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CURRENT ISSUES OF FEDERAL TAX POLICY

*Bernard Wolfman**

I. INTRODUCTION

It is a distinct honor to have been selected as the Spring 1994 Alzheimer Lecturer, and I thank Dean Eisenberg and the Faculty of the School of Law for the invitation they extended to me. I also express my appreciation to the Alzheimer Foundation for having made this Lectureship possible.

Before discussing the particular issues of federal tax policy that I want to encourage you to think about this evening, it is important that I indicate what, for me, is the important goal of good tax policy. In this way you will have before you the yardstick against which I measure tax policy determinations, and you will be able to decide for yourselves whether my measurements are right. You may also decide whether some other yardstick would be more desirable.

By my lights, the goal of federal tax policy should be to raise the revenue necessary to enable the government to operate and to fund its general welfare programs effectively, with a fair distribution of the tax burden, with like transactions and situations treated in like fashion, and with a minimum of added transaction costs and economic distortions.

Obviously, in this evening's talk I cannot even begin to discuss most of the important issues of tax policy that the country should be facing, and so I have selected four areas that are very important in themselves and may illustrate principles that will be helpful in the consideration of others. The four areas I have chosen are *capital gains at death, integration, personal injury recoveries, and simplification*.

II. CAPITAL GAINS AT DEATH

In early January of 1993, a few weeks before his inauguration, President-elect Clinton floated the idea of taxing the "unrealized" capital gains of a deceased taxpayer. It was not a new idea, but it

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had never been pressed hard enough to come close to enactment in the past. In 1993, it might have made sense for the Clinton Administration to explain the proposal to the public and to urge the case for its adoption. Instead, the idea was dropped almost immediately because, according to the Wall Street Journal, it had evoked "strong opposition from powerful interest groups."¹

The Clinton Administration had said that it favored a fairer income tax regime, with a relative increase in tax burden for the wealthy, and a net increase in revenue to help with deficit reduction. Taxing capital gains at death would fit well with all three objectives. Under current law, capital gain (the appreciation in the value of a security or other asset) is not taxed until the asset is sold. The result is substantial tax deferral for capital income. And if the taxpayer never sells the appreciated asset - holding it until death - the income tax deferral turns into income tax exemption because it gives the taxpayer's estate and beneficiaries a taxfree step-up in the basis of the decedent's assets.² The Treasury predicted that this exemption would result in lost revenue of more than \$28 billion in 1993 alone,³ and it is an exemption enjoyed principally by the wealthiest segment of American society.

The Clinton proposal would have continued a complete exemption for assets passing to a spouse or to charity, an exemption for the first \$75,000 of capital gains on assets passing to others, and a \$125,000 exemption for capital gains on the decedent's residence. As a result, 90% of all taxpayers would, as now, be exempt from taxation on their unrealized appreciation. Yet, with only the most affluent taxpayers affected, such a modest change in law would raise \$4 to \$5 billion in additional revenue each year.⁴

To be sure, technical issues of some intricacy would require attention before Congress adopted the change. To avoid the wholesale evasion of taxation of the gains at death, the unrealized gains on assets made the subject of inter-vivos gifts would have to be taxed, terminating the shelter of tax deferral earlier than if the donor were to hold the assets until death. Transition problems would need solution, and taxpayers would need guidance in establishing the basis of assets acquired long ago. Liquidity problems would no doubt require some attention so that in some cases the tax might be made

1. Rick Wartzman, *Clinton Suggestion of Possible Capital Gains Tax Upon Death Stirs Ire Among Powerful Interests*, WALL ST. J., Jan. 5, 1993, at A16.

2. I.R.C. §1014 (West 1994).

3. Wartzman, *supra* note 1.

4. Wartzman, *supra* note 1.

payable over time (as the case is now with respect to federal estate taxes⁵). But in the end, we would have a more equitable income tax system and more revenue (or revenue to substitute, perhaps, for some of the relatively heavy burden of tax imposed on income from personal services).

In my view, taxing gains at death would advance all of the goals of good tax policy and could stimulate the economy by reducing a substantial economic lock-in that current law induces.

III. INTEGRATION

The federal income tax on corporations is the oldest continuous internal revenue tax we have. Enacted in 1909, it preceded the Sixteenth Amendment and the income tax on individuals by four years. With a tax on corporate income imposed first on the corporation and then on its shareholders when they receive dividends or sell their stock, our corporate-shareholder income tax system is understandably dubbed a "double-tax" system. It is more kindly called the "classical" system. The other major industrialized nations of the world, our trading partners, used to have the classical system of double taxation, but over the past several decades have all moved to integrate their corporate and shareholder income taxes so that the double tax has been either eliminated or substantially reduced.

From time-to-time corporation-shareholder income tax integration has been discussed in this country and schemes to achieve it have been proposed. Until recently, however, the studies have been somewhat superficial, and no strong political force has pressed for the adoption of an integration proposal. Although one might have expected corporate managements to support the idea of eliminating the double tax, the corporate executives of public companies seemed more concerned that in a single-tax world they would be pressured to increase their rate of dividends and distribute more of their earnings, contrary to the preference of management to accumulate earnings to the extent possible.

In the past few years, however, two major studies have emerged that propose the enactment of integration systems, one by the Bush Treasury⁶ and the other by the American Law Institute (ALI).⁷ The

5. I.R.C. §6166 (West 1994).

6. U.S. TREASURY DEP'T, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, No. 92-0073-P (Jan. 1992); U.S. TREASURY DEP'T, *A Recommendation for*

ALI study would convert the corporate tax into a withholding tax under which shareholders would take credit on their individual income tax returns for their share of the corporate tax after grossing up their dividends to include their proportionate share of the corporate tax paid. The ALI proposal would operate very much like the familiar withholding system applicable to wages. The Treasury proposal would simply permit domestic shareholders to exclude dividends from their gross income. Professor Fred Peel's 1985 article, *A Proposal for Eliminating Double Taxation of Corporate Dividends*,⁸ may well have influenced the Treasury.

I have given you only a simplistic, contrasting summary of the two most important integration studies, but they both deserve the careful attention of tax and nontax professionals alike. The issue of integration should not and will not go away, but it will not receive full Congressional consideration until the professionals and their clients have given it their attention and then urge Congress to take the subject seriously.

Not all students of the subject favor integration for publicly traded enterprises, faulting both the Treasury and the ALI proposals. Indeed, an earlier, 1989 ALI study makes a strong, persuasive case for a reformed, "double-tax" corporate-shareholder tax system, but one in which corporations would be able to deduct both interest on debt and, with respect to newly contributed equity, dividends as well - in effect, a proposal for a form of partial integration.⁹ Just as they have neglected the major integration studies, however, professionals have not paid sufficient attention to basic reform of the existing system.

In the meantime, how have we dealt with the problems of the double tax system? Our revisions of the existing system have, with a few notable exceptions, been non-comprehensive and often laden with unnecessary complexity. Our system for taxing partnerships and partners is an integrated one, imposing but a single tax on the

Integration of the Individual and Corporate Tax Systems, No. 93-0485-M (Dec. 1992).

7. INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (American Law Institute Federal Income Tax Project, Alvin C. Warren, Jr., Reporter, 1993).

8. Fred W. Peel, *A Proposal for Eliminating Double Taxation of Corporate Dividends*, 39 TAX LAW. 1 (1985).

9. PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (American Law Institute Federal Income Tax Project, Subchapter C, William D. Andrews, Reporter, 1982); REPORTER'S SUBCHAPTER C SUPPLEMENTAL STUDY (American Law Institute Federal Income Tax Project, Subchapter C, William D. Andrews, Reporter, 1989).

partners, but publicly traded partnerships are treated as corporations for tax purposes¹⁰ and therefore cannot enjoy the single tax world. Moreover, business realities and state law strictures often demand a corporate framework. Subchapter S corporations come under a single tax regime, but the tax law will not permit them to have more than 35 shareholders nor more than one class of stock.¹¹ The latest development, the *Limited Liability Company* (LLC), is sweeping the country.¹² By the end of 1993, thirty-six states had authorized their formation; a year earlier only eighteen states had enacted LLC legislation. The IRS has agreed to treat LLCs as partnerships, making it possible to provide limited liability for all the investors and a single-tax system. As with partnerships, however, public trading of the investor interest in an LLC will cause it to be taxed as a corporation.

The goals of corporate tax simplification and corporate tax restructuring ought not be viewed as polar antagonists. They can and they should go together. For the non-public firm, the evolving LLC is an innovation that promises integration, simplification, and flexibility, but it is being achieved without Congressional participation in the process or Congressional approval of the substantial revenue loss that it may entail. It seems clear that until there is sustained Congressional focus on comprehensive corporate tax reform, including the proposals for partial or full integration for publicly traded companies, piecemeal Code amendments, hit-or-miss administrative action, further complexity, and a lack of coherence are likely to remain the order of the day.

IV. PERSONAL INJURY RECOVERIES

Almost from the start the income tax statute has provided that recoveries for "personal injuries or sickness" are tax-exempt. The statutory exemption was preceded by several years, however, by IRS rulings that reached the same result. Congress in effect codified the administrative position. Unfortunately, neither the Internal Revenue Service nor Congress indicated in any full or coherent way just *why* those recoveries were to be exempt, and the term "personal injury" was undefined. In the earliest period, the Service took the position that only a physical injury to the person could constitute a "personal injury." Later, mental injuries were included, and in 1960 the Treas-

10. I.R.C. §7704 (West 1994).

11. I.R.C. §1361(b)(1) (West 1994).

12. See Bernard Wolfman, *Self-Help Integration (LLCs) or Otherwise*, 62 TAX NOTES 769 (1994).

ury issued regulations that appeared to broaden the exemption to include unspecified injuries, beyond the physical (or mental) if they were tort-like.¹³ Nevertheless, for years the IRS took the position that defamation recoveries, though resulting from tort, were not exempt if the defamation occurred in a commercial setting, if it were not *personal* defamation. In the end, the Service lost in a few significant litigated cases, and it finally threw in the towel, accepting as "personal injury" recoveries, and therefore tax-exempt, all defamation recoveries.¹⁴

As the defamation cases were winding down, new controversies arose involving the tax status of recoveries for race and sex discrimination under Title VII of the Civil Rights Act of 1964,¹⁵ and, more recently, for age discrimination as well. In these discrimination cases, the recoveries were all for back pay. The statutes did not provide for ancillary or compensatory damages for psychological harm or for loss of status or reputation.

The Service could not contend in the discrimination-based cases that all recoveries awarded in lieu of wages should be taxed on the ground that they were mere substitutes for the wages which would have been taxable. It could not do so because the exemption for "personal injury" recoveries had always been construed to include the damages for lost wages, past and future, as well as for medical expenses, disfigurement, and pain and suffering. And so the Service contended that the discrimination recoveries were not "personal injury" recoveries because they were not tort-like, and they were not tort-like because they did not include compensatory damages *in addition* to the backpay awards. The lower courts split on the issue, and finally the Supreme Court resolved it two years ago in the *Burke*¹⁶ case. In *Burke* the Court held for the government on the ground it had urged, that the recoveries were not sufficiently tort-like. The Court took note of the fact, however, that in 1991, a year subsequent to the trial court's decision in *Burke*, Congress had amended the anti-discrimination laws to provide for broader, more compensatory recoveries, leading to the conclusion that future recoveries might indeed be sufficiently tort-like to be tax exempt.

Justice Scalia concurred, but in his separate opinion he said the government had been too generous in providing that any recovery,

13. Treas. Reg. §1.104-1(c) (1960).

14. For citations to the historical materials, see *United States v. Burke*, 112 S. Ct. 1867 (1992).

15. 42 U.S.C. §§ 2000e-2 (1988).

16. *United States v. Burke*, 112 S. Ct. 1867 (1992).

although not based on physical or mental injury, would be exempt merely because the lawsuit had sounded in tort. He based his position in large part on the fact that the exemption language in the statute referred to "personal injury or sickness," and he thought that that juxtaposition suggested something much narrower than *tort*. Moreover, the whole of Section 104,¹⁷ the statutory exemption provision, led him to believe that Congress had focused only on physical, and possibly mental, injuries. Discrimination awards just did not fit. He concluded, therefore, that the Treasury regulation¹⁸ was invalid and that no recoveries were exempt unless they compensated for physical or mental injury.¹⁹

Since *Burke*, the Service has gone where its tort-based logic had led it, as the Court in *Burke* had implicitly predicted, and has ruled that discrimination recoveries under the broader, more compensatory 1991 Title VII amendments²⁰ are tax-exempt.²¹ The result is that those who work and are paid, those who are promoted and paid more, those not discriminated against, are taxed on all they receive. Those who recover the equivalent by way of litigation will end up with considerably more because they are not taxed. Perhaps that is the sensible outcome, but the problem is that neither the Service nor the Supreme Court has done anything to suggest what is or is not sensible. It is just as though the question whether something makes sense or not is beside the point. Neither the government nor the Court has deigned to provide a rationale for the exemption for recoveries for "personal injury or sickness." They have gone off on a tangent about whether the recoveries are tort-like or not, but they have not told us *why* that is a right or sensible test.

Recoveries for physical and mental injury seek to help a person back into the position of well-being enjoyed by that person prior to the injury. Since one's well-being, one's happy psyche, is not taxed, it is not unreasonable (although not essential to an income tax system) to exclude from taxation the sums recovered for the purpose of restoring the person to his or her well-being *ante*. It is true that the wage portion of a physical injury recovery is not taxed, although wages are, but that is an oddity that simply does not fit the rationale. It has long history behind it and little else. It does

17. I.R.C. §104 (West 1994).

18. Treas. Reg. § 1.104-1(c) (1960).

19. Presumably, in the case of mental injuries this would involve an injury that caused mental *sickness* (although the Scalia concurrence does not fully develop this).

20. 42 U.S.C. §§1981a, 2000e to 2000e-17 (1988 & Supp. IV 1992).

21. Rev. Rul. 93-88, 1993-41 I.R.B. 4.

not make sense, therefore, to build upon the unexplained, irrational part of the otherwise rational exemption for personal injury recoveries. It also does not make sense to have stretched the personal injury exemption to include wage-substitute recoveries for purely workplace phenomena like employment discrimination that are not hinged to a direct physical or mental injury. The extremity of current law is illustrated by the very recent Tax Court decision in *McKay*,²² a case in which a former executive of Ashland Oil Company, discharged for being a whistle blower, was held tax-exempt on \$12 million of a \$16 million dollar settlement of a wrongful discharge case. Twelve million dollars was the amount the taxpayer's settlement agreement with his former employer expressly allocated to "tortious personal injury."

Now, all that I have argued is not put forth as gospel. It is not even to persuade you that in this instance Justice Scalia has gotten it right. It is put forth only to suggest that in areas where general statutory language requires administrative and judicial interpretation, the Service and the courts should exercise their responsibility to interpret in light of good tax policy, in light of some purpose that they can glean from the statutory scheme. It would have been helpful if at some point someone in Treasury or someone on a court had discussed what relevance, if any, the breadth of *tort* has to an exemption stated to be for "personal injury or sickness." No one did.

Finally, let me say that it is possible that a very perverse outcome will develop in the area of tax-exempt personal injury recoveries. Historically, the collateral source rule prevented a defendant in a tort case from advising the jury that a wage-substitute recovery would be tax-exempt in the hands of the plaintiff and from urging the jury to reduce the damage award in order to make sure that the plaintiff would be no better off than he or she would have been if never injured. Today, however, the collateral source rule has been eroded. In a growing number of state and federal courts defendants are permitted to argue to the jury for award diminution because of the tax exemption.²³ Where this occurs, and the award is trimmed, it is the defendant, the tortfeasor, not the injured plaintiff, who gets the benefit of the tax exemption. And so if one were to think that maybe the exemption, liberally construed, was good just because it provided a bonanza to someone discriminated against, even that

22. *McKay v. Commissioner*, 102 T.C. No. 16 (1994).

23. See, e.g., *Norfolk & Western Ry. v. Liepelt*, 444 U.S. 490 (1980).

justification - never a very compelling one - is going by the boards. Good civil rights law calls for full compensation to those discriminated against, with the burden to be borne by the discriminators. Good tax policy calls for the awards to be taxed, no more or less than one's wages are taxed. Very bad policy leads to giving the discriminators the benefit of a tax subsidy never intended for them.

V. SIMPLIFICATION

I want to close with an observation about the often bruited goal of statutory simplification. Understandably, as the Internal Revenue Code has grown over the last several decades by thousands of pages from a slim, single volume, to two mammoth volumes, professionals have bemoaned the difficulties they have in keeping up, in understanding, and in giving good advice. People have urged legislative writers to use "plain language," to learn how to write, and they have urged Congress to legislate less frequently. By my lights, however, real simplification will come only when the statute deals with large problems more comprehensively. When Congress is pressured into making specific, narrow refinements and exceptions, there is no escape from technical intricacy and lingual convolutions. Comprehensive solutions to pervasive problems, however, can often produce *transactional* simplification and that, in the end, is really what counts. I will mention three examples of what I mean.

In 1986, Congress repealed the so-called *General Utilities* doctrine²⁴ under which, with Congressional codification, corporations were permitted in some circumstances, by following a maze of particular transactional paths but not others, to avoid corporate tax when they realized gain on the disposition of their assets.²⁵ This tax avoidance opportunity, available to some but not all, added enormous complexity to corporate transactions. With the repeal of the doctrine, corporations are more uniformly subject to tax on their asset appreciation when they dispose of assets, and corporate tax rates have come down across the board. Transactions have been simplified, and transaction costs have been reduced or eliminated. That, in my judgment, was real simplification and good tax policy.

In the heyday of tax shelters, from the 1970's to the mid 1980's, an array of economically wasteful transactions provided high income taxpayers with widespread opportunities to avoid taxation at the

24. The doctrine developed following the decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

25. The repeal of the *General Utilities* doctrine is reflected primarily in I.R.C. §§311 and 336 (West 1994).

expense of the Treasury, almost bringing our income tax system to its knees. It was rescued by the 1986 enactment of the passive activity loss rules,²⁶ a set of rules so intricate and convoluted that they have evoked widespread condemnation on both theoretical and other grounds. They are not pretty, to be sure, and they are hard to comprehend in detail. Nevertheless, I suggest that they are a blow for simplification and fairness. How could that be? Well, since the available alternative to those rules seems only to be a return to the situation that antedated them, we are much better off with them. The passive activity loss rules, virtually single-handedly, with only relatively minor exceptions, ended the world of tax shelters as we had come so well to know them. Those complicated shelter transactions, those plans for unneeded condominiums in far off places and for a never ending stream of office buildings for which there were no tenants, and for phony loans to finance investments in oil and gas drilling ventures - they are no more. That is real simplification! Would it have been preferable to deal with the shelter problem by going through the Code and eliminating or reshaping the various tax preferences that underlay the shelter transaction? Yes, of course, in an ideal world, but politically the ideal solutions were not possible. In a life in which a second best solution is the only one feasible, the passive activity loss rules look good. Do most lawyers, or even most tax lawyers, have to deal with the intricacies of the passive activity loss rules? Not at all. The rules have had the very prophylactic result for which they were created. Most tax shelters can be identified immediately when they run afoul of the rules, and so the existence of the rules has ended the unseemly, uneconomic, costly tax shelter industry. That is real simplification and good tax policy.

In 1986, Congress also delivered an important blow for simplification when it eliminated the capital gains preferential rate. There may indeed have been reasons for opposing the elimination of the preference, but there is no doubt that from the perspective of *simplification* it was a major step forward. The complicated aspects of many transactions that were crafted solely to convert ordinary income into capital gains were eliminated. That crafting took substantial portions of the typical tax lawyer's time although it was devoid of any economic objective except tax avoidance. Last year, of course, Congress reversed itself, and we once again have a substantial capital gains preference. There are many who favored

26. I.R.C. §469 (West 1994).

that return on the theory that it helps the economy - a much debated, controversial view to be sure. Every lawyer knows, however, how the return of the preference has already increased the volume of tax planning and has contributed to the distorting of ordinary business and commercial transactions just to gain the advantage of the preferential rate. In a relatively short period of time we have gone from complexity to substantial simplification and now back to the complexity that an almost 12 point preferential rate has induced.²⁷ This has been an interesting and important phenomenon to observe, but in terms of tax policy it sacrifices a great deal.

VI. CONCLUSION

I hope that when you consider issues of tax policy you will keep in mind that real tax simplification may not be achieved merely (or perhaps at all) by statutory brevity or clarity, good though they would be. Real simplification comes when business transactions can proceed in a straight-forward manner, when lawyers know they need not manipulate the form of a deal to gain a tax goodie that is otherwise unavailable. Tax fairness comes when major unjustified opportunities of escape from the income tax are eliminated, such as the taxfree step-up in basis at death and the ever expanding exemption for "personal injury" recoveries. And comprehensive reform, such as that advocated in the integration proposals and in the ALI study recommending preservation and reform of the classical system, is much more likely to help our economy produce more efficiently and to treat taxpayers even-handedly and fairly than the narrow, brokered, complicating amendments and exceptions to which we have become accustomed.

27. The maximum rate on long term capital gains is 28%, I.R.C. §1(h) (West 1994); the top marginal rate on ordinary income is 39.6%, I.R.C. §1(a)-(g) (West 1994).

