed to take account of losses that would impair taxpaying capacity. The rules are complex, the distinction between casualty loss and ordinary wear and tear is subtle and difficult for taxpayers to understand, and the deduction is susceptible to widespread abuse that is difficult for the Revenue Service to police.

160. The tax revenue cost of deduction of nonbusiness state gasoline taxes has been estimated at \$575,000,000 for 1976. Surrey & Sunley, *supra* note 157, at 43.

161. I.R.C. § 164(b)(5); IRS, *Your Federal Income Tax* 185 (1977).

162. The Energy Tax Bill of 1977, in the form in which it passed the House, would repeal deduction of state and local taxes on gasoline for nonbusiness use. H.R. 8444, 95th Cong., 1st Sess. § 2023 (1977).

163. I.R.C. § 213. The tax revenue cost of deduction of medical expenses has been estimated at \$2,020,000,000 for 1976. Surrey & Sunley, *supra* note 157, at 44.

164. 88 Cong. Rec. 8469, 77th Cong., 2d Sess. (1942) (remarks of Cong. Hinshaw on Report of Conf. Comm. on the Rev. Act of 1942).

165. I.R.C. §§ 104(a), 105(b).

166. *Id.* § 165(c)(3). The tax revenue cost of deduction of casualty losses has been estimated at \$300,000,000 for 1976. Surrey & Sunley, *supra* note 157, at 46.

PROPOSAL 13. REPEAL THE EXCLUSIONS FROM GROSS INCOME THAT MAKE THE TAX SYSTEM MORE COMPLEX.

The major statutory exclusions from gross income, in all likelihood, make the income tax system simpler. These are exclusions of gifts and inheritances,¹⁶⁷ life insurance proceeds,¹⁶⁸ interest on state and local securities,¹⁶⁹ and damages received on account of personal injuries or sickness.¹⁷⁰ Other exclusions add to the complexity of the tax system, however, and it is proposed that at least the following ones be repealed:

- a. Gain on sale of residence for \$35,000 or less by persons 65 or over.¹⁷¹
- b. \$5000 of employee's death benefits.¹⁷²
- c. \$1000 of income received annually by a surviving spouse from investment of insurance proceeds left with the insurer.¹⁷³
- d. Disability pensions paid to persons with less than \$15,000 of taxable income per year.¹⁷⁴
- e. The rental value of parsonages and rental allowances paid to ministers.¹⁷⁵
- f. Scholarship and fellowship grants.¹⁷⁶

PROPOSAL 14. EXCLUDE FOREIGN SOURCE PERSONAL SERVICE INCOME OF UNITED STATES CITIZENS LIVING ABROAD.¹⁷⁷

This proposal essentially would restore the earned income ex-

167. I.R.C. § 102.

168. *Id.* § 101(a).

169. *Id.* § 103.

170. *Id.* § 104.

171. *Id.* § 121. The tax revenue cost of exclusion of capital gains on home sales if over 65 has been estimated at \$45,000,000 for 1976. Surrey & Sunley, *supra* note 157, at 44.

172. I.R.C. § 101(b).

173. *Id.* § 101(d)(1)(B).

174. *Id.* § 105(d).

175. *Id.* § 107.

176. *Id.* § 117. The tax revenue cost of exclusion of scholarship and fellowship grants has been estimated at \$210,000,000 for 1976. Surrey & Sunley, *supra* note 157, at 43.

See Commission to Revise the Tax Structure, *Reforming the Federal Tax Structure 7* (1973) (published by Fund for Public Research).

177. For a broader exemption proposal, see Patton, *United States Individual Income Tax Policy As It Applies to Americans Resident Overseas*, 1975 Duke L. J. 691. *Contra*, Task Force on Foreign Source Income, 95th Cong., 1st Sess., Comm. on Ways and Means, Recommendations 16-17 (1977). The Task Force recommended phasing out for taxpayers generally the present \$15,000 exclusion of income earned abroad. Also, § 313 of Congressman Corman's bill, The Tax Equity Act of 1977, H.R. 1040, 95th Cong., 1st Sess., would repeal the present exclusion of income earned abroad.

clusion for bona fide foreign residents that was contained in the law prior to 1951.¹⁷⁸ It reflects a principle applied almost universally by other countries.¹⁷⁹ It would reduce the difficult compliance burden on the Internal Revenue Service, and it would reduce the complexity of the foreign tax credit. It would still be desirable, however, to complicate the foreign tax credit to the extent of denying credit against United States tax for foreign income tax attributable to the excluded income.

PROPOSAL 15. REPEAL THE EXEMPTION OF PRIVATE FOUNDATIONS AND DENY DEDUCTIONS FOR CONTRIBUTIONS TO THEM.

Outright repeal of the exemption for private foundations would be much simpler than the intricate system of penalty excise taxes enacted in the 1969 Act. Indeed, the present system appears to be an attempt to harass the private foundations out of existence by financial threats to their trustees and officers and by a suffocating web of compliance detail.¹⁸⁰

The definition of private foundations would need to be sharpened. The objective should be to draw a line between organizations controlled by their donors and associates and organizations under independent, broad-based or community control. It is reasonable to limit exemption and the benefit of deductible contributions to the latter type of organizations because the Government is entitled to be assured that the deductible contributions and exempt income are put to public uses that justify favored tax treatment.

PROPOSAL 16. CONCENTRATE THE LITIGATION OF CIVIL TAX DISPUTES IN A SINGLE COURT SYSTEM.

It is inconceivable that anyone starting from scratch would have designed the present system for the adjudication of tax disputes. Taxpayers may choose between the district court and the Court of Claims for refund suits, with the possibility of a jury trial in one forum but not in the other. The Tax Court is forbidden to handle refund suits, though it can determine that a refund is due in an appropriate case. The Tax Court's decisions are appealable to

178. Int. Rev. Code of 1939, § 116(a), 53 Stat. 510, (in effect prior to Pub. L. No. 183, § 321, 65 Stat. 498 (1951)).

179. Address by Robert J. Patrick, Jr., Nat'l Meeting of the Int'l Fiscal Ass'n—U.S.A. Branch (Nov. 19, 1976).

180. Taggart, *The Charitable Deduction*, 26 Tax L. Rev. 63, 65 (1970).

all the circuits, resulting in the peculiar situation that the Tax Court decides issues differently depending on the circuit in which appeal would lie.¹⁸¹

It is proposed that:

a. The federal district courts and the Court of Claims be relieved of jurisdiction over tax refund cases;

b. The Tax Court be given exclusive jurisdiction of refund cases as well as the review of proposed deficiencies;¹⁸²

c. The Tax Court be reorganized on a regional basis;¹⁸³

d. Regional Tax Court decisions be appealed to a National Tax Court of Appeals (relieving the circuit courts of appeals jurisdiction);¹⁸⁴ and

e. The Supreme Court provide final review on certiorari.

This proposal would not change the treatment of criminal tax fraud cases, but the option of jury trial in civil tax cases would be eliminated.

This proposal would put an end to forum shopping by taxpayers. It is reasonable to hope that it would provide assurance that civil tax litigation would be judged by persons expert in the tax law. The proposal should expedite the resolution of questions of interpretation that now are often delayed by conflicts of authority between district courts and the Tax Court and between different circuits.

Conclusion

The foregoing proposals are keyed to simplifying the income tax system to the greatest extent possible without interfering with basic policy objectives that Congress has adopted. Many more changes may be desirable on policy grounds. Further simplification could be achieved by eliminating tax incentive provisions. Suggestions on these provisions would, however, require a review of policy objectives that is beyond the scope of this article.

181. Jack E. Golsen, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1970), *cert. denied*, 404 U.S. 940 (1971).

182. Traynor, *Administrative and Judicial Procedure for Federal Income, Estate, and Gift Taxes—A Criticism and a Proposal*, 38 Col. L. Rev. 1393, 1425 (1938); Traynor & Surrey, *New Roads Toward the Settlement of Federal Income, Estate, and Gift Tax Controversies*, 7 Law and Contemp. Prob. 336, 347 (1940); and Comm. on Tax Policy, *supra* note 13, at 352-54.

183. Traynor, *supra* note 182, at 1425, and Traynor & Surrey, *supra* note 182, at 346.

184. For similar suggestions, see Comm. on Tax Policy, *supra* note 13, at 354-58; Traynor, *supra* note 182, at 1425; Traynor & Surrey, *supra* note 182, at 349; Griswold, *The Need for a Court of Tax Appeals*, 57 Harv. L. Rev. 1153 (1944); Del Cotto, *The Need for a Court of Tax Appeals*, 12 Buffalo L. Rev. 5 (1962); and Friendly, *Averting the Flood by Lessening the Flow*, 59 Cornell L. Rev. 634, 644 (1974).

It is important not to oversell the potential for simplification of the income tax. If the proposals suggested here were enacted and all the tax incentive provisions in the Code were repealed, the income tax still would be complex.