Income Averaging: A Canadian Suggestion

Under a progressive income tax with annual accounting periods, persons with fluctuating incomes will usually pay more taxes over the years than those having equal amounts of stable income. To lighten this burden most countries, including the United States, have adopted some form of income averaging. The recent Carter Report of the Canadian Royal Commission on Taxation suggested a new averaging device as part of its general reformation of the Canadian tax system: the "income adjustment account." Although the government has decided not to adopt the Report as the foundation for its tax reform, the income account idea could be applied in a variety of tax contexts and deserves more comprehensive treatment than the Report was able to give.

The Report proposed that all individual and family tax units be


3. 3 REPORT 259-61.


The Report has recommended major changes in the Canadian tax system. It calls for integration of the personal and corporate income taxes, inclusion of gifts and bequests in taxable income, the use of the family as the basic tax unit, and the application of an expanded definition of income. Most of these changes have long been part of the standard canon of tax reform espoused by economists. E.g., H. Simon, Personal Income Taxation (1938). But the central recommendation, the comprehensive tax base, has recently been severely criticized. Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 HARV. L. REV. 925 (1967). But see Musgrave, In Defense of an Income Concept, 81 HARV. L. REV. 44 (1967); Pechman, Comprehensive Income Taxation: A Comment, 81 HARV. L. REV. 63 (1967).

Business and industry strongly opposed the Report, and this plus the difficulty of foreseeing the results of such substantial changes was enough to prevent its enactment. In lieu of the reforms suggested by the Commission, the government will apparently move toward a system closer to that of the United States. The Gazette, supra.


The Report proposes the adoption of the family as the basic tax unit, lumping the income and deductions of all members together. Separate tax schedules are provided for unattached individuals and families. 3 REPORT 117-51. Trusts, cooperatives, and corporations are taxed as separate entities, but the taxes imposed on them are integrated with the personal income taxes of their beneficiaries. 4 Id. 3-9, 155-61. Use of the accounts is not explicitly restricted to personal tax units, but the intention to exclude other tax entities is clear.
allowed to establish income adjustment accounts by making non-interest-bearing deposits with the government.\textsuperscript{7} The taxpayer would be able to deduct deposits from his taxable income in the year of deposit and would include the deposits in his taxable income upon withdrawal.\textsuperscript{8} By making deposits in periods of high income and withdrawals in times of reduced income, the taxpayer with fluctuating income would be able to mitigate the effects of progressive rates and to reduce his total tax burden.

To prevent the taxpayer from realizing any economic benefits during the period that taxation is postponed, the deposits would be non-assignable\textsuperscript{9} and would normally not be transferable between tax units.\textsuperscript{10} Depositors would be prohibited from borrowing against the accounts,\textsuperscript{11} and to discourage speculation on changes in tax rates deposits could not be withdrawn within twelve months of when they were made.\textsuperscript{12} There would be no limitations on the amount which a taxpayer could deposit, although normally a taxpayer would never deposit more than his current taxable income.\textsuperscript{13}

\textsuperscript{7} 3 Report 270-71.
\textsuperscript{8} Id. 271. Deposits would have to be withdrawn whenever a tax unit was terminated, \emph{e.g.}, by death, immigration, except at marriage and divorce when the deposits would be carried over to the new tax unit. The Report suggests that a 30 per cent withholding tax be imposed at withdrawal. Id. Deposits made within 60 days of the close of the taxable year would be deductible from the income of the prior year. Id. 270.
\textsuperscript{9} Id. 270. The Report shows some confusion. At places it speaks of making the deposits \emph{non-negotiable} (id. 270, 278), but the tenor of the Report made explicit in other sections is that the accounts should be \emph{non-assignable}. Id. 260.
\textsuperscript{10} Id. 260, 270, 278. Limited transferability would be permitted between tax units upon marriage or divorce. At marriage the taxpayer would not have to bring the deposits into taxable income upon termination of his individual tax unit and the formation of a family unit. Similarly, at divorce or separation the deposits could be transferred without taxation between the family tax unit and the ensuing individual units.

Transfers within the tax unit are not discussed in the Report. Normally, this would present no problem as a deposit could be liquidated by one member of a unit and the proceeds redeposited by another member of the same unit without any tax consequences. During the initial twelve-month holding period, however, such withdrawals and redeposits would be impossible, yet the ability to make changes in ownership within the tax unit may be important in contexts other than taxation.

This problem can be avoided either by permitting transfer of the accounts between members of a tax unit or by allowing a member of the tax unit to tack on to his holding period the holding period of the transferor when both persons involved are members of the same tax unit and the new deposit is made directly from the proceeds of the former.

\textsuperscript{11} Id. 260. See pp. 1238-39 infra.
\textsuperscript{12} 3 Report 270.
\textsuperscript{13} Since the tax saving is the difference between the applicable rate in the year of deposit and the year of withdrawal, the taxpayer normally could not benefit from reducing his taxable income below the lowest tax bracket. There would be several exceptions to this rule. In periods in which the minimum rate is reduced, profits would still be possible. P. 1241 \textit{infra}. If the accounts are used in conjunction with block averaging, a taxpayer might wish to have a negative income for certain years in the block averaging period. In this case his tax savings would be the difference between the marginal rate which he would have paid on the income if it were left in the block averaging period and the applicable rate at withdrawal in a subsequent block averaging period. See pp. 1230-31 \textit{infra}.
The apparent simplicity of the accounts makes them immediately attractive as an averaging method. Neither the government nor the taxpayer would need to keep extensive records of the taxpayer's previous returns, and verification and control by the government would be much simpler than under most averaging devices. The taxpayer would be able to compute his tax liability in the same manner as other taxpayers and would not need to apply multiple or complex schedules.

Finally, unlike some averaging schemes, the taxpayer could readily understand the operation of the accounts, a factor which might contribute both to the taxpayer's compliance and to his feeling of fair treatment.

The income accounts would benefit two groups of taxpayers. The...
first is taxpayers who receive large non-recurring items of taxable income. Because the Report concluded that income should be measured comprehensively, it swept both realized capital gains and all major transfers (including gifts and bequests) within the definition of taxable income.

The income accounts would permit taxpayers whose income is temporarily increased by these sources to spread the impact over several years.

The accounts would also aid those taxpayers who can foresee sharp permanent drops in income—the most important beneficiaries being those with high incomes and short career lives such as professional athletes and entertainers. Through the accounts these taxpayers would be able to spread their income forward into the years when they expect diminished receipts, an option now only selectively available in both the United States and Canada.

Most taxpayers, because they have relatively stable incomes, would ordinarily not use the accounts. Only at retirement, when incomes tend to drop sharply, would the accounts be useful for the average wage earner. Retirement, however, presents far broader concerns than the income fluctuations which averaging deals with, and the Report treats retirement as a separate problem. It suggests the adoption of more generous although more controlled provisions for retirement savings and tries to inhibit the use of income accounts for retirement purposes. Similarly, United States tax law already includes special provisions for retirement income, most notably those which encourage

even stream of income with a higher tax burden over a smooth distribution of the income.

20. Id. 242.
22. See p. 1232 infra; 3 Report 244-47, 402-08.
24. Id. 495-99. Taxpayers would be permitted to make donations of cash and other property to registered retirement plans, and donations would be deductible from current income until they reached the maximum allowable levels of savings. These plans differ from the accounts in several ways. They are not governmental deposits, earnings are attributed to the taxpayer, and the ceiling limits the maximum tax benefits.
25. All deposits in income accounts would have to be withdrawn in the year in which the youngest member of a tax unit reached sixty. Id. 272. This was done in part to avoid the pyramiding of liabilities at death. Whenever a tax unit is terminated by death, there is a deemed realization of all property gains, and this may produce a high taxable income in that year with high effective rates. In addition, the subsequent taxation of the bequests to the beneficiaries may give the illusion of "double taxation."

The 60 year rule may have some capricious results, for it would permit those taxpayers who have young spouses to take advantage of the accounts for retirement purposes while making this use impossible for taxpayers whose spouses are about as old as they are.
retirement savings through qualified pension plans. Although both qualified pension plans and income accounts permit the taxpayer to postpone taxes on contributions until withdrawal, only funds placed in qualified plans may be invested; this advantage is compounded by the fact that the investment earnings are also exempt from taxation until received by the beneficiary. Because of these differences, a taxpayer may use a qualified pension plan to accumulate savings throughout his working life but could profitably forego earnings on funds deposited in income accounts for only a few years before actual retirement. Since income accounts would not be an efficient way of generating retirement savings for most taxpayers, they cannot be considered a substitute for such measures as qualified pension plans. At retirement the accounts must be evaluated in terms of their applicability to that limited group of taxpayers with declining income for whom qualified plans and other devices are unavailable or inadequate.

Although expanding the averaging opportunities available to taxpayers with large lump sum receipts or high but declining incomes may offer some social or administrative benefits, the fundamental justification for extending tax relief to them through the income accounts rests, as it does for most averaging devices, upon notions of equity. The Report invokes several sorts of equitable considerations in favor of the income accounts. First, it suggests that some kind of averaging is required because the annual accounting period is thought to be too short a period, for equity purposes, over which to measure income. This proposition is central to most defenses of general averaging, but unhappily the most common notions of equity embodied in the ability-

26. Int. Rev. Code of 1954, §§ 401-05. For a review of both the tax and other policy concerns in this area, see President's Committee on Corporate Pension Funds, Public Policy and Private Pension Programs (1963).

27. See note 18 supra for the maximum periods which different taxpayers could hold deposits in income accounts profitably. These periods are independent of savings in qualified pension plans except inasmuch as benefits paid out under qualified plans increase the taxpayer's taxable income after retirement and thereby increase the applicable marginal tax rate on withdrawals.

28. See pp. 1236-37 infra.

Averaging is sometimes defended as a counter-cyclical tool. If fluctuations in personal income are closely related to general economic trends, averaging by refunding taxes during declines, or in the case of the income accounts by encouraging withdrawals, will tend to sustain demand and will dampen the downturn. The income accounts would seem especially suitable in this regard because they would increase disposable personal income by the entire amount of withdrawal and not just the amount of tax savings. There is, however, no reason to believe that the types of income fluctuations which would cause taxpayers to use the accounts would be related to cyclical economic activity, and in any case the amounts of money involved would be relatively small in terms of total national income changes.

29. Id Report 241.

30. But see pp. 1233-34 infra.
to-pay concept do not point unambiguously to any ideal time period for measuring income.

Equity, whether measured horizontally in terms of the taxes paid by persons in similar economic positions or vertically in terms of the relative tax burdens on persons in different economic positions, is commonly defined independently of any time horizon. In developing initial principles of vertical and horizontal equity, the Report itself fails to consider whether its concepts require or even justify a particular time horizon as appropriate for measuring income. Later, when it does discuss the time horizon problem, the Report only notes that some intermediate period less than a lifetime seems the most equitable period for measuring income, making no serious attempt to justify this conclusion.

The Report’s cursory statements reflect the lack of any agreement among scholars. Some assert that lifetime averaging is at least theoretically required. Others suggest the opposite and argue that ability-to-pay should be related closely to immediate changes in financial capacity and therefore that the taxpayer should, as perforce he will under an annual accounting period, be taxed more heavily “when his ship is in.” A third approach would try to relate the period for measuring income to the taxpayer’s own time horizon for economic decisions.

31. See, e.g., Musgrave, supra note 4, at 45. Musgrave would ideally define income on a lifetime basis, id. 59, but that is not required by his choice of income as his index for horizontal and vertical equity. See pp. 1228-29, infra.
32. The Commission followed the ability-to-pay school. Horizontal equity is achieved when “individuals and families with the same gains in discretionary economic power pay the same amount of tax.” 1 REPORT 5. Vertical equity results when “individuals and families pay taxes that are a constant proportion of their discretionary economic power.” Id. For these purposes economic power, income, is measured by the Haig-Simon definition, consumption plus accretion. Id. 5-6.

Manipulation of these and other principles leads to the familiar system of progressive marginal tax rates on total income. Different schedules are provided for families and unattached individuals, and tax credits are allowed for a few specially recognized specific non-discretionary expenditures. 3 REPORT 32-33.

The key relationship explaining the scheme of progression is the assumption that non-discretionary expenditures—those “necessary to maintain the appropriate standard of living of the family or unattached individual relative to others”—increase with income but at a less than proportional rate until income reaches $100,000. 3 REPORT 8. Recognizing the subjective nature of its assumption, the Commission puts it forth as one of the “shared values” which the Commission hopes will “commend themselves to most Canadians.” Id. 5. Needless to say, the relationship provides no information about the appropriate time horizon for measuring income.

33. 3 REPORT 241.
34. E.g., Vickrey, supra note 2, at 165, 185-86; Musgrave, supra note 4, at 59-60.
Income Averaging: A Canadian Suggestion

This latter concept lends itself to a number of interpretations. It could be measured by the period in which most individuals adjust their actual consumption and savings patterns to changes in income, or it might be the period in which expected receipts influence the taxpayer's present behavior. But whatever precise meaning is given to the period, it is clear that for most individuals, including those with fluctuating incomes, it is rather short. Existing empirical studies indicate that averaging under this approach would be justified for intermediate periods of three to five years, at most.

The appeal of income accounts, of course, will depend in large part upon one's view of the appropriate measuring period. Obviously, the accounts would have no place, except for certain ad hoc uses, in a tax

37. The observed period in which changes in measured income are followed by changes in consumption is rather short although it may depend in part upon the nature of the receipt. See, Ando & Brown, *Lags in Fiscal Policy*, in STABILIZATION POLICIES 1, 9-10, 111-38 (1965) (86 per cent of the expected change in consumer expenditures may take place by the end of the third quarter following the change in income); Liviatan, *Estimates of Distributed Lag Consumption Functions from Cross Section Data*, 47 REV. Econ. & STATISTICS 49 (1965) ("combined effect of all past [annual] incomes on current consumption is extremely small compared with the effect of current income"). The relationship may be asymmetric—a longer period being required for adjustments to declines. See J. Duesenberry, *Income, Saving and the Theory of Consumer Behavior* 70-89 (1949); Suits, *The Determinants of Consumer Expenditure: A Review of Present Knowledge*, in COMMISSION ON MONEY AND CREDIT, IMPACTS OF MONETARY POLICY 1, 17 (1963). From the viewpoint of the income tax, the relationship between changes in income and changes in consumption would seem the most important. There are, of course, many other factors which may determine the level of consumption, and current income may not be the most significant. See generally J. Duesenberry, supra; M. Friedman, *A Theory of the Consumption Function* (1957); Ando & Modigliani, *The "Life Cycle" Hypothesis of Savings: Aggregate Implications and Tests*, 53 AM. ECON. REV. 56 (1963); Suits, supra at 14-23, at 48-54; Houthakker & L. Taylor, *Consumer Demand in the United States 1959-1970*, 173-94 (1966).

38. This interval is arguably the most relevant because it would describe the individual's own subjective view of the time dimensions of his income. Friedman in his permanent income hypothesis uses such a period to calculate the individual's "wealth" and, hence, permanent income. He estimates that the average period for all persons is about three years. Friedman, *Windfalls, the "Horizon," and Related Concepts in the Permanent-Income Hypothesis*, in MEASUREMENT IN ECONOMICS 1, 7 (1953); M. Friedman, supra note 37, at 137-56, 211.

Testing the Friedman hypothesis has been extremely difficult because of the alternative interpretations which may be placed upon results derived from measured income and consumption. Compare H. Houthakker & L. Taylor, supra note 37, at 179-82, with Perry, *Consumer Demand in the United States*, 57 AM. ECON. REV. 833, 837-38 (1967). The estimates which have been made indicate an even shorter horizon than that suggested by Friedman. E.g., Liviatan, supra note 37, at 49 ("permanent income" is determined almost completely by current income).

39. See authorities cited notes 36-38 supra.

40. Regardless of what time period is thought ideal for measuring income, the accounts might be defended as a logical extension of the Report's decision to tax individuals on their accretions in economic power. 1 REPORT 4-6. If the accounts neutralize the economic power which the deposited funds represent, they should arguably be excluded from income until the taxpayer withdraws the deposits and recognizes their economic potential. But no one could seriously maintain that the taxpayer holding deposits is in the same economic position as one who does not, and the accretion theory requires that this difference be taken into account.
system premised upon measuring ability to pay by short-run changes in income. Even if an intermediate or long period offering a greater role for the accounts is accepted for measuring income, the utility of income accounts must be evaluated within the context of specific tax systems. Because the accounts cannot benefit taxpayers who are experiencing steady increases in income or who suffer unexpected income declines, they must be used in conjunction with other averaging methods in order to provide complete averaging for fluctuating incomes.

To implement its decision that income for the purposes of equity should be measured over an intermediate period, the Commission recommended a system of block averaging over five-year intervals as a supplement to the income accounts. Block averaging is relatively simple and may be used for both upward and downward shifts in income. The five-year period is capable of providing relief for most fluctuating incomes and lump-sum receipts, but block averaging, even as a short-run device, is somewhat less adequate for permanent income changes because the amount of tax relief and its timing depend heavily upon the particular grouping of years used. The income accounts would alleviate some of these peculiarities for those anticipating income drops.

---

41. The taxpayer may average over periods of five or less consecutive years. Except at death, when a five year period would be allowed regardless of earlier averaging, no year could be used more than once. The taxpayer would add his taxable income for the period, and using special tables which would reflect rate changes during the period, the taxpayer would calculate the tax he would have paid if his income had been spread evenly throughout the period. After the deduction of his tax credits, he would compare the tax assessed on that basis with the amount of tax actually paid. He would be entitled to a refund of any difference over $50. REPORT 264-65. The Canadians already have some experience with this form of averaging. CAN. REV. STAT., ch. 148, § 42 (1952).

42. Under block averaging the amount of savings is independent of the year in which a lump-sum is received if income is otherwise constant. But if there is a permanent change in income, the amount of relief depends upon the year in the block period the change takes place. The following table indicates the tax savings provided by block averaging for a couple whose taxable income drops permanently from $60,000 to $10,000 per year.

<table>
<thead>
<tr>
<th>Year of the Averaging Period in Which Drop Occurs</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Savings</td>
<td>0</td>
<td>$5,660</td>
<td>$7,370</td>
<td>$6,580</td>
<td>$3,790</td>
</tr>
</tbody>
</table>

(Table derived from recommended tax schedule for a family with no dependents. REPORT 174.)

The timing of relief, particularly when income drops, also has disadvantages. The refund may be received only a substantial period after the change in income and will be of little assistance in helping the taxpayer adjust to his new income levels.

1230
by allowing them to transfer income between block averaging periods, and would permit averaging for periods longer than five years.

The United States presently permits averaging of ordinary income by allowing the taxpayer, in effect, to spread his income back over the previous four taxable years. Averaging thus is limited to significant increases in taxable income. These provisions are capable of handling most occasional receipts as well as increments in permanent income. They do not, however, provide any relief for persons suffering from income drops, and therefore represent an incomplete acceptance of the theories urging averaging over intermediate periods. Because income accounts also do not provide complete averaging, they should not seriously be considered as an alternative to the present averaging provisions. But the adoption of the accounts to supplement the current provisions would create some symmetry by permitting averaging for anticipated income decreases. In addition, the accounts would permit some persons to average their income over a longer period. The taxpayer would, however, still be without averaging privileges when his income declines unexpectedly.

In assessing the case for adoption of the income accounts it is im-

43. If the taxpayer were allowed to regroup the years used in any averaging block after seeing his actual income pattern, the variations in relief could be reduced. But this would require the taxpayer to keep information at hand for as long as nine years and would mean that prior averaging computations could be reopened for four years after filing.

44. The income accounts would allow taxpayers to transfer income from one block averaging period to another, thus increasing the averaging period from five to ten years. If the taxpayer is effectively restrained from receiving earnings on the accounts (see pp. 1237-43 infra), he would make deposits only at the end of one averaging period, carry the accounts for the minimum holding time of twelve months, and then withdraw them in the first year of the next block averaging interval. There would be only two exceptions. The first is when the taxpayer is speculating on changes in tax rates. Speculation is not possible through block averaging alone because the applicable schedules are adjusted for rate changes. See p. 1241 infra. The second is when use of the accounts within a block averaging interval would allow the taxpayer to accelerate receipt of the tax reduction from the end of the period to an earlier year and when the earnings on the tax savings during the remainder of the block averaging interval would be greater than the loss of earnings on the funds during the period of deposit.

45. Averaging is not permitted for wagering income, certain income from gifts and bequests, and capital gains. I.R.C. § 1302(b). 46. Id. § 1302(c)(3).

47. Id. § 1301. Because the base period income must be multiplied by 1.33, the relief is less than what full block averaging over the five year period would provide. Unlike the Canadian system the income is all taxed at current rates.

48. Minor relief is available for temporary income declines. When his normal income level is restored, the taxpayer may average back over the period of the decline. This possibility would be enhanced and relief made more quickly available if averaging periods shorter than five years could be used.

49. In enacting the provisions, Congress apparently accepted lifetime averaging as ideal, but felt constrained by administrative considerations to restrict averaging to intermediate periods. H.R. Rep. No. 749, 88th Cong., 1st Sess. 110 (1964).

50. See p. 1229 supra.
portant to remember that many taxpayers are already able through a variety of statutory schemes to adjust the timing of their taxes. Because the income accounts bear no earnings, taxpayers are unlikely to prefer them when other devices are available to delay taxes. In some cases, however, availability of the accounts would tend to equalize the tax burdens of persons in otherwise similar positions who are unable to take advantage of existing forms of avoidance.

This is most obvious and important in the case of deferred compensation agreements. In the typical deferred compensation contract the employee agrees to be paid in the future for his present services. The employer on the accrual basis is allowed a current deduction for the incurred obligation, but the employee using cash-basis accounting is not required to report his income from the agreement until he is actually paid. This kind of contractual arrangement for forward averaging would usually be preferred to deposits in income accounts because the contracting parties do not lose the use of the money involved during the period that payment is deferred.

Deferred compensation agreements, however, are inferior to forward averaging through income accounts in several respects. The employee is unable to postpone non-contractual income, and he must decide upon the ideal time for realization at the moment of making the contract—a decision sometimes made more difficult because the size of the payments is still contingent. More important, the employee must depend upon the continued solvency of the employer. If the employee attempts to avoid this risk by collaterally securing or funding the agreement, the employer may lose his deduction entirely or the employee may realize income currently. As a result of these restrictions the present rules governing deferred compensation agreements favor the employees of established, ongoing businesses.

52. But see note 74 infra.
54. Irell & Stone, supra note 53, at 394-95.
55. Id. 397.
56. The most famous example is William Holden's contract for appearing in "Bridge on the River Kwai" in which he agreed to receive his share of the gross receipts at $50,000 a year. The picture was so successful that it would have taken him more than forty years to receive full payment. See Time, Jan. 19, 1959, at 66.
The introduction of the income accounts in the present code would thus extend to a wider group at least part of the privileges already available to some through deferred compensation agreements, and with the accounts available as an alternative means of forward averaging, it would be possible to cut back on the use of deferred compensation agreements by revoking Revenue Ruling 60-31 and using the cash equivalent and constructive realization doctrines more vigorously. This would provide more equitable treatment of taxpayers who wish to avail themselves of forward averaging because it would permit the inclusion of non-contractual income and would eliminate distinctions flowing solely from the financial status of the employer.

Quite apart from notions of general averaging, the Report suggests that the accounts may be justified as an ad hoc compensatory device for other distortions in the tax system. Even if the annual period is accepted as ideal, other considerations, notably the need for liquidity and the difficulties of valuation, may require the realization in a single accounting period of gains accrued over a period of years. The most common example, of course, is the taxation upon realization of accrued gains on property. This problem was particularly important to the Royal Commission because of its decision to tax capital gains as ordinary income, but the same considerations also apply to slowly maturing earned income.

The Report would use the income accounts as an alternative to preferential taxation of these gains, permitting the taxpayer to spread out the income received from disposition of an appreciated asset or for services rendered over several years. But the income accounts are not the most suitable averaging device for this purpose. Tax savings obtained by the use of the accounts will bear no relation to the time pattern of the income during accrual, yet this is the period which is logically relevant for determining the appropriate tax burden. Because they at least look backward toward the time of accrual, albeit imprecisely, both the present United States averaging provisions and, to a lesser extent, block averaging would be preferable to the income accounts as devices for granting tax relief when major gains are realized. From the taxpayer's point of view, the five-year spreading avail-

59. § Report 322.
60. See pp. 1229-31 supra. Because of the advantages of postponing taxes until realization, complete parity of tax burden need not be achieved. See Bittker, supra note 4, at 929.
able from either block averaging or existing American law would not necessarily be inferior to that available through the income accounts because of the substantial loss of earnings which would result from holding deposits in the accounts over long periods.\textsuperscript{61}

When income can be valued and allocated to particular years, the best solution from the point of view of equity is not averaging at all, but annual revaluation.\textsuperscript{62} This approach avoids the bunching of income but does not permit the taxpayer to take advantage of postponement. The \textit{Report} recognized this and suggested that optional revaluation be permitted for either gains or losses.\textsuperscript{63}

The final equity argument made by the Commission in favor of the accounts is that they would help dampen the impact of progressive tax rates on lump-sum transfers.\textsuperscript{64} Since the Commission recommended integrating the estate and gift tax into the income tax, its proposals would substantially increase the effective rates of tax on those transfers when made to persons outside the family or between generations.\textsuperscript{65} The income accounts would allow the recipient to spread the income over any desired period in order to reduce the impact of these changes.

There is nothing in the other equity principles adopted by the Commission to justify this concession.\textsuperscript{66} Indeed, use of the accounts to offset the increase in taxes on gifts and bequests caused by the shift to a comprehensive income base would favor property income\textsuperscript{67} at the cost of the Commission's conceptions of equity and thereby push the system away from the ideal distribution of burdens which the \textit{Report} postulates.\textsuperscript{68} The real reason for the Commission's suggestion was

\textsuperscript{61} See note 18 for examples of maximum profitable holding periods.
\textsuperscript{62} See Musgrave, \textit{supra} note 4, at 49.
\textsuperscript{63} 3 \textit{Report} 506-08. In the United States wash sales may be used to recognize gains but not losses. INT. REV. CODE of 1954, § 1091. For a proposal to value and tax certain capital gains annually, see Slawson, \textit{Taxing as Ordinary Income the Appreciation of Publicly Held Stock}, 76 YALE L.J. 623 (1967).
\textsuperscript{64} 3 \textit{Report} 242.
\textsuperscript{65} 3 \textit{Report} 504-07. In evaluating these changes it is important to realize that gifts and bequests would only be taxed when made outside of the family tax unit. In general this would mean that there would be no tax when an estate passed to a surviving spouse but that gifts and inheritances would be fully taxed when they passed to adult children or others not within the immediate family. In effect, taxation to the family is limited to inter-generational transfers.
\textsuperscript{66} See note 32 \textit{supra}. Arguably, gifts and inheritances should be taxed more heavily because they represent totally discretionary income.
\textsuperscript{67} Gifts and bequests are derived primarily from property income. Cf. R. Barlow, H. Brazer & J. Morgan, \textit{Economic Behavior of the Affluent} 87-93 (1967).
\textsuperscript{68} The Commission's recommended schedule of rates deviates only slightly from its "ideal" schedule. 3 \textit{Report} 166. The calculations, however, do not take into account the value of postponement, which would significantly reduce the effective tax on property appreciation, and the income accounts would further decrease the taxation of capital. Of course, the total effect of the recommendations of the Commission would have been
probably to mute some of the criticism which would inevitably accompany a sharp increase in taxes on lump transfers. It may also have been a response to the more favorable treatment of bequest and gift income in the United States, a comparison to which the Report was sensitive throughout.

In the United States, of course, the transfer problem does not exist because of the exclusion of gifts and bequests from taxable income. The accounts could be considered, however, as a useful adjunct of any integration of the gift and estate taxes into the income tax. They would satisfy one of the objections to such a reform—the high rate of tax resulting from the bunching of the receipts in a single year. From the viewpoint of ability to pay, integration and the accounts would also be superior to a separate accessions tax, a commonly-suggested alternative technique of taxing transfers to the donee. Accessions tax rates do not take into account the taxpayer's other income, and equal transfers result in the same tax burdens on high- and low-income taxpayers.

In its defense of the accounts the Commission was primarily concerned with equalizing the tax burdens of persons in similar positions. But even if the accounts do promote horizontal equity, the gains must also be weighed against the impact the accounts would have on ver-

to increase the taxation of investment income—no doubt an important factor in their demise. In this sense the Report as a whole is an improvement over the present Canadian system when judged by the Report's own principles.

69. Compare C. ShoP, FEDERAL ESTATE & GIFT TAXES 89 (1959) (effective estate tax rates in the United States) with 3 REPORT 174 (income tax rates for married couple applicable to bequests included within income). Any comparison of rates will underestimate the difference because of the availability in the United States of special avoidance devices under the estate tax, e.g., generation-skipping trusts, or disposition through the gift tax with lower effective rates and a high exclusion.

70. E.g., 3 REPORT 158-63, 619-32; 6 id. 81-82. The entire corporate tax structure is keyed to the levels of corporate taxation in the United States. 4 id. 5-6. This is probably inevitable because of the nearly integrated capital market existing between the United States and Canada.

71. INT. REv. CODE of 1954, § 102.

72. A revision of the gift and estate taxes in this way, however, seems highly unlikely. Current reform proposals are directed towards either unifying the present gift and estate taxes while keeping them separate from the income tax or substituting in their place an accessions tax. See Casner, American Law Institute Federal Estate and Gift Tax Project, 22 TAX L. REV. 515 (1967); Alexander, Federal Estate and Gift Taxation: The Major Issues Presented in the American Law Institute Project, 22 TAX L. REV. 635 (1967); Andrews, The Accessions Tax Proposal, 22 TAX L. REV. 589 (1967). At least in theory it would not necessarily be inequitable to have a transfer tax as well as an income tax on gifts and bequests. See B. BITTNER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 598 (4th ed. 1964).

73. See Andrews, infra note 72.


75. 3 REPORT 241.
tical equity. The availability of income accounts would tend to reduce the progressivity of any tax structure. The benefits of averaging are only significant for those who are in the higher income brackets during at least part of their lifetime,76 and only affluent taxpayers could afford to hold large deposits relative to their income.77

The benefits from the limited averaging already available in the United States, although small, are highly regressive in their distribution.78 Introduction of the income accounts might marginally spread the benefits of averaging over a wider group, possibly increasing horizontal equity; the incidence on the system as a whole, however, would further reduce progressivity. Certainly, there is no consensus about precisely what constitutes vertical equity,79 but given the already low effective rates on high income, comprehensively measured,80 the argument for further reductions seems weak in a tax system which pretends to be progressive. In the absence of other compensatory changes, the deposits would undoubtedly increase the discrepancies between effective rates and the rate structure commonly espoused by the advocates of a comprehensive tax base.81

Aside from equity the Report suggests that the accounts would be a useful addition to the tax system because they would reduce the amount

76. Seventy per cent of Canadian taxpayers have incomes less than $5,000 and would pay taxes at an effective rate of 7 per cent or less under the Commission's proposals. See 6 Report 57-58.

77. See, e.g., R. Lampman, The Share of Top Wealth-Holders in National Wealth 1922-56, at 23-24 (1962) (56 per cent of personal sector wealth held by top one per cent of adults in 1956); Friend & Schor, Who Saves? in 2 Consumption and Saving 223 (L. Friend & R. Jones eds. 1960) (the highest tenth of spending units possess between 73 per cent and 125 per cent of the net savings for all spending units).

78. See U.S. Internal Revenue Service, Preliminary Report, Statistics of Income—1965, Individual Income Tax Returns, U.S. Treasury Dep't Pub. No. 198, at 5 (1967). Less than 10 per cent of the savings from income averaging was realized by taxpayers having adjusted gross incomes of under $20,000, yet these taxpayers comprised more than 97 per cent of all taxpayers filing returns. Id. 5, 17. This comparison exaggerates the total effect because the taxpayers using averaging necessarily had lower AGI's in prior years, but the overall impact of averaging is clear.


80. Recent estimates of the effective tax rates on total income (adjusted gross income plus excluded capital gains, tax-exempt interest, imputed rent, and social security benefits) show effective tax rates in the United States rising to a maximum of 27.80 per cent in the 100,000 thousand dollar bracket and then dropping to 25.46 per cent for incomes above that level. B. Okner, Income Distribution and the Federal Income Tax 75 (1965). Even these figures would overestimate liability for the highest income groups if (1) adjustments were made for the advantages from postponement until realization of taxes on accrued property gains, (2) gifts and bequests were included in gross income, and (3) percentage depletion deductions used in calculating gross income were reduced by the excess of such deductions over those available from cost depletion. All of these changes would seem required by a more thorough application of the accretion notion of income. See generally authorities cited note 4 supra.

of litigation between the tax authorities and the taxpayer about the timing of receipts. This may be so in some cases, but whenever sizeable sums are involved the taxpayer will still have considerable incentive to manipulate his income so that he can receive the tax benefits of postponement without having to bear the loss of earnings on the income which would result from placing it in an income adjustment account. The accounts would decrease the need for year-end manipulation by cash-basis taxpayers, but because of the minimum twelve-month holding period for deposits the taxpayer may prefer to adjust the timing of receipts rather than use the deposits.

Finally, against whatever savings in litigation of this type might result must be offset the costs of policing the accounts. These costs may be much greater than the Commission recognized. Even if the accounts are thought to be a desirable addition to the tax code, there are a number of practical difficulties in their implementation. One group of problems arises from the need to restrain the taxpayer from enjoying before withdrawal the economic power which the deposits represent. It was for this reason that the Report suggested that no interest be paid on the accounts and that the restrictions be imposed on transferability and borrowing. But neutralization of the accounts may be nearly impossible. For instance, the prohibition on assignment may be avoided by making a contract for payment out of the proceeds of the deposits after withdrawal and payment of withholding taxes.

---

82. § REPORT 241. Tax avoidance has been of even more concern in Canada than in the United States because of the rather narrow construction courts have given tax statutes, and as a consequence, broad delegation of discretionary powers is given the Minister of National Revenue to set aside acts in avoidance of tax. See generally § REPORT 557-1-53.

83. Unfortunately under almost any conceivable form of averaging, timing is still going to make a difference, and taxpayers will take that difference into account in ordering their affairs. Cf. Bittker, supra note 4, at 958-61; Bittker, An Optional Simplified Income Tax? 21 TAX L. REV. 1, 9 (1965).

84. By delaying actual receipt so that it falls in the following accounting period, the taxpayer is able to postpone taxation one year. See Treas. Reg. § 1.451-1 (1957). See also Hahn, Methods of Accounting: Their Role in the Federal Income Tax Law, 1960 WASH. U.L.Q. 1, 44-48.

85. This is necessary for several reasons. First, under the equity principles adopted by the Commission, the deposit holder should bear the same tax burden as a person having a smooth income pattern only if he is put in the same position, i.e., if he is restrained from enjoying the economic power which the deposits represent until he takes them into income. § REPORT 259. More fundamentally, if the taxpayer were permitted to earn income on the accounts, savings would be effectively exempted from taxation, and the whole basis of the income tax would be shifted from income to consumption.

86. See p. 1224 supra.

Even if the prohibition on transfer is made effective, the deposits represent resources which creditors should be able to reach either through attachment or levy or in bankruptcy proceedings. The accounts are clearly the property of the taxpayer and except for the minimum twelve-month holding period they can be reduced immediately to cash by the simple expedient of withdrawal. Prohibition of attachment and levy by judgment creditors or seizure by the trustee in bankruptcy would effectively allow the debtor an unlimited exemption for cash holdings, a radical departure from the present limited exemptions allowed by statute.

These difficulties will not be as important if the prohibition on borrowing can be made effective. But this too may be difficult. Banks and other credit agencies could be barred from lending against the security of the accounts either directly or indirectly; this could


88. Cf. Guldager v. United States, 204 F.2d 487 (6th Cir. 1953) (saving bonds although not transferable may be attached by judgment creditors); 31 C.F.R. § 315.21(a) (1966) (savings bond may be paid to authorized officer in satisfaction of money judgment).

89. Cf. Segal v. Rochelle, 382 U.S. 375 (1966) (tax refund from loss carryover passes to trustee in bankruptcy even though refunds are not assignale); In re Goodson, 203 F. Supp. 837 (S.D. Cal. 1963) (prorated portion of tax refund on withheld wages passes to trustee); 31 C.F.R. § 315.21(b) (1966) (savings bonds pass to trustee in bankruptcy).

90. Only cash may be deposited in the accounts. § 70(a)(3) of the Bankruptcy Act vestsing in the trustee the power to withdraw the deposit. The accounts would be property to cash so that it could be deposited might be set aside as fraudulent. The mere conversion of property from non-exempt to exempt forms, however, does not constitute fraud. Myers v. Matley, 316 U.S. 622 (1943); Love v. Menick, 341 F.2d 650 (9th Cir. 1965).


In the absence of modifying legislation, the trustee should ordinarily be able to exercise the power of withdrawal under § 70(a)(5) of the Bankruptcy Act vesting in the trustee "powers which [the bankrupt] might have exercised for his benefit." 11 U.S.C. § 110(a)(6) (1964). The more difficult case arises during the minimum holding period when the bankrupt himself would have no power to withdraw the deposit. The accounts would be property within § 70(a)(6), but they would pass to the trustee only if they could be levied upon under state law or be "by any means ... transferred." 11 U.S.C. § 110(a)(6) (1961). The closest analogy is the loss carryback tax refund which, after a division between the circuits, the Supreme Court recently held passes to the trustee. Segal v. Rochelle, 382 U.S. 375 (1966). See 4A COLLIER ON BANKRUPTCY § 70.28, at 398-405 (14th ed. 1967); 110 U. PA. L. REV. 275, 275-81 (1962).

92. Cf. 12 C.F.R. §§ 220.1-8 (1967) (Regulation T of the Federal Reserve limiting the amount of credit on securities accounts which brokers and dealers may extend); 12 C.F.R. §§ 221.1-4 (1967) (Regulation U, limiting the amount of credit which banks may extend for the purchase of securities when the credit is secured directly or indirectly by stock); 31 C.F.R. § 315.15 (1967) (savings bonds may not be "hypothecated, pledged as collateral or used as security . . .").

Admnistration of any prohibition would be simpler than administration of Regulations T and U in as much as the only test would be a "collateral" one without the need for a "purpose" test. See generally McEvoy, Bank Loans and Regulation U, 81 BANCOMER L.J. 658 (1967).

93. Cf. 12 C.F.R. § 221.113 (1967) (loan to a mutual fund which agreed to leave in the

1238
supplement the anti-assignment rule and prevent the more obvious circumventions of those provisions. But unsecured creditors will probably be willing to lend more money or to charge less interest to persons with substantial deposits than to persons not holding accounts.\textsuperscript{64} Consumer credit should be more readily available to a taxpayer with large deposits; the same is true for unincorporated businessmen wishing credit on open accounts. Even if the taxpayer does not receive additional credit, he will be able to undertake activities which he could not otherwise risk because of the security and additional liquidity which the funds provide.

Cash-basis accounting provides another means of reducing the cost of holding non-interest-bearing deposits. The taxpayer may be able to cut such costs in half by manipulating the timing of his deposits and withdrawals. By depositing income at the close of his taxable year or within 60 days afterwards, and subsequently withdrawing the deposits just after the expiration of the twelve-month minimum holding period, the taxpayer could postpone his taxes for two years while foregoing the use of the income for only a single year.\textsuperscript{65} A variant of this procedure would allow the taxpayer to enjoy earnings on the income every other year without ever paying tax on it. In theory, the profitability of such maneuvers could be limited by adjusting the withholding tax at withdrawal.\textsuperscript{66} A completely effective flat rate, however, would have to be

\begin{equation}
\text{cost of using the accounts in this way at the close of the taxable year in which the withdrawal is made would be:}
\end{equation}

\begin{equation}
v^t(1-t)^2 + 2t(1-t)^2 - (1-w) t (1-t)
\end{equation}

where \( w \) is the rate of withholding, \( r \) is the marginal rate of return on investments held by the taxpayer, and \( t \) is the taxpayer's marginal tax bracket. Since the first term of the formula is relatively insignificant, the taxpayer is essentially foregoing one year's earnings on his after-tax income but is gaining one year's earnings on the difference between his marginal tax rate and the withholding rate. An analogous situation used to exist under the partnership provisions when the taxable year of the partners differed from the taxable year of the partnership. See B. Bittker, \textit{supra} note 72, at 748 (1964).

\textsuperscript{65} The Commission suggests a withholding rate of 30 per cent. 3 \textit{Revorr} 271.
set at the maximum marginal rate, penalizing individuals in lower brackets by denying them use of the excess amount withheld until the end of the tax year. Nor would it be simple to individualize withholding rates. Using income prior to the deposit deduction as a guide would usually overstate liability because persons holding the accounts will naturally tend to have declining incomes. Another approach would be to attribute withdrawals made early in the taxable year to the prior year's income in the same way that the Code formerly tried to cope with "Dean" trusts, but this would further decrease the flexibility of the accounts and their availability for intended uses.

It is important to estimate accurately the ability of account holders to borrow on the strength of accounts or to manipulate the timing of deposits, for if this power is significant, it will reduce sharply the opportunity costs of holding the non-interest-bearing deposits. Indeed, if the power is sufficiently great, there may be cases in which a taxpayer without fluctuating income would still find it profitable to make deposits. Yet it is the lack of earnings which is relied upon to limit use for purposes other than averaging.

99. The cost to the taxpayer of using the accounts is equal to his after-tax return on the difference between what he could earn on his after-tax income and his net return on the amount which he can borrow while holding the deposits. This may be represented algebraically as

\[
(1) \quad (1-t) \left[ r (1-t) - b (r-i) \right] r \geq 1
\]

where \( r \) and \( t \) are used as in note 95, supra, \( r \) equals the marginal cost of borrowing if the taxpayer holds the income in deposits, and \( b \) equals the proportion of the deposits which the taxpayer is able to borrow.

When the taxpayer is unable to borrow on the strength of the deposits or when the rate of return on his investment is less than the rate at which he must borrow, the cost of holding deposits becomes

\[
(2) \quad (1-t) r (1-t) = (1-t)^2 r
\]

If earnings on investments are not effectively taxed because of postponement until realization, these formulas become

\[
(1') \quad r (1-t) - b (r-i) \quad r \geq i
\]

and

\[
(2') \quad r (1-t).
\]

100. This can occur only if the net benefit from borrowing is greater than the amount of earnings on the after-tax income. Although this would not normally be the case, it may result when marginal tax rates are high, the proportion which the taxpayer can borrow is large, and the spread between the borrowing rate and the rate of return is significant. For example, if the taxpayer's marginal rate is 70 per cent and he is able to borrow 70 per cent of the amount of his deposits (the percentage which he could realize after withholding under the Commission's proposals) and the cost of borrowing were 8 per cent, the taxpayer would find the accounts profitable whenever he could earn more than 14 per cent on his investment. He would need to earn only 10.5 per cent if he could borrow for 6 per cent; he would have to earn 17.5 per cent if the cost of borrowing were 10 per cent.
Even were one to succeed in neutralizing the accounts, a second serious abuse is possible. The accounts may be used for speculation on changes in tax rates. 101 In order to avoid complex sets of schedules and the need to retain tax information over long periods, the deposits must be taxed in the year of withdrawal without regard to the rates existing at the time of deposit. 102 To dampen speculation the Commission suggested that withdrawals be prohibited for twelve months after deposit. 103 Although this would increase the cost of speculation, the attractiveness of speculation depends upon a number of factors, and profits would still be possible even if the taxpayer's income does not fluctuate.

Without borrowing or timing manipulation, account-holding taxpayers could have realized sizable profits from the 1964 and 1965 tax reductions in the United States. 104 Moreover, in both cases the taxpayer would have had to take almost no risk because the tax decrease was announced within 60 days of the close of the 1965 taxable year, 105 the period the Report would have allowed for depositing 1963 income.

How frequently such opportunities arise will depend upon how often rate or other changes affecting the computation of taxable income occur. 106 Although there have been rate changes in the United States in only two years since 1954, 107 rates were altered 25 times between the inception of the income tax in 1913 and 1954, 108 and if the income tax is used more actively in the future as a tool for economic stabilization, rate changes may again become more frequent. 109

If rates go up, depositors should not be allowed to escape the consequences. But the taxpayer may be able to avoid paying the higher rates by liquidating after the new rates are enacted but before they

101. See 3 REPORT 270-71. 
Speculation in the absence of borrowing effects or the manipulation of taxable years, is profitable when formula (2), supra note 99, results in a figure less than the change in marginal tax rates.
102. See p. 1225 supra.
103. 3 REPORT 270.
105. The act was adopted on Feb. 25, 1964. 1964 U.S. CODE CONG. & AD. NEWS 22; 2 id. 4556.
107. See text accompanying note 104 supra.
109. See, e.g., the Swedish structure in which adjustments to the base rate are made annually without the necessity of reopening the entire statute. WORLD TAX SERIES, TAXATION IN SWEDEN 77 (1959). See also R. Goode, THE INDIVIDUAL INCOME TAX 301-07 (1964).
take effect or by holding through the period of high rates. Unlike more specialized taxes such as the interest equalization tax, it would not be feasible to prevent this by making any income tax increase retroactive to the time of original submission. To alter the timing of such major tax changes only to prevent abuse by account holders would be senseless. To adopt special rules for holders of the accounts would require the very administrative complexity which the accounts are designed to avoid.

Holding through the period of high rates would be desired by the government and an attractive gamble for taxpayers when a temporary surcharge is used to dampen cyclical economic peaks. It could backfire, however, when, as in so many cases, temporary surcharges become permanent. The result might be political pressure from account-holders. In fact, whenever there is a tax increase deposit-holding taxpayers will seek exemption from the increase on the ground that the income was received in earlier periods. These pressures would probably be even more severe when inflation, a normal accompaniment of the need for rate increases, reduces the real value of the accounts.

To suggest that such losses were part of the risks accepted when the deposits were made may be a rational answer, but it will predictably fail to satisfy account holders.

Both the likelihood of speculation and the incentive to evade efforts to neutralize the accounts depend upon the level of tax rates. If the alternative to tax postponement through deposits is low preferential taxation, such as capital gains treatment in the United States, speculation would rarely be profitable unless a very substantial change in rates is expected. If the taxpayer cannot otherwise avoid high marginal

---

110. See S. REP. No. 1267, 88th Cong., 2d Sess. 9, 23 (1964) (interest equalization tax made retroactive to the day following the announcement of the President that he would seek legislation).

111. The gestation period of income tax increases may be extremely long. President Kennedy requested a tax reduction on January 24, 1963 as his highest priority legislation. The reduction did not become law until 13 months later on February 26, 1964, 22 Cong. Q. 387 (1964). The problems from under-withholding for such a period are just one example of the difficulties which retroactivity would create.

112. See p. 1225 supra.


114. Price changes are a cost in holding the accounts, but they will usually influence the taxpayer through their effect on the rates of return offered by alternative investments. The income tax system does not elsewhere recognize income transfers caused by price fluctuations, and there is no reason why the accounts should be an exception. See R. A. Musgrave, The Theory of Public Finance 168-69 (1959).

115. This is readily apparent from the formulas, supra note 99, expressing the cost of holding the accounts. As the rate of tax, t, becomes smaller, the holding costs always become larger.
Income Averaging: A Canadian Suggestion

rates, however, speculation would be more attractive. For a person paying taxes at the maximum marginal rate proposed by the Report, 50 per cent, a deposit held for one year would be as profitable as an investment with a ten per cent before-tax return if the tax rate were decreased by less than three percentage points. When marginal tax rates are higher, as in the United States, extremely small decreases in tax rates would make speculation profitable.

The limited usefulness of the income adjustment accounts in either the proposed Canadian system or the present United States code must be balanced against these substantial dangers. Since other methods of averaging are available for short-run periods, there seems little justification for adopting a program of income accounts unless a stronger case is made for long-term averaging. On the other hand, if long-term averaging is felt to be that important, the adoption of more complex but more controlled methods, available to all taxpayers, should be considered.

116. A taxpayer could well have a high marginal rate for ordinary income while having a low effective rate. Slightly less than half of the taxable income of all taxpayers having adjusted gross incomes over $100,000 in the United States was taxed at capital gains rates in 1965. The other half of their income was taxed at ordinary rates. See Statistics of Income, supra note 78, at 17-18. The high marginal rates on ordinary income would make speculation attractive to these taxpayers unless their alternative investments would yield returns in the form of capital gains.

117. Speculation in the absence of borrowing effects or manipulation of taxable years is profitable when the result of formula (2), supra note 99, is less than the change in marginal tax rates.

118. At the present maximum marginal rate in the United States, 70 per cent, a rate change of less than 1.3 per cent would be equivalent to a before tax investment yielding 10 per cent, and a change in the maximum rate of only three percentage points, from 70 per cent to 67 per cent, would be equivalent to a 10 per cent after tax return for persons in the highest marginal tax brackets.


120. See W. Vicker, supra note 4, at 172-95.