

The Treasury's Tax Reform Proposals: Not A "Fair" Tax

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*The present income tax is badly in need of fundamental simplification and reform. It is too complicated, it is unfair and it interferes with economic choices and retards saving, investment and growth.*¹

The Treasury Department's view of the current income tax system, as reflected in its 1984 Report to the President on tax reform, is reminiscent of Thomas Hobbes' view of life in the state of nature. To Hobbes, such a life was "nasty, brutish and short,"² and accordingly in desperate need of change. To alter this state of affairs, Hobbes created the Leviathan, an all powerful creature capable of imposing order on the existing political chaos.

The Treasury has only slightly less ambitious hopes for its proposed reform of the tax code. According to the Treasury, the present income tax system is deeply unfair. Two households with equal incomes pay different amounts of tax depending on how they receive or spend income,³ and families can be taxed even though their income is below the poverty level.⁴ The current income tax is also extremely complex. According to the Treasury, many Americans have become part-time bookkeepers, required to keep extensive records in order to compute their tax liability.⁵ The greatest flaw of

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1. U.S. TREASURY DEPARTMENT, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH, THE TREASURY DEPARTMENT REPORT FOR THE PRESIDENT 1 (1984) [hereinafter cited as TREASURY REPORT].

2. T. HOBBS, LEVIATHAN: ON THE MATTER, FORME AND POWER OF A COMMONWEALTH ECCLESIASTICALL AND CIVIL, 82.

3. 1 TREASURY REPORT, *supra* note 1, at 5. Examples of tax preferred income include life insurance (I.R.C. § 101), scholarships (I.R.C. § 117) and employer provided child care (I.R.C. § 129). Examples of tax-preferred expenditures include deductions for medical expenses (I.R.C. § 213), charitable contributions (I.R.C. § 170) and interest on home mortgages (I.R.C. § 163).

4. 1 TREASURY REPORT, *supra* note 1, at 14.

5. 1 TREASURY REPORT, *supra* note 1, at 3. "A simple tax system would not require 41 percent of all taxpayers—and about the 60 percent of those who itemize deductions—to engage professional assistance in preparing their tax returns." *Id.* at 16. Complexity arises because of the large number of special provisions that depart from basic income tax principles. These include many of the items the Treasury seeks to repeal, such as the deduction for two earner married couples (I.R.C. § 221), the treatment of

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the current income tax, contends the Treasury, is its economic inefficiency. The income tax is replete with preferences that distort business and investment decisions. In addition, the system fails to account adequately for the effects of inflation.⁶

The Treasury has proposed a modified flat rate tax to right what is wrong with our tax system. The Treasury thinks a modified flat tax imposed upon a broad base will rationalize a tax system that has developed without a consistent theory, induce a public bent upon tax avoidance to embrace compliance and, perhaps most importantly, stimulate economic growth. The Treasury's view is that a lower tax rate coupled with a broadened base and larger personal exemptions will yield a fairer, more balanced system. Reducing rates, eliminating preferences and other modifications, such as the partial integration of the corporate income tax, will, it is hoped, lead to a more efficient, growth-oriented tax. Finally, these changes, together with the elimination of a host of deductions and credits, ranging from the state and local tax deduction⁷ to the residential energy credit,⁸ will simplify the system sufficiently to cause a return to the halcyon compliance of years past.⁹

Few would dispute the claim that the present income tax system is seriously flawed.¹⁰ Admittedly, the Internal Revenue Code contains serious impediments to a fair, efficient and easily administered tax.¹¹ However, in evaluating the Treasury's proposals it is not sufficient to end the inquiry by noting the existing problems in the Code. The issue is whether these flaws are sufficient cause to re-

voluntary employee beneficiary associations (I.R.C. §§ 401-420), and the deduction for state and local taxes (I.R.C. § 164).

6. 1 TREASURY REPORT, *supra* note 1, at 6. The Accelerated Cost Recovery System was enacted in 1981 partially to account for the disparity between historic and replacement costs of depreciable assets. I.R.C. §§ 167-168. The rules governing the tax treatment of debt instruments using original issue discount rather than stated interest have recently been expanded. The rules now apply whenever debt is issued for property rather than only when the debt was publicly traded or issued by a corporation. I.R.C. §§ 1271-1275. The failure to require the accrual of interest on all such obligations had allowed taxpayers to treat interest payments as part of the purchase price of the property. Thus, they could obtain a larger basis for depreciation deductions or could treat a larger portion of their proceeds from the sale of the property as capital gain.

7. I.R.C. § 164.

8. I.R.C. § 44(c).

9. All compliance estimates are, of course, speculative. According to the Treasury, however, unreported income for 1981 was \$90.5 billion. 1 TREASURY REPORT, *supra* note 1, at 89.

10. See, e.g., OPTIONS FOR TAX REFORM, (J. Pechman ed. 1984) (Brookings Institution).

11. See Graetz & McDowell, *Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax*, 3 YALE LAW & POL'Y REV. 5, (1984).

place our progressive income tax with the proposed modified flat tax.

This discussion will approach this question by first identifying those characteristics of an "ideal" tax system that can be considered universal or around which a consensus has emerged. These characteristics—described in Part I—constitute the shared premises of an ideal tax system. The extent to which the Treasury's proposals reflect the most important of these premises—fairness—will be explored in Part II. That discussion will suggest that the Treasury's claim that its proposals will not result in an overall redistribution of tax burdens is specious. In fact, in practical economic terms, the Treasury's proposals would have a generally regressive effect, favoring the wealthy at the expense of the poor.

There are, of course, some limitations to this approach. One might question whether it is at all meaningful to speak of an ideal tax system. Perceptions of what is desirable in a tax system are often colored by the observer's self-interest, and value judgments are not necessarily made on the basis of detached, objective analyses. Moreover, even if a system of shared premises could be imagined, it remains questionable whether it could emerge unscathed from the political process.¹² Despite these practical limitations, no useful critique of the Treasury's approach to tax reform can be offered without reference to the norms suggested by these shared premises.

I. *The Normative Framework*

The shared premises of an ideal tax system can generally be described as fairness, efficiency and simplicity. These normative assumptions are not objectively measurable; rather they reflect particular subjective values. The means by which these values are realized are certain to reflect individual political outlooks. Those who believe the government's role in the economy should be restricted will view these goals differently from those who believe the government has an obligation to mitigate the adverse impact of the free market system. For instance, to those who believe in the distributive justice of the free market economy, fairness may mean not depriving the successful of their earnings; to those who emphasize the redistributive obligations of government, fairness may mean imposing greater taxes on those of greater means.¹³ In brief, the

12. See, e.g., Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L. J. 259, 274-77 (1984).

13. See generally STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 2D SESS.,

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choice of a system of taxation reflects subjective political orientation more than objective economic truth.

A. *Fairness*

All agree that a fair and equitable tax system is desirable. There is less agreement about the contours of such a system. Various tests of fairness exist; two will be discussed here. Horizontal equity measures deviations from the equal treatment of equally situated taxpayers. Vertical equity, on the other hand, focuses on how relevant differences among taxpayers are accounted for.¹⁴ Each concept carries with it a unique set of difficulties; both are susceptible to ambiguous interpretation; neither is purely objective.

For a system to be fair it must, at a minimum, achieve horizontal equity.¹⁵ In an income tax system, horizontal equity mandates that taxpayers with the same income pay the same amount of taxes. Identical income implies an identical ability to pay. Since both components can be quantified, horizontal equity is a purportedly objective measure of fairness.

The goal of equal treatment for those in equal economic positions is an admirable one. Even if this principle were universally accepted, however, serious problems remain in giving content to its terms. Is income rather than wealth or consumption the proper measuring rod?¹⁶ Is an annual measurement, substantially divorced from the events of prior years, the proper approach?¹⁷ Similar questions abound. Thus, as a threshold matter, we must acknowledge that horizontal equity is not capable of precise computation.

Another measurement of fairness is vertical equity. This requires that taxpayers with different levels of income pay differing proportions of their income in tax. But whether vertical equity has been achieved is not subject to objective verification either. Rather, the

ANALYSIS OF PROPOSALS RELATING TO BROADENING THE BASE AND LOWERING THE RATES OF THE INCOME TAX, (Comm. Print 1982).

14. *Id.*

15. *Id.*

16. See 1 TREASURY REPORT, *supra* note 1, at 255 (comparing the Treasury's Proposal with the tax systems of several other countries). See also Andrews, *A Consumption-Type or Cash-Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

17. The Code contains provisions designed to mitigate the effects of an annual accounting period. The present carryover rules for net operating losses, however, are limited to trade or business losses and restricted to a specified number of years. (I.R.C. § 172). For individuals, income averaging offers some ability to account for widely differing income in different years. However, the income averaging rules apply only when income in the current year substantially exceeds the average of the prior years. (I.R.C. § 1302).

degree to which a system should be progressive or regressive implicates fundamental value judgments. Advocates of a progressive tax system argue that the costs of government should be imposed in proportion to the ability of taxpayers to bear them.¹⁸ Central to this normative concept is a belief that government should facilitate wealth redistribution. Opponents of progressivity argue that it is unfair to penalize those who are successful in a free market economy, and implicitly reject the idea that the government should help the unsuccessful through the tax system.¹⁹ Complete lack of progressivity would result in a pure flat rate tax.²⁰ This kind of tax does not appear to command majority support. Despite the rising political influence of opponents of progressivity, a national consensus clearly exists in favor of imposing a greater tax burden on those with a greater ability to bear that burden.²¹

A third way in which fairness defies objective characterization is that both vertical and horizontal tests of equity presuppose some measurement of the base upon which tax is imposed. For instance, the income of two taxpayers is not, in fact, the same if the system excludes economic benefits conferred on one taxpayer, but not on the other.²² Similarly, if the system favors a certain type of expenditure, a taxpayer who can make this kind of expenditure will not have the same income as a taxpayer who cannot make such expenditures.

These ways of looking at fairness and equity illustrate what is at stake. An important task of a tax system is to allocate the burden of paying for government. This task is properly carried out in the context of an overall social and economic policy. The decisions we make when we choose a tax system reflect our most basic views of how society should be organized. If we believe the tax system should attempt to increase the benefits available to those of lesser

18. See, e.g., C. GALVIN & B. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* (1966).

19. See, e.g., Blum, *Revisiting the Uneasy Case for Progressive Taxation*, 60 *TAXES* 16 (1982). Even strident free market advocates, one hopes, recognize some minimal burden on society to aid the desparately impoverished.

20. For a summary of recent flat tax proposals see Graetz, *The 1982 Minimum Tax Amendments: A First Step in the Transition to a "Flat-Rate" Tax*, 56 *S. CAL. L. REV.* 527 (1983). A pure flat rate tax is imposed at a single rate with no personal exemptions or deductions.

21. The Treasury notes that the degree of progressivity is a matter "on which opinions differ." 1 *TREASURY REPORT*, *supra* note 1, at 14. It assumed that the distribution of the tax burden across income classes under current law should be preserved, not because the present distribution is correct, but because its preservation would render the proposal neutral with respect to the current system. 1 *TREASURY REPORT*, *supra* note 1, at 15.

22. See, e.g., I.R.C. § 119 (employer provided meals and lodging).

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means, we will allocate a greater proportion of the tax burden to those of greater means. On the other hand, if we believe that individuals who succeed financially are entitled to enjoy their winnings while those who fail, or are less successful, must suffer their losses, we will choose a system that imposes more proportionate burdens upon all taxpayers. Thus, the debate over the tax system occurs amidst a general debate over social policy and the proper role of government.²³ Flat rate tax proposals are often associated with positions favoring a limited government role in the economy and fewer social programs. General distributive notions and government monitoring of the economy are conceptually consistent with a progressive tax system.

Because the issues involved go to the heart of our notions of democratic government, it is impossible to resolve fully the debate between these competing views. The equity sought in the tax structure can be found neither in ostensibly objective measurements of horizontal equity, nor in debates over value judgments concerning progressivity. Rather, equity requires a sensitive balancing of competing values. Those who equate the allocation of tax burdens with the redistribution of wealth believe a fair tax system must impose upon those with high incomes a proportionally greater tax burden. This typically involves progressivity in the rate structure. The progressivity must be sharp enough to persuade the middle classes that their tax burden is significantly lighter than that of the wealthy. Fairness also requires that wealthy taxpayers not exploit the rules to lower their effective tax burden. This demands not only the elimination of mechanisms that permit tax avoidance, but also a reevaluation of preferences and incentives to insure that only clearly defined policy interests are served.²⁴

For those adopting the view that government should not interfere with the economy, the tax system must permit some wealth to be accumulated. To be perceived as fair, such a system must reward those who succeed in the market economy. Further, the tax must not be confiscatory, or even viewed as such. These ends can be achieved either through lower rates or through a combination of other incentives.

Both camps must share a conception of the base upon which tax is

23. See, e.g., R. NOZICK, *ANARCHY, STATE AND UTOPIA* (1974), but compare J. RAWLS, *A THEORY OF JUSTICE* (1971).

24. The present system is replete with exemptions that can be characterized as subsidies of preferred activity. See generally S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* (1973).

imposed. It is not necessary that all agree on each inclusion in, or exclusion from, income. Neither must all agree on which expenditures properly give rise to a tax benefit. Rather, it is probably sufficient that the net income upon which tax is imposed be fairly determined. The result is not necessarily a base that is comprehensive, but one in which deviations from a comprehensive base can be readily justified by policies recognized as legitimate by a national consensus.

B. *Efficiency*

To be efficient, a tax system must satisfy a number of concerns. Among these are the kinds of economic activity the tax system encourages or discourages, the degree to which the system impedes business transactions, and the costs of enforcement.

Particular attention has been focused on the economic incentives created by the tax code.²⁵ A common attack on the present system is that it encourages transactions that are, at best, motivated primarily by tax considerations and, at worst, excuses for fraud and willful noncompliance.²⁶ The ease with which inefficient and otherwise undesirable transactions are consummated is a major flaw in the present system.

Largely as a reaction to tax preferences, the Treasury lists as the first goal of tax reform "economic neutrality."²⁷ By use of this term, the Treasury manifests its judgment that the tax system should not interfere with a free market economy, which tends "to allocate economic resources to their most productive uses."²⁸ Thus, the Treasury's "ideal tax system would be as neutral as possible toward private [economic] decisions."²⁹

One may share the Treasury's concern about tax preferences without agreeing that the system should be entirely "neutral". An alternative view is that the tax system, as part of a national economic policy, should be used to encourage activities that the government believes desirable. Tax policy should be used in conjunction with other policies to pursue social and economic ends. For instance, to encourage the development of low income housing, Congress enacted special tax rules benefiting both developers of, and investors

25. *Id.*

26. 1 TREASURY REPORT, *supra* note 1, at 87-91.

27. *Id.* at 13.

28. *Id.*

29. *Id.*

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in, low income housing projects.³⁰ The benefits available to capital intensive industries through accelerated cost recovery deductions and investment tax credits are further examples of how tax policy can be integrated with economic and social policies to pursue useful ends.³¹ In fact, no one is suggesting the elimination of perhaps the most prominent economic incentive in the Code—the subsidy given to homeowners and the housing industry in the form of deductions for interest on mortgages and real estate taxes.³²

The debate over whether the tax system should promote social and economic ends reflects many of the same political issues underlying the fairness debate. Economic neutrality is an affirmation of faith in the free market economy. More particularly, it is an assertion that those private actors who control economic development will make the “right” choices for society without government involvement.³³ Making tax policy part of an overall social and economic policy, however, does not imply the abandonment of a free enterprise economy. Rather, it is a recognition that there are times and circumstances in which the public good is served by government moderation of unrestrained economic forces through the tax code.³⁴

The economic efficiency of the tax system can also be measured by its impact on business. Because taxes constitute a part of the cost of most transactions, taxpayers will naturally structure transactions to avoid them. This is usually accomplished by legal means. Tax considerations, however, may cause a transaction to be structured in an unnecessarily complex manner. The desire to avoid taxation thus may result in additional transaction costs, as expensive professionals will be required to reduce taxable income. An efficient tax system will minimize the distortion of sound business practices.

A third measure of a tax system’s efficiency is its administrability. This measure of efficiency is a combination of the ease with which taxpayers can comply and the costs associated with enforcement. For example, payroll withholding taxes are efficient because their collection is simple and easily monitored. Taxes on imported liquor,

30. I.R.C. § 167(k) (Prentice Hall 1984).

31. The investment tax credit (I.R.C. §§ 46-48) and, to some extent, the accelerated cost recovery provision (I.R.C. § 168) are designed to encourage businesses to invest in new plant and equipment.

32. I.R.C. §§ 163-164.

33. Absent government intervention private economic actors would, of course, exercise a dominant influence on the economy.

34. See, e.g., Graetz & McDowell, *supra* note 12; C. GALVIN & B. BITTKER, *supra* note 18.

however, are not efficient because their collection is difficult and not easily monitored. A tax system's efficiency is thus inextricably related to its simplicity.

C. *Simplicity*

A third generally accepted premise of an ideal tax system is simplicity. A tax system must be comprehensible to the public, not just to sophisticated business executives and professional advisers. The concepts underlying the system should not be complex or intricate. Compliance should be relatively easy in most situations for most taxpayers. Taxpayers whose returns do not involve trade or business computations should be able to avoid using tax professionals. Further, the system should not be so complex that it affords significant tax avoidance opportunities for those able to hire skilled advisers.

It is important to note, however, what simplicity does not require. The statutory provisions themselves need not be easily understood by all taxpayers. The enormous complexity of the American economy demands complex rules to make subtle distinctions among transactions of similar appearance but different consequences. No modern tax system can afford not to make these difficult distinctions.

As the foregoing analysis of fairness, efficiency and simplicity indicates, a tax system requires a balancing of conflicting normative perspectives. A fair system must balance the views of those advocating the primacy of economic self-interest against the views of those advocating redistribution of wealth. An efficient system must balance the views of those who believe that the tax law must direct investment towards certain social goals against the views of those who believe the tax law must be economically neutral. A simple tax system must balance the need to make the system comprehensible to most taxpayers, against the need for a system complex enough to tax transactions appropriately. How well does the Treasury's proposal mediate these conflicts? This is the subject of Part II.

II. *Analysis of the Modified Flat Tax*

The Treasury's proposal is a poor substitute for even the seriously flawed present system. Although the Treasury makes some meritorious proposals, it fails to reflect a true national consensus, or to strike an appropriate balance between competing views of fairness, efficiency and simplicity. The Report is strongly influenced by

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free market perspectives. The Treasury's disregard for the contrary viewpoint makes its version of the modified flat tax unfair, inefficient and not particularly simple.

The Treasury's proposal measured against the premises of an ideal system, seems primarily intended to preserve the wealth of those who now possess it. Although the proposal bestows some benefit on those with incomes below the poverty line, it offers the majority of taxpayers little relief from the present system.³⁵ The Treasury's proposal is unfair because it is unlikely to convince most taxpayers that the well-off will pay their fair share. In terms of efficiency, the Treasury makes progress in eliminating tax shelters, but abdicates responsibility for determining the type of economic activity the nation ought to have. For simplicity, the Treasury offers a system with fewer provisions, but one that introduces new complex concepts and fails to correct many existing complexities in the Code.

This section will make some observations regarding the level of fairness embodied in the Treasury's proposals. Although touted as distributionally neutral, the practical economic effects of the proposed modified flat tax will disproportionately favor higher income Americans. This is a direct consequence of the mechanisms chosen for implementing tax reform: the reduction in tax rates, and the broadening of the tax base through the elimination of tax preferences. This latter set of reforms will be shown to be pretextual justifications for an important readjustment of relative tax burdens among economic classes.

The Treasury's approach to fairness is far from fair. Its principal component is the reduction in rates. The Treasury would replace the present system of 14 tax brackets, ranging from 11 percent to 50 percent, with three tax brackets of 15 percent, 25 percent and 35 percent.³⁶ Thus, for taxpayers in the top bracket, the Treasury's proposal would result in a 30 percent decrease in the maximum marginal rate.³⁷ According to the Treasury, rate reduction will make

35. The Treasury would insure that the poor not be taxed by increasing the zero bracket and personal exemptions. 1 TREASURY REPORT, *supra* note 1, at viii. A simpler alternative would have been to raise the zero bracket without increasing personal exemptions. Under the Treasury's proposal two families with identical incomes will be taxed differently depending on the number of children and other dependents.

36. 1 TREASURY REPORT, *supra* note 1, at 63. There are currently 14 brackets for married couples and heads of households and 15 brackets for individuals.

37. Of the Treasury's examples, the largest benefit will be realized by the "typical" married couple with annual income in excess of \$600,000. 2 TREASURY REPORT, *supra* note 1, Example 6.

the system more equitable in several ways. First, it will discourage tax shelters.³⁸ Rate reduction will reduce the attractiveness of both legal and illegal tax avoidance devices. Second, lower tax rates, the Treasury suggests, will lower barriers to entering the workforce. Under the present system after-tax wages may not be sufficient to compensate workers for the added costs of producing that income. Finally, the Treasury notes that “[e]ven without elimination of the tax preferences, credits and deductions, rate reduction will lessen the disparity on the tax treatment of various sources and uses of income.”³⁹

These claims are easily disproven. On its face, the lowering of tax rates disproportionately favor the wealthy. High income taxpayers will reap a major windfall in the reduction of the marginal rate from 50 percent to 35 percent. The supposed benefits of the elimination of employment disincentives are equally illusory. The Report states that “while lower marginal rates tend to increase work incentives for everyone, the incentive effects will be especially pronounced for secondary workers, persons who often have considerable discretions over their labor market activity.”⁴⁰ It is questionable, however, whether the reduction in the maximum tax rate will affect radically the incentive structure of the present system. Moreover, the extent to which the Treasury’s proposal would remedy the present system’s adverse effect on productivity can easily be exaggerated.⁴¹ Finally, while rate reduction necessarily reduces the economic benefit derived from tax preferences, no serious tax analyst would defend the “neutrality” of the Treasury’s proposals were rate reduction not combined with a broadened tax base. It is to these reforms that we turn next. Ironically, these base broadening reforms actually support the charges of unfairness levelled at the Treasury’s Report.

The Treasury proposes broadening the tax base in several ways. It proposes to end the exclusion from income of virtually all forms of employee benefits, government transfer payments and other previously tax free receipts.⁴² Among the items to be included in in-

38. 1 TREASURY REPORT, *supra* note 1, at 4-7.

39. *Id.* The Treasury implies that rate reduction is contingent on the expansion of the tax base. *Id.* at viii.

40. *Id.* at 64

41. For example, a married couple currently reaches a 42 percent marginal rate at a taxable income of \$60,000. But the couple must have more than \$80,000 in taxable income to reach the 45 percent rate, more than \$100,000 of taxable income to reach the 49 percent rate and finally, more than \$162,000 of taxable income to reach the maximum 50 percent marginal rate.

42. 2 TREASURY REPORT, *supra* note 1, at 22.

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come are group health insurance payments above a specified amount,⁴³ the benefits of term life insurance,⁴⁴ and employer provided death benefits.⁴⁵ In addition, unemployment benefits would be included in income,⁴⁶ as would scholarships and fellowships to the extent they exceed tuition charges.⁴⁷ Finally, awards and prizes would also be included in income.⁴⁸

The Treasury would further broaden the tax base by eliminating deductions and credits for many currently preferred uses of income. The recommendation likely to have the greatest effect on revenue is the repeal of the deduction for state and local income, sales and property taxes.⁴⁹ Other measures include new limitations on charitable contribution deductions for those who itemize deductions and the elimination of this deduction for those who do not itemize.⁵⁰

In its effort to make the tax base more comprehensive the Treasury also proposes to eliminate certain particularly abused provisions. Among the proposals are limitations on deductions for business meals and elimination of deductions for ostensibly "business related" entertainment.⁵¹ In addition, the "at risk" rules,⁵²

43. *Id.* at 25. The Treasury's proposal would include in income the cost of employer provided health insurance benefits to the extent they exceed \$70 per month for an individual and \$175 per month for a family.

44. *Id.* at 29-30. The proposal would include in income the cost of all group-term life insurance. Current law includes only the cost of such insurance in excess of \$50,000.

45. *Id.* at 31. The Code excludes up to \$5,000 of employer provided death benefits. I.R.C. § 101(b). The Report would also include in income the cost of employer provided group legal services, 2 TREASURY REPORT, *supra* note 1, at 33, and cafeteria plans which offer employees a choice of benefits. *Id.* at 39.

46. *Id.* at 51

47. *Id.* at 58. Under present law, scholarships and fellowships are excluded. I.R.C. § 117.

48. 2 TREASURY REPORT, *supra* note 1, at 60. I.R.C. § 74(b) excludes prizes and awards from income if given in recognition of religious, literary or other meritorious achievement. The recipient must not have sought the award and cannot be required to render substantial future services.

49. 2 TREASURY REPORT, *supra* note 1, at 62-65. According to the Treasury, repeal of these deductions should yield increased revenues in excess of \$33 billion. The Treasury argues that state and local revenues are expended largely for services that satisfy the personal needs of the individual taxpayer, such as public education, fire and police protection, mass transit, etc. A federal subsidy for personal expenditures is inconsistent with a broad based tax.

50. *Id.* at 75-79. The Treasury would allow the charitable deduction when the contribution exceeds 2 percent of adjusted gross income. The Treasury contends that monitoring small deductions is administratively difficult. Moreover, the Treasury asserts that these deductions are an inefficient subsidy of charitable activities because taxpayers would make these small contributions regardless of their tax consequences. Deductions for large contributions, however, are to be maintained on the theory that they are an efficient and necessary subsidy. In addition, a deduction for large gifts is appropriate, the Treasury argues, because such gifts can affect substantially the ability to pay taxes.

51. *Id.* at 81-85. The Treasury would replace the present system, which allows deductions for properly substantiated entertainment expenses if such expenses are not

which were designed to limit non-recourse financing of tax shelter investment, would now be applied to real estate as well as to other activities. Limitations would be imposed upon interest deductions, other than interest incurred in a trade or business.⁵³ The period over which capital assets may be depreciated would be extended.⁵⁴ Another proposal would curtail the ability of taxpayers to use family trusts to shift income to family members in lower tax brackets.⁵⁵

These changes in the tax base are intended to negate the clear benefits to high income individuals from reduced tax rates. According to the Treasury, wealthy taxpayers disproportionately benefit from tax preferences, deductions and exclusions from income. Therefore, the Treasury contends, the elimination of these tax avoidance mechanisms will increase the aggregate tax liability of

extraordinary, with a detailed system that would place specific dollar limits on the amounts that may be spent for hotels and meals. The standard would be based on the federal per diem allowance. The Treasury seems to believe that entertainment expenditures outside a strict business context are often little more than public subsidies of private pleasures.

52. *Id.* at 334-335. I.R.C. § 465 limits losses to the amount the taxpayer has at risk, "including cash and property invested, and debt only if the taxpayer is personally liable for repayment or if the debt is secured with personal assets (up to the value of the taxpayer's interest in the property). The taxpayer is not at risk if he is protected against loss through nonrecourse financing, guarantees, etc." B. BITTKER & L. STONE, *FEDERAL INCOME TAXATION* 573 (5th ed. 1980).

53. The Treasury would extend the investment interest rules to all interest deductions other than interest paid or incurred in order to purchase or carry the taxpayer's principal residence. The \$10,000 limitation in present law (I.R.C. § 163(d)) would be reduced to \$5,000. All interest in excess of the \$5,000 would be deductible against investment income, whereas under present law investment income can be used to shelter investment interest, with interest incurred for personal purposes deductible without limitation. 2 *TREASURY REPORT*, *supra* note 1, at 331-332. The Treasury would also index indebtedness for inflation, with the result that deductions for interest would be limited to the extent the expense represents only the true interest expense after inflation. For example, an interest payment of \$10 on a \$100 loan bearing 10 percent interest would be deductible only to the extent of \$6 or six percent if the inflation rate is 4 percent. *Id.* at 197-198.

54. The Treasury would replace the present accelerated cost recovery system with a "real cost recovery system." *Id.* at 299. Under present law, assets are generally divided into 3 year, 5 year, 10 year and 18 year real property with the classes describing the period over which the cost of the asset may be recovered. I.R.C. § 168. Under the Treasury's proposal, assets would be divided into seven classes with fixed deductions ranging from 32 percent to three percent per year. The fixed rate would be applied against the remaining unrecovered cost, which would be equal to the original cost, adjusted for inflation and decreased by previously claimed cost recovery deductions. The net effect of this proposal would be to extend significantly the period over which the cost of an asset may be recovered. The expansion of the "at risk" rules rests on a different basis. This provision is intended to discourage taxpayers from using tax shelter investments to reduce their tax liabilities from their principal trade or business. 2 *TREASURY REPORT*, *supra* note 1, at 334-335. The at risk rules are codified at I.R.C. § 465.

55. The proposal would tax unearned income of children at their parents' marginal rate, 2 *TREASURY REPORT*, *supra* note 1, at 93, and would tax trust income at the grantor's marginal rate, *Id.* at 99.

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high income taxpayers. The Treasury’s logic is almost appealing. As the Report correctly notes, taxpayers in the 50 percent bracket disproportionately benefit from current exclusions from income, such as those for medical insurance or group legal services. These taxpayers also benefit disproportionately from deductions such as those for state and local taxes.⁵⁶ The Report thus concludes that these items are “unfair,” because they are not generally available to all taxpayers.⁵⁷

This conclusion is misleading and disingenuous. It ignores the practical economic consequences of the repeal of these deductions and exclusions. Taxpayers in higher tax brackets may actually receive a greater benefit, relatively speaking, once the exclusions and deductions are repealed. The Treasury forgets the relative inability of those with lower incomes to use after-tax income to purchase the subjects of these exclusions and deductions. Higher bracket taxpayers, on the other hand, are affluent enough to acquire these benefits with after-tax income. In fact, as the taxpayer’s income increases, such purchases become comparatively easier, and accordingly the lost benefit to wealthy taxpayers, while greater in terms of absolute dollars, is far less significant to their general economic well-being. The converse is true as taxpayer income declines. A taxpayer with minimal income can ill-afford to use resources already committed to necessities to purchase what might be regarded as luxuries. For instance, the Treasury proposes to include in income employer paid death benefits. These benefits are limited under current law to \$5,000 per employee.⁵⁸ That exclusion is likely to be more valuable to low income than high income families though the latter actually receive a greater benefit in terms of absolute dollars.⁵⁹

These proposals illustrate a distinct bias in the Report. Under the guise of base broadening and fairness, the Treasury seeks to eliminate those deductions and exclusions whose benefits are not reaped predominantly by the affluent. The primary beneficiaries of

56. See generally B. BITTKER & L. STONE, *supra* note 52, at 452-475.

57. 2 TREASURY REPORT, *supra* note 1, at 334-335.

58. I.R.C. § 101(b).

59. Another example of the Treasury proposal’s unfairness is the likely effect of its proposed changes on the charitable contribution rules. The Treasury would preserve charitable deductions for large gifts on the theory that such gifts significantly reduce the ability to pay taxes. This argument, that taxes should be imposed on the basis of the ability to pay, is rejected where the deduction for state and local taxes is concerned. These would no longer be deductible regardless of size. The necessary inference is unfortunate. Large charitable deductions can generally be made only by those with incomes sufficient to satisfy any desired standard of living. For these individuals, the deduction for state and local taxes is not very important.

these tax preferences, measured by their standard of living, tend to be low and moderate income taxpayers. It is difficult to see how such proposals insure that the well-off will pay their fair share of taxes.

III. *Conclusion*

The publication of the Treasury's tax proposals has focused the debate over the tax system. The Treasury recommends a major revision of the present income tax. Although denominated a "fair" tax, the Treasury's proposal nevertheless fails to meet its obligation to create a just and equitable tax system. The Report's central shortcoming is that it fails to reflect accurately a national consensus over the shared premises of an ideal tax system. The Treasury purports to have drafted an economically neutral tax system. In fact, the Treasury has replaced one set of subsidies, preferences and political biases with another. In short, the Treasury's Report is not the creature destined to bring economic order to the political chaos of the Internal Revenue Code. Order can be achieved, but only by reforms that balance more sensitively competing visions of fairness, efficiency and simplicity.