TAX LEGISLATION IN THE REAGAN ERA—MOVEMENT TO OR FROM A CONSUMPTION BASE?

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I

INTRODUCTION

The burden of this paper is to discuss and to contrast the essential features of an accretion system and a consumption system for determining taxable income and the policy implications of each system. As a principle of national policy, we should opt for one or the other, but not mix them in a hybrid form, both because of the complexities a hybrid produces and because of the resulting unfairness in the system.

II

A THEORETICAL ANALYSIS OF THE ACCRETION SYSTEM

A. Components of a Pure System

Economists express the accretion system by the formula: $I = A + C$, where I (income) equals A (savings or accretion in net worth) plus C (consumption). If the factor A is a negative, this denotes a reduction in net worth resulting from savings withdrawal or disinvestment. In a pure accretion system for determining taxable income the taxpayer's net assets would be inventoried at market value at the end of each taxable year. The difference between the net asset values at the beginning and end of the accounting period reflects the net accretion or decrement in monetary value of the taxpayer's command over consumption (the A component). The consumption expenditures (the C component) for the accounting period are added to the A component to determine income. To illustrate:

Market value of taxpayer's net assets at the end of the period	\$150
Market value of taxpayer's net assets at the beginning of the period	<u>125</u>
Net accretion in market value during the period	25
Add: Expenditures for consumption during the year	<u>40</u>
Income	\$65

This formula derives from the traditional Haig-Simons measure of income;¹ it has been the subject of numerous discussions about tax policy.² The Commissioner of Internal Revenue has described this principle in his annual report:

Economists generally agree that . . . the ideal measure of income over a particular period of time . . . is the amount that the individual or family has consumed over that period plus the change in its net worth.³

From the beginning of the income tax system this concept has been the basis of what reformers describe as the "pure" accretion system. The present tax law falls short of the pure system in two important respects: first, it shelters certain income of the taxpayer by removing it from the taxable base⁴ and, second, it allows deductions for certain "consumption expenditures."⁵

B. Advantages of a Pure System

Economic data reflect that the aggregate national income tax base under a pure system would be more than twice that of the base under existing law.⁶ Therefore, approximately the same revenue could be collected with tax rates of 5.5% to 25% instead of the present 11% to 50%, or alternatively, with a flat rate of 10% to 12%.

A no-exception, no-modifications accretion system would tax each individual on current real economic income as defined in the previously

1. H. SIMONS, PERSONAL INCOME TAXATION 61-62, 206 (1938); Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 7 (R. Haig ed. 1921).

2. See, e.g., B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE (1968); CONGRESSIONAL BUDGET OFFICE, REVISING THE INDIVIDUAL INCOME TAX 72 (1983); FUND FOR PUBLIC POLICY RESEARCH, REFORMING THE FEDERAL TAX STRUCTURE (1973); C. GALVIN & B. BITTKER, THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE? (1969); J. PECHMAN, COMPREHENSIVE INCOME TAXATION (1977); U.S. DEP'T OF THE TREAS., BLUEPRINTS FOR BASIC TAX REFORM (1977); 3 REPORT OF THE ROYAL COMM'N ON TAXATION 39 (1966); American Bar Association, Section of Taxation, Special Committee on Simplification, *Evaluation of the Proposed Model Comprehensive Income Tax*, 32 TAX L. 563 (1979); Bittker, *Reflections on Tax Reform*, 47 U. CIN. L. REV. 185 (1978); Goode, *The Economic Definition of Income*, in M. MCINTYRE, F. SANDER & D. WESTFALL, READINGS IN FEDERAL TAXATION 3, 9-11 (2d ed. 1983); Graetz & McDowell, *Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax*, 3 YALE L. & POL'Y REV. 10 (1985); Hettich, *Henry Simons on Taxation and the Economic System*, 32 NAT'L TAX J. 1 (1979).

3. U.S. DEP'T OF THE TREAS., INTERNAL REVENUE SERVICE, 1982 STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS 101 (1984) [hereinafter cited as STATISTICS OF INCOME].

4. E.g., I.R.C. §§ 101-134 (Lawyers Co-op. 1984 & Supp. 1985) (providing for exclusions from gross income); *id.* §§ 401-425 (Lawyers Co-op. 1983 & Supp. 1985) (providing for deductions from income for amounts contributed to pension, profit-sharing, stock bonus plans or with respect to stock options).

5. E.g., I.R.C. § 164 (Lawyers Co-op. 1974 & Supp. 1985) (deduction for state and local taxes not related to trade or business or income producing activity); *id.* § 165(c)(3) (Lawyers Co-op. Supp. 1985) (deduction for personal casualty losses); *id.* § 170 (Lawyers Co-op. 1974 & Supp. 1985) (deduction for charitable contributions); *id.* § 213 (Lawyers Co-op. Supp. 1985) (deduction for medical and dental expenses).

6. See generally AMERICAN BAR FOUNDATION & SOUTHERN METHODIST UNIVERSITY, STUDIES IN SUBSTANTIVE TAX REFORM 33 (1969); COMM'N TO REVISE THE TAX STRUCTURE, REFORMING THE FEDERAL TAX STRUCTURE 56 (1973); CONGRESSIONAL BUDGET OFFICE, REVISING THE INDIVIDUAL INCOME TAX xviii (1983). The data reflect that a modified expanded income that took into account only certain unrealized net gains and, therefore, was not a pure accretion system would, nevertheless, double the taxable base from \$415 billion to \$882 billion. COMM'N TO REVISE THE TAX STRUCTURE, *supra*, at 56.

to time by requiring taxpayers who might otherwise have used the cash basis either to convert to the accrual basis or to convert to the accrual basis for certain transactions.¹⁶ In the case of accrual basis taxpayers, on the other hand, the courts have treated such taxpayers as on a cash basis for certain transactions, that is, for example, cash collected in one period representing income to be earned in a later period is treated as income when received.¹⁷ The Congress has responded to some of these decisions by enacting remedial legislation for certain groups.¹⁸ Thus, the evolution of tax accounting rules by the Congress and the courts has blurred the distinction between the cash receipts and disbursements basis and the accrual basis.¹⁹

Despite this confusion, the enactment of an accretion system would not represent too great a legislative leap from present law. It could be accomplished by expanding the definition of adjusted gross income to include in full all unrealized gains and losses and by repealing the Code sections permitting exclusions from income. In addition, personal deductions such as those for medical expenses, charitable contributions, personal interest, and taxes (i.e., the *C* component) would be disallowed.

The inclusion of unrealized gains and losses might have been regarded as a radical proposition in the past; yet, as the Staff of the Joint Committee on Taxation has recently commented, the Congress has moved towards taxing unrealized income, generally in areas where valuation and liquidity were not significant, the income was primarily attributable to sophisticated taxpayers, and the tax avoidance possibilities were serious.²⁰ In particular, the Joint Committee pointed to the 1969 legislation that required inclusion in income of original issue discount on corporate bonds,²¹ the 1981 legislation requiring marked-to-market valuation of commodity futures contracts,²² and the 1984 legislation extending such treatment to many option transactions.²³

16. See, e.g., I.R.C. § 447 (Lawyers Co-op. 1983) (requiring certain corporations engaged in farming to use the accrual basis); *id.* § 461(b) (requiring cash basis taxpayers paying interest in advance to use the accrual basis for determining the amount of deduction).

17. *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957).

18. E.g., I.R.C. § 455 (Lawyers Co-op. 1983) (providing for accrual basis treatment of prepaid subscription income for publishing houses); *id.* § 456 (providing for accrual basis treatment of prepaid dues in certain membership organizations); *id.* § 458 (providing for accrual basis treatment of returned magazines, paperbacks, and records in the case of dealers of such items).

19. In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the Supreme Court discussed the differences between tax accounting and financial accounting, noting that financial accounting tended to understate income in the interests of conservatism, whereas tax accounting required the recognition of income at the earliest possible time in order to meet the Treasury's objectives of efficient administration and collection of the tax. *Id.* at 541.

20. JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., ANALYSIS OF PROPOSALS RELATING TO COMPREHENSIVE TAX REFORM (Comm. Print 1984), reprinted in 25 TAX NOTES 161, 172 (1984).

21. I.R.C. § 1232 (repealed 1984).

22. *Id.* § 1256(a) (Lawyers Co-op. Supp. 1985) (providing for the treatment of each "section 1256 contract" as if it were sold for its fair market value on the last business day of the taxable year). A "section 1256 contract" is now defined as any regulated futures contract, any foreign currency contract, any nonequity option, and any dealer equity option. *Id.* § 1256(b) (West Supp. 1985).

23. *Id.* § 1256.

A. Compromises in a Pure Accretion System to Achieve Practical Administration of the *A* Component

If taxpayers in all income brackets were required to value all net assets each year in order to determine income, the problems of compliance and administration would be substantial. Compromises could be adopted, however, to relieve most taxpayers of the annual valuation requirement without causing a serious distortion in the amount of income reportable under an accretion system. If the requirement applied only to the taxpayer who owned consumer durables (e.g., home, automobile, furnishings) of a value of \$250,000 or more, and who owned investments (stocks, bonds, vested interest in a qualified plan) of \$100,000 or more, a relatively small percentage of tax filers would make the annual valuation. This suggested compromise is proposed on the basis of an analysis of the Statistics of Income published by the Commissioner of Internal Revenue²⁴ and the statistics with respect to wealth holding in the United States.²⁵

Table 1 displays cumulatively for adjusted gross income brackets the number of returns, the aggregate adjusted gross income, taxable income, and tax. Table 2 compiles similar data for 1980-1981 noncumulatively by income brackets. These statistics reflect that, for 1982, 94.3% of the filers reported adjusted gross incomes under \$50,000. Even when certain expanded income concepts are applied to this group, about 200,000 returns out of ninety million now reporting *less* than \$50,000 of adjusted gross income would then reflect *more* than \$50,000 of adjusted gross income.²⁶ What these data indicate is that the vast majority of filers are in the middle, lower middle, or lower income brackets.

The overall savings rate is about 6% of personal income²⁷ and for those under \$50,000 of adjusted gross income, one may reasonably assume that their principal investments are in a home, family automobile, furnishings, and personal effects of a value less than \$250,000 and stocks, bonds, cash values of life insurance and vested interests in qualified plans of a value less than \$100,000. This assumption is corroborated by the data in Table 3 which reflect that a total of 803,000 persons (less than 1% of the number filing annual income tax returns) hold gross assets having a value of \$500,000 or more. Therefore, under the suggested compromise approximately 95% of

24. STATISTICS OF INCOME, *supra* note 3, at 4; see also Galvin, *The Commissioner's Statistics of Income: Required Reading for Tax Reformers*, 27 TAX NOTES 945, 947 (1985). The statistics reflect that 94.3% of returns report under \$50,000 of adjusted gross income. Because of the low savings rate (about six percent of personal income) the total wealth accumulation of this large sector of the filing group would be relatively small.

25. U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 1984, at 445-82 (1984) [hereinafter cited as STATISTICAL ABSTRACT]. The statistics reflect that in 1976 only 803,000 persons held gross assets of \$500,000 or more. *Id.* at 479. This number would be greater in 1985 but the rates to total population would not be significantly different.

26. STATISTICS OF INCOME, *supra* note 3, at 104.

27. STATISTICAL ABSTRACT, *supra* note 25, at 455, 458. In 1982 disposable personal income was \$2,177 billion, of which \$125 billion, or 5.8%, was saved.

the annual tax return filers would be exempt from the annual valuation requirement.²⁸

TABLE 1
ANALYSIS OF INCOME TAX RETURNS BY SELECTED ADJUSTED GROSS
INCOME BRACKETS CUMULATED FROM THE LOWEST
BRACKET TO \$100,000 A.G.I.—1982

<u>All Taxpayers:</u>		
<u>Individual Tax Returns</u>		
	1982	
All returns	95,337,432	
AGI (total)	1,852,135,465	
TI (total)	1,473,348,899	
Tax (total)	276,077,369	
Percent of TI	19.2	
<u>Under \$10M AGI</u>		
Returns	34.0 million	35.7% (of all returns)
AGI	172.1 billion	9.2% (of total AGI)
TI	93.3 billion	6.5% (of total TI)
Tax	6.9 billion	2.5% (of total tax)
Percent of TI	7.5	
<u>Under \$20M AGI</u>		
Returns	58.9 million	61.8%
AGI	532.2 billion	28.4%
TI	375.3 billion	26.0%
Tax	41.5 billion	15.0%
Percent of TI	11.1	
<u>Under \$50M AGI</u>		
Returns	89.9 million	94.3%
AGI	1488.7 billion	79.5%
TI	1141.4 billion	79.0%
Tax	178.3 billion	64.6%
Percent of TI	15.6	
<u>Under \$100M AGI</u>		
Returns	93.7 million	98.3%
AGI	1728.0 billion	92.1%
TI	1329.0 billion	91.9%
Tax	228.5 billion	82.8%
Percent of TI	17.2	
<u>Over \$100M AGI</u>		
Returns	.74 million	.8%
AGI	147.9 billion	7.9%
TI	116.6 billion	8.1%
Tax	47.5 billion	17.5%
Percent of TI	41.6	

Source: U.S. DEP'T OF THE TREAS., INTERNAL REVENUE SERVICE, 1982 STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS 2 (Table A), 4 (Table C), 37 (Table 1.1) (1984).

28. In 1975 approximately 82 million returns were filed, *id.* at 326.

TABLE 2

ANALYSIS OF INCOME TAX RETURNS BY SELECTED ADJUSTED GROSS
INCOME BRACKETS—1980, 1981

All Taxpayers: Individual Tax Returns		1980		1981	
All returns		93.9 million		95.4 million	
AGI (total)		1,613.7 billion		1,772.6 billion	
TI (total)		1,280.0 billion		1,410.9 billion	
Tax (total)		250.3 billion		284.1 billion	
Percent of TI		20		20	
<u>\$0-\$10M AGI</u>					
Returns		38.4 million	40.9% (of all returns)	36.4 million	37.3%
AGI		186.4 billion	11.5% (of total AGI)	178.3 billion	10.0%
TI		100.5 billion	8.0% (of total TI)	97.0 billion	7.0%
Tax		8.4 billion	3.4% (of total tax)	8.1 billion	2.8%
Percent of TI		8.4			
<u>\$10-\$20M AGI</u>					
Returns		25.4 million	27.0%	25.2 million	26.4%
AGI		370.4 billion	23.0%	367.2 billion	20.7%
TI		291.0 billion	23.3%	288.5 billion	20.4%
Tax		39.9 billion	15.9%	39.5 billion	13.9%
Percent of TI		13.7		13.7	
<u>\$20-\$50M AGI</u>					
Returns		27.0 million	28.8%	29.7 million	31.1%
AGI		799.3 billion	49.5%	904.7 billion	51.0%
TI		643.9 billion	51.4%	729.1 billion	51.6%
Tax		123.3 billion	49.3%	142.2 billion	50.0%
Percent of TI		19.2		19.5	
<u>\$50-\$100M AGI</u>					
Returns		2.6 million	2.8%	3.4 million	3.6%
AGI		165.9 billion	10.0%	219.4 billion	12.3%
TI		133.1 billion	10.6%	174.1 billion	12.3%
Tax		39.7 billion	15.8%	51.0 billion	17.9%
Percent of TI		29.8		29.2	
<u>Over \$100M AGI</u>					
Returns		.55 million		.65 million	.6%
AGI		91.7 billion	6.0%	111.9 billion	6.3%
TI		81.5 billion	6.7%	94.8 billion	6.7%
Tax		39.0 billion	15.6%	43.2 billion	15.2%
Percent of TI		47.8			

Source: U.S. DEP'T OF THE TREAS., INTERNAL REVENUE SERVICE, 1981 STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS 2 (Table A), 4 (Table C), 35 (Table 1.1) (1983).

TABLE 3
WEALTH HOLDING IN THE UNITED STATES—1976

Top 1%, or 2.2 million people, hold 20% of the wealth.

Persons holding gross assets of more than \$120,000	8,695,000
Persons holding gross assets of \$120,001 to \$199,999	4,759,000
Persons holding gross assets of \$200,000 to \$499,999	3,133,000
Persons holding gross assets of \$500,000 to \$999,999	555,000
Persons holding gross assets of at least \$1,000,000	248,000

Source: U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS,
STATISTICAL ABSTRACT OF THE UNITED STATES
1984 479 (1984) (statistics for 1976).

B. The Exempt Group and Compliance

Because those filers in the exempt group would not be making an annual valuation of net assets, they should be permitted some appropriate annual cost recovery system. Thus, they could deduct depreciation under the Treasury's proposed Capital Cost Recovery System (CCRS),²⁹ depletion under a cost method determined by units of recovery, and amortization on a straight-line basis. They could make an accounting, as they do now, for gains and losses on sales and other taxable dispositions, and in addition, they could be required to make an accounting for gains and losses on transfers by gift or at death. Accordingly, this compromise of the pure accretion system would be administrable and would assure that all lifetime and deathtime transfers would ultimately be accounted for on a marked-to-market principle.

C. The Nonexempt Group and Compliance

Although the nonexempt group, that is, those required to make annual valuation of net assets, would be only a small percentage of all filers, their problems of valuation and access to liquid funds to pay the tax could nonetheless be significant. A taxpayer with rapidly appreciating shares in a closely held corporation, a partnership interest in a real estate development, or an investment in an improving patent might have difficulty both in establishing values and paying the tax resulting from the unrealized appreciation. For taxpayers with a diverse portfolio of investments, the mechanics of valuation could be administered as follows:

(1) marketable securities would be valued at the end of the taxable year based on published quotations;

29. THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 132-59 (1985) [hereinafter cited as PRES. PROPOSALS].

(2) not readily marketable assets would be valued or accounted for at the taxpayer's election by any one of the following methods:

- (a) independent appraisal;
- (b) capitalization of earnings;
- (c) average of comparable sales of similar property;
- (d) await the event of sale, exchange, gift, or death, determine the amount of gain or loss, prorate such amount over the taxable years during which the taxpayer has held the asset, and determine the resulting deficiency or refund for each year; or
- (e) apply methods (a), (b), or (c) every five or seven years and prorate the resulting gain or loss to the intervening periods.³⁰

Although every asset would not be marked-to-market³¹ value each year, there would be either a recognition of unrealized gain or loss or an accounting for gain or loss at all lifetime or deathtime transfers. Thus, the objectives of an accretion system would be achieved in a practical, administrable way: income would be accounted for as earned and the opportunities for deferral of recognition of income or nonrecognition of income would be substantially eliminated.

IV

THE C COMPONENT

In a pure accretion system there would be no deduction for consumption expenditures (the *C* component); the expanded adjusted gross income concept (the *A* component) would become the taxable base. As in the case of the *A* component, however, some compromises with respect to the *C* component could be achieved without serious distortion.

A. Effect on Nonitemizers

Table 4 reveals that about 70% of present filers, mostly in middle and lower income brackets,³² do not itemize. If we assume that in an accretion system some form of personal exemption deduction and zero bracket amount would be continued from the present system, and if we assume that, in general, middle and lower income taxpayers would be in the exempt group of filers (those not required to make annual asset valuation), then the accretion system would operate in a manner substantially similar to the current tax system for the great majority of filers. Thus, most present nonitemizers would determine adjusted gross income under an expanded definition but

30. These are methods presently employed for determining valuations for estate and gift tax purposes.

31. The term "marked-to-market" is used because it is now part of Code language with respect to the requirement of valuation on the last day of the taxable year. I.R.C. § 1256 (Lawyers Co-op. Supp. 1985).

32. In 1982, a total of \$284.5 billion was claimed in itemized deductions, of which \$214.5 billion, or 75%, was claimed by taxpayers with adjusted gross incomes of \$25,000 or more. STATISTICS OF INCOME, *supra* note 3, at 8.

would not make the market value accounting for assets except for lifetime and deathtime transfers. They would deduct some exemption deduction for themselves and dependents and determine tax liability at lower rates after allowing for a zero bracket amount.

TABLE 4
PERCENT OF ALL INDIVIDUAL RETURNS WITH ITEMIZED
DEDUCTIONS—1972-82

Source: U.S. DEPT. OF THE TREAS., INTERNAL REVENUE SERVICE, 1982 STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS 7 (1984).

B. Effect on Itemizers

Although consumption expenditures would not be deductible in a pure system, social policy and fairness would dictate in favor of allowing some adjustment for large involuntary expenditures such as extraordinary medical or casualty losses. A taxpayer who is drained of resources to meet some calamity experiences a reduction in net worth that can hardly be described as a routine living expense. In this connection, the recent enactment of

legislation increasing the floor above which medical and personal casualty losses may be deducted³³ and the President's recent proposals to limit charitable contributions and interest deductions and to eliminate the deduction for state and local taxes are indicative of a greater acceptance of restricting deductions for consumption expenditures.³⁴

Each compromise made with respect to the deductibility of consumption expenditures significantly narrows the base, whether under the present law or an accretion system. Even among the 30% who itemize, the amounts deducted are substantial:

1982 DEDUCTIONS IN BILLIONS

1. Nonbusiness interest	\$121.8
2. Nonbusiness taxes	88.0
3. Charitable contributions	33.5
4. Medical and dental	21.7
5. Other (including casualty losses)	19.4
Total	<u>\$284.4³⁵</u>

Thus, a proposal must strike the delicate balance of recognizing certain deductible expenses while not dangerously reducing revenue.

V

AN OVERVIEW OF THE ACCRETION SYSTEM

Table 5 explains the \$1.8 trillion gap between gross national product and taxable income. A modified accretion system as described above would narrow this gap and could be practically administered; it would more nearly reflect an aggregate tax base consistent with gross national product and national income.

TABLE 5
RECONCILIATION OF GNP AND TAXABLE INCOME—1982
(IN BILLIONS OF DOLLARS)

Item	Amount
Gross national product (GNP)	3,069.3
– Depreciation	–358.8
– Indirect business taxes	–258.8
– Statistical discrepancy	–0.5
+ Government subsidies	+8.8
– Corporate retained earnings and corporate income tax	–92.6
– Employer social insurance contributions	–140.0
+ Net interest paid by government and consumers	+105.7

33. See I.R.C. § 213(a) (Lawyers Co-op. Supp. 1985) (effective in 1983, the floor on medical expenses was increased from 3% to 5%); *id.* § 165(h)(2) (effective in 1983, the floor on personal casualty losses was increased from zero to 10%).

34. PRES. PROPOSALS, *supra* note 29, at 62, 70, 322.

35. STATISTICS OF INCOME, *supra* note 3, at 60-61.

+Taxable government transfers	+35.5
-Fringe benefits excluded from AGI	-153.3
-Imputed income in GNP	-74.3
-Investment income of insurance companies and pension funds	-62.2
-Investment income of nonprofit organizations and fiduciaries	-25.9
-Differences in accounting treatment between GNP and AGI	-30.9
-Income of nonfilers and unreported income	-170.5
-Other discrepancies between GNP and AGI	-42.1
-IRA deductions	-27.8
-Second-earner deduction	-8.9
+Capital gains in AGI	+32.5
+Taxable private pensions	+42.4
+Subchapter S corporation income	+0.2
Adjusted gross income (AGI)	1,847.8
-AGI on nontaxable returns	-51.5
-Medical deduction	-17.2
-Tax deduction	-85.4
-Interest deduction	-111.9
-Charitable deductions	-32.1
-Other deductions	-18.0
+Floor under itemized deductions (zero bracket amount on itemizing returns) ...	+100.0
-Personal exemptions	-190.7
Taxable income on taxable returns (net of deficits)	1,441.0
-Deduction equivalent of tax credits (estimated)	-21.2
-Zero bracket amount (estimated)	-220.0
Tax base (estimated)	1,199.8
Individual income tax after credits	276.9

Sources: *Survey of Current Business*, July 1984; *Statistics of Income: SOI Bulletin*, Winter 1983-84 and Spring 1984, Internal Revenue Service; and staff estimates, reprinted in Staff of Jt. Comm. on Tax., *Analysis of Proposals Relating to Comprehensive Tax Reform*, 25 TAX NOTES 161, 164 (1984).

A. The Effect on Individuals

In a broadened base, as suggested above, taxpayers in the upper income brackets would in general pay proportionately more taxes because net unrealized appreciation, presently excluded income, and presently deductible consumption expenditures would become part of the taxable base. Some additional revenue would be raised in the middle income brackets more or less proportionately throughout the group because of the expanded income base. The lower income brackets, whose income is from salaries and wages and who would be in the group exempt from making annual valuations, would determine income approximately as they do now.

B. The Effect on Corporations

An accretion system could function with a separate corporation tax, but the combination of two systems, one for individuals and one for corporations, would result in onerous double taxation. If X Corporation's assets appreciate in value from 100x to 110x, that factor would be reflected in the greater value of its stock. A shareholder of X would inventory his stock at the greater value, so that the factor of appreciation at the corporate level would appear contemporaneously in both the incomes of the corporation and the shareholder. Both reinvested corporate earnings and distributed corporate

earnings would be accounted for by the shareholder in the expanded income concept of an accretion system. Therefore, there would be little reason for imposing additional taxes at the corporate level. In practical terms, the trend of recent tax policy has been in the direction of eliminating the corporate tax. In 1960 the corporate income tax constituted 23% of tax revenues.³⁶ For fiscal 1986 that percentage is expected to drop to 9%.³⁷

In order to protect the revenue, corporations would be required to withhold some tax for their shareholders so that shareholders receiving dividends and accounting for gains and losses in stock values could rely on such withholding credits for liquidity in meeting their individual tax liabilities.

C. The Effect on Exempt Organizations

If a modified accretion system were adopted and corporate taxes were eliminated, various exempt organizations holding corporate shares should be accountable in some manner for such investments; otherwise, the stream of corporate income passing to the exempt group would escape tax altogether. A solution would be to impose an excise tax on investment income, similar to the present excise tax imposed on investment income of private foundations.³⁸ Investment income would also include unrealized gains and losses. Accordingly, an exempt organization with contributions that are received and expended would have no tax; an exempt organization that invests and reinvests its surplus funds in restricted or unrestricted endowment accounts would incur some excise tax on its investment income.

D. The Estate and Gift Tax System

If all accretions to wealth through gifts, devises, bequests and inheritances are included in income, there would be little reason for an estate and gift tax system, except perhaps on the transfer of the very largest accumulations of wealth.

VI

ADDITIONAL AREAS REQUIRING CONSIDERATION

A. Moving Average

Using a modified accretion system for all taxpayers would mean that income reported will tend to follow the ups and downs of the consumer price index or some other inflation index. In order to level out hills and valleys of annual income, taxpayers would use a moving average of five years, that is, income for 1984 would be averaged with 1980-1983, 1985 with 1981-1984,

36. J. PECHMAN, *FEDERAL TAX POLICY* 352 (4th ed. 1983).

37. EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, *THE UNITED STATES BUDGET IN BRIEF, FISCAL YEAR 1986*, at 66 (1985) [hereinafter cited as *UNITED STATES BUDGET IN BRIEF*]. Total revenues are projected at \$793.7 billion; corporate income taxes are estimated at \$74.1 billion, or 9.33%.

38. See I.R.C. § 4940 (Lawyers Co-op. 1980 & Supp. 1985).

and so on. This would avoid the effect of unusual peaks and valleys in net worth evaluation on a particular date. Of course, in order to preclude averaging for many taxpayers whose incomes are relatively constant, a floor could be established, as at present, below which no averaging would be required or permitted.³⁹

B. The System's Applicability to Foreign Taxpayers

Aliens, both resident and nonresident, would be required to conform to the same rules as apply to United States citizens. Treaty arrangements presently extant could be modified to require proper reporting of gains and losses in value of marketable securities and periodic reporting, as suggested previously, on the changes in values of assets not susceptible of ready valuation.

VII

THE CONSUMPTION SYSTEM

As the formulation of the accretion system described above is expressed: I (income) = A (accretion in wealth) + C (consumption), so the consumption system may be expressed: I (income) = C (consumption). Thus, in a consumption system, savings or investment fall outside the taxable base. The taxpayer's income is measured only by that amount which he consumed during the period.⁴⁰ For most taxpayers the accounting for income and the administration of the system would be similar to that of an accretion system. Income from personal services would be accounted for as under present law. Amounts set aside each year in investments would be deducted in determining taxable income. The accounting for investments would be maintained in a qualified account similar to an unlimited individual retirement account under present law; the taxpayer would account for gains and losses in, and income from, investments in this account. As withdrawals were made for living expenses, the qualified account balance would be reduced, and the taxpayer's taxable income would be increased. Thus, a taxpayer could have income from two principal sources: personal services and withdrawals from the qualified account. As taxpayers moved through their most productive years, they would tend to build up the amounts in their qualified accounts, and in their later years would tend to withdraw amounts from such accounts.

Expenditures for consumer durables, e.g., home, automobile, furnishings, recreation vehicle, could be handled in one of several ways:

The consumer durable would be treated as any other form of savings and deducted from taxable income. A dollar limitation would be put on these transactions in the aggregate so that taxpayers acquiring luxury homes, luxury

39. See *id.* §§ 1301-1305 (Lawyers Co-op. 1974 & Supp. 1985).

40. The 1977 Treasury analysis of a consumption tax is in U.S. DEP'T OF THE TREAS., BLUEPRINTS FOR BASIC TAX REFORM 113-43 (1977) [hereinafter cited as BLUEPRINTS FOR BASIC TAX REFORM]. For further analysis, see Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979).

cars, vacation cottages, and the like would be required to treat the amount of consumer durables above a certain minimum as nondeductible ordinary consumption and, therefore, part of the taxable base.

Another alternative would be to exclude some part of the acquisition of consumer durables from the taxable base but to require the taxpayer to treat the use of such items as consumed income over some period of useful life. For example, in the case of a home financed by a 20% down payment and a thirty-year mortgage, the payments on the debt service each year could be the measurement of consumption value. This amount would not be deductible and would thus be part of the taxable base. This alternative would be applied to those consumer durables having an acquisition cost above a certain minimum. Thus, a taxpayer with a home, car, and personal effects having a cost below a reasonable minimum would deduct the acquisition cost and exclude the value of the use of such items from the taxable base.

A final alternative would deny any deduction for the entire acquisition cost of all consumer durables. They would be treated as any other living expense. Thereafter, the taxpayer would not be required to make any accounting for use value or cash received on sale.

A. The Consumption System in Operation

For the vast majority of taxpayers in the middle and lower income brackets for whom labor is the principal source of income and for whom the opportunity to set aside savings is minimal, compliance with a consumption system would vary little from the present system.

For taxpayers in the higher income brackets with substantial capital and income from capital, the taxable base would generally be reduced as they would deduct transfers to a qualified account for investments and the income therefrom. In this connection, several factors would have to be considered: (a) it might be necessary to impose a sharp progressive tax on high levels of consumption for upper income brackets to offset the revenue loss from excluding investments from the base;⁴¹ (b) the estate and gift tax system would have to be strengthened; otherwise, wealthy taxpayers could pass their investments in qualified accounts to their heirs who would retain them in their own qualified accounts free of tax accountability until withdrawals were made.

B. Comparison with the Present System

The present system follows the consumption system in many respects. Table 6, compiled from the Commissioner's Statistics, reflects the fact that sweat-of-the-brow income—salaries, wages, commissions, etc.—now comprises about 90% of adjusted gross income. The balance consists of dividends, interest, rents, royalties, gains from asset sales, and other capital income. Moreover, with tax shelters, maximum contributions to pension, profit sharing, and company sponsored savings and thrift plans, the high

41. Graetz, *supra* note 40, at 1581-82.

bracket taxpayer can now achieve the results of a quasi-consumption tax system. Therefore, the loss in revenue of a pure consumption system as contrasted with the present hybrid system would not be great.⁴² Moreover, advocates of a consumption system would contend that such a system offers opportunities for major capital formation, greater gross national product, and greater prosperity.⁴³

TABLE 6
AN ANALYSIS OF PERSONAL SERVICE INCOME AS A PERCENTAGE OF
ADJUSTED GROSS INCOME ⁹

	1980	1981	1982
Number of returns	94 million	95.4 million	95.3 million
Taxable	74 million	76.7 million	77.0 million
Nontaxable	20 million	18.7 million	18.3 million
Percent of returns reflecting no tax	21.3%	19.6%	19.2%
Percent of returns itemizing deductions	31%	33.1%	34%
AGI total	1,613 billion	1,772 billion	1,852 billion
Salaries and wages	1,350 billion	1,486 billion	1,565 billion
Percent to total AGI	83.7%	83.9%	84.5%
Other "sweat-of-the-brow" income:			
Business and profession income	55.1 billion	53.0 billion	50.5 billion
Pension income	43.3 billion	53.8 billion	60.1 billion
Total other sweat-of-the-brow	98.4 billion	106.8 billion	110.6 billion
Total all personal service	1,448.4 billion	1,592.8 billion	1,675.6 billion
	(89+%)	(89+%)	(90+%)

Source: U.S. DEPT. OF THE TREAS., INTERNAL REVENUE SERVICE, 1982 STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS 4 (1984).

C. Value-Added Tax

The value-added tax (VAT) is another form of consumption tax that places a premium or surcharge on consumption. It has been the subject of considerable national attention since the early seventies.⁴⁴ If one assumes

42. In 1977, the Treasury estimated that to obtain the same revenues, the rates under a consumption system would have to be 2% higher. BLUEPRINTS FOR BASIC TAX REFORM, *supra* note 40, at 162, 169.

43. Galper, *Tax Policy*, in SETTING NATIONAL PRIORITIES, THE 1984 BUDGET 188-89 (J. Pechman ed. 1984).

44. 3 U.S. DEP'T OF THE TREAS., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984) (the pros and cons of a VAT are the subject of the volume); A.B.A. Section of Taxation, Report of the Special Comm. on the Value-Added Tax [hereinafter cited as Special Comm. on VAT], *The Choice Between Value-Added and Sales Taxation at Federal and State Levels in the United States*, 29 TAX L. 457 (1976); Special Comm. on VAT, *Evaluation of an Additive-Method Value-Added Tax for Use in the United States*, 30 TAX L. 565 (1977); Special Comm. on VAT, *Report of the Special Subcommittee of the Committee on General Income Tax Problems on the Value-Added Tax*, 24 TAX L. 419 (1971); Special Comm. on VAT, *Should the United States Adopt the Value-Added Tax?—A Survey of the Policy Considerations and the Data Base*, 26 TAX L. 45 (1972); Special Comm. on VAT, *Technical Problems in Designing a Broad-Based Value-Added Tax for the United States*, 28 TAX L. 193 (1975); Galvin, *It's VAT Time Again*, 21 TAX NOTES 275 (1983); Galvin, *The Value-Added Tax—A Proposal for the 80's*, 7 PEPPERDINE L. REV. 505 (1980);

that consumption of goods and services in the United States is about \$2 trillion, then a broad based VAT of, say, 10% could produce revenues of \$200 billion. Such a tax would be regressive, adding, in effect, an extra surcharge on those incomes below \$50,000, because those incomes now are expended almost entirely in consumption. Therefore, a VAT layered on an existing income tax system would require some credit for the VAT paid for lower income taxpayers. Alternatively, the necessities of food, clothing, housing, and medicine could be excluded from the VAT base, but as Table 7 demonstrates, the principal items of consumption expenditures are housing, food, and clothing, and their elimination would substantially narrow the VAT base. Furthermore, if necessities were removed from the VAT base, the highest bracket taxpayers would benefit proportionately more because of their accustomed higher standard of living. Accordingly, a broad based VAT with a credit for lower income taxpayers would be preferable.

As Congress seeks further revenue, the trend is to increase excises on alcohol, tobacco, motor fuel, and other selected items. Rather than impose excises selectively on particular items, it would be more equitable to employ the VAT.

VIII

THE PRESENT SYSTEM—A HYBRID

Section 61(a) of the Internal Revenue Code describes gross income as "all income from whatever source derived," Standing alone and without more, this section, which echoes the language of the sixteenth amendment, would mandate a pure accretion system. As the law developed, however, Congress introduced measures, consistent with a consumption system, specially favoring capital investment, capital formation, and the income therefrom. Provisions for capital gains, percentage depletion, the deduction of intangible drilling and development costs, the deduction of mining exploration and development expenditures, the exclusion of interest on state and local government obligations have long been in the law as economic incentives.

These defections from a pure accretion system were given further impetus beginning with the Kennedy Administration through the introduction of

Turnier, *Designing An Efficient Value Added Tax*, 39 TAX L. REV. 435 (1984); see *Tax Restructuring Act of 1979: Hearings on H.R. 5665 Before the Ways and Means Comm., 96th Cong., 1st Sess.* 14-24 (1979) (statement of G. William Miller, Treasury Secretary), reprinted in 9 TAX NOTES 561 (1979); Brannon, *Is the Regressivity of the Value-Added Tax an Important Issue?*, 9 TAX NOTES 879 (1979); Brown, *Chilly VAT Reception Doesn't Daunt Ullman*, 9 TAX NOTES 703 (1979); Kingson, *VAT: It's Broccoli, Dear*, 8 TAX NOTES 283 (1979); McClure, *Thoughts on a Value-Added Tax*, 9 TAX NOTES 539 (1979); Schenk, *The Value-Added Tax as a Replacement for Part of the Corporate Income Tax*, 9 TAX NOTES 767 (1979); Tait, *The Value-Added Tax: A World-Wide Problem or Solution?*, 9 TAX NOTES 611 (1979); Note, *VAT Editorials*, 9 TAX NOTES 411 (1979); see also A. ANDERSEN & CO., PERSPECTIVES ON THE VALUE-ADDED TAX (1979); D. SMITH, J. WEBBER & C. CERF, WHAT YOU SHOULD KNOW ABOUT THE VALUE-ADDED TAX (1971); Cohen, *Foreign Experience with the Value-Added Tax*, 24 NAT'L TAX J. 399 (1971); Smith, *Value-Added Tax: The Case For*, 2 HARV. BUS. REV. 77 (1970); Surrey, *The Value-Added Tax for the United States—A Negative View*, 21 TAX EXECUTIVE 151 (1968).

TABLE 7

**PERSONAL CONSUMPTION EXPENDITURES IN CURRENT AND CONSTANT
(1972) DOLLARS: 1960-82**

[In billions of dollars, represents market value of goods and services purchased by individuals and nonprofit institutions and value of food, clothing, housing, and financial services received by them as income in kind. See *Historical Statistics, Colonial Times to 1970*, series G 416-469, for single years prior to revisions issued in 1981.]

ITEM	1960	1965	1970	1975	1977	1978	1979	1980	1981	1982
Total, current dollars . . .	324.9	430.4	621.7	976.4	1,204.4	1,346.5	1,507.2	1,668.1	1,857.2	1,991.9
Durable goods ¹	43.1	63.0	85.2	132.2	178.2	200.2	213.4	214.7	236.1	244.5
Motor vehicles and parts . .	19.7	30.0	36.2	55.8	84.8	95.7	96.6	90.7	101.6	109.1
Furniture and household equipment	17.7	24.7	35.2	53.5	65.7	72.8	81.8	86.3	93.3	93.5
Nondurable goods ¹	151.1	188.6	265.7	407.3	478.8	528.2	600.0	668.8	733.9	761.0
Food, beverages, ² tobacco	88.0	107.0	149.7	228.5	266.4	293.9	330.8	365.8	398.9	421.9
Food, excl. alcoholic beverages	70.5	85.8	119.6	185.2	217.4	240.9	272.2	301.2	328.4	347.8
Alcoholic beverages	10.6	13.1	19.2	28.4	32.5	34.9	39.3	43.9	47.4	49.1
Tobacco products	6.9	8.1	10.8	14.8	16.6	18.0	19.3	20.6	23.0	25.0
Clothing, accessories, jewelry ¹	32.2	40.3	55.8	81.6	96.8	108.2	116.3	124.2	136.5	140.7
Clothing, accessories (except footwear)	22.2	28.1	39.0	58.8	69.5	77.6	82.7	87.1	95.8	98.6
Women's and children's	14.4	18.4	25.2	38.2	45.2	50.7	54.1	56.9	62.8	64.9
Men's and boys'	7.7	9.7	13.8	20.6	24.3	26.9	28.7	30.1	33.0	33.7
Shoes and other footwear	4.5	5.3	7.6	10.7	13.1	14.7	16.3	17.4	19.4	20.3
Jewelry and watches	1.9	2.6	3.9	6.4	7.8	8.8	9.5	11.1	12.2	12.2
Cleaning, storage, and repair of shoes and clothes	3.2	3.6	4.2	4.3	4.7	5.2	5.6	6.1	6.5	6.7
Gasoline and oil	12.0	14.7	22.4	40.4	48.1	51.2	66.6	84.8	94.6	91.5
Services ¹	130.7	178.7	270.8	437.0	547.4	618.0	693.7	784.5	887.1	986.4
Housing	48.1	65.5	93.9	149.8	185.9	209.6	236.0	266.2	302.0	334.1
Household operation	20.1	26.3	37.7	63.3	81.1	90.1	99.3	113.0	128.4	144.3
Transportation	10.7	13.7	22.0	33.2	46.4	51.2	56.3	61.1	65.5	88.4
Total, constant (1972) dollars	452.0	557.5	672.1	779.4	864.3	903.2	927.6	931.8	956.8	970.2
Durable goods ¹	51.4	72.6	89.1	112.7	138.0	146.8	147.2	137.5	141.2	139.8
Motor vehicles and parts . .	24.4	34.8	38.2	47.5	63.5	66.9	62.6	54.4	56.0	57.4
Furniture and household equipment	19.7	27.8	36.1	45.9	52.9	56.5	60.4	60.2	61.7	59.7
Nondurable goods	206.2	244.0	283.7	307.5	333.4	344.4	353.1	355.6	362.5	364.2
Gasoline and oil	14.2	16.8	22.9	25.6	27.7	28.3	27.4	25.1	25.2	25.6
Services ¹	192.4	240.9	299.3	359.3	393.0	412.0	427.3	438.8	453.1	466.2
Housing	64.0	81.6	102.0	128.3	141.3	148.5	154.8	159.8	166.7	171.3
Household operation	27.6	33.9	42.3	49.9	55.1	57.8	60.1	62.3	63.0	63.5
Transportation	17.0	19.9	25.2	29.6	32.7	34.0	35.0	33.2	32.3	31.7

¹Includes items not shown separately. ²Includes alcoholic and nonalcoholic beverages.

Source: U.S. Bureau of Economic Analysis, *The National Income and Product Accounts of the United States, 1929-76*, and *Survey of Current Business*, July 1983.

investment credits, a direct dollar for dollar offset against tax liability to encourage capital investment. In the ensuing years Congress has responded with greater frequency to constituents' calls for help, and the tax law is now littered with special provisions partially or completely excluding from the taxable base income that would otherwise be taxable under section 61.⁴⁵

The erosion of the accretion system became of sufficient concern that in the Budget Act of 1974⁴⁶ Congress provided for an annual Tax Expenditure Budget (Table 8) to reflect the revenue impact of those particular provisions of the law that deviate from what would be a comprehensive tax on all income. Tax Expenditures have increased from 24.8% of federal revenues in 1971 to

45. For an excellent discussion of the rash of special interest legislation, see Calkins, *A Federal Income Tax Designed for Revenue Only*, 23 TAX NOTES 201, 203-05 (1984).

46. Pub. L. No. 93-344, 88 Stat. 297 (codified in scattered sections of title 31).

46% in 1984.⁴⁷ The issue is, therefore, not an insubstantial one in national policy.

TABLE 8
TAX EXPENDITURES BY FUNCTION,
FISCAL YEARS 1982-84

Millions of dollars				
	Item	1982	1983	1984
<i>National defense</i>				
	Exclusion of benefits and allowances to armed forces personnel	2,890	2,780	2,820
	Exclusion of military disability pensions	165	165	160
<i>International affairs</i>				
	Exclusion of income earned abroad by U.S. citizens	1,850	2,155	2,165
	Deferral of income of domestic international sales corporations	2,870	2,565	2,000
	Deferral of income of controlled foreign corporations	520	560	605
<i>General science, space, and technology</i>				
	Expensing of research and development expenditures	115	-1,160	-1,070
	Credit for increasing research activities	640	1,060	1,180
	Suspension of regulations relating to allocation under section 861 of research and experimental procedures	100	220	110
<i>Energy</i>				
	Expensing of exploration and development costs			
	Oil and gas	3,285	1,830	1,710
	Other fuels	45	45	50
	Excess of percentage over cost depletion			
	Oil and gas	3,065	2,545	2,295
	Other fuels	600	730	790
	Capital gains treatment of royalties on coal	310	275	295
	Exclusion of interest on state and local government industrial development bonds for certain energy facilities	5	15	20
	Residential energy credits			
	Supply incentives	390	515	690
	Conservation incentives	435	400	390
	Alternative, conservation and new technology credits			
	Supply incentives	250	240	255
	Conservation incentives	290	155	100
	Alternative fuel production credit	20	45	70
	Alcohol fuel credit ^b	5	5	5
	Energy credit for intercity buses	10	15	15
<i>Natural resources and environment</i>				
	Expensing of exploration and development costs, nonfuel minerals	85	90	100
	Excess of percentage over cost depletion, nonfuel minerals	595	640	690
	Exclusion of interest on state and local government pollution control bonds	870	1,020	1,150
	Exclusion of payments in aid of construction of water, sewage, gas, and electric utilities	30	40	75
	Tax incentives for preservation of historic structures	245	320	385
	Capital gains treatment of iron ore	40	40	40
	Capital gains treatment of certain timber income	565	730	910
	Investment credit and seven-year amortization for reforestation expenditures	20	30	40
<i>Agriculture</i>				
	Expensing of certain capital outlays	550	570	590
	Capital gains treatment of certain income	775	725	745
	Deductibility of patronage dividends and certain other items of cooperatives	1,010	1,040	1,075
	Exclusion of certain agricultural cost-sharing payments	105	90	80
<i>Commerce and housing credit</i>				
	Dividend and interest exclusion	1,530	615	605
	Exclusion of interest on state and local industrial development bonds	1,795	2,250	2,625

47. Galper, *supra* note 43, at 178.

Millions of dollars

Item	1982	1983	1984
Exemption of credit union income	225	245	270
Excess bad debt reserves of financial institutions	660	680	1,090
Exclusion of interest on life insurance savings	6,625	6,780	7,310
Deductibility of interest on consumer credit	10,900	10,710	10,530
Deductibility of mortgage interest on owner-occupied homes	23,495	25,255	28,335
Deductibility of property tax on owner-occupied homes	8,405	8,810	9,645
Exclusion of interest on state and local housing bonds for owner-occupied housing	955	1,185	1,315
Depreciation on rental housing in excess of straight line	565	705	820
Depreciation on buildings other than rental housing in excess of straight line	300	400	465
Capital gains (other than agriculture, timber, iron ore, and coal)	26,590	22,865	23,465
Deferral of capital gains on home sales	2,090	2,225	2,515
Exclusion of capital gains on home sales for persons aged 55 and over	710	765	865
Carryover basis of capital gains at death	3,120	3,330	3,685
Investment credit, other than for ESOPs, rehabilitation of structures, energy property, and reforestation expenditures	19,255	17,170	18,325
Safe harbor leasing rules	2,880	3,270	3,035
Accelerated depreciation on equipment other than leased property	7,300	12,400	18,620
Amortization of start-up costs	125	195	290
Exclusion of interest on certain savings certificates	1,970	840	105
Reinvestment of dividends in public utility stock	400	590	670
Reduced rates on first \$100,000 of corporate income	12,230	13,195	14,935
<i>Transportation</i>			
Deferral of tax on shipping companies	25	35	40
Exclusion of interest on state and local government bonds for mass transit	*	5	15
<i>Community and regional development</i>			
Five-year amortization for housing rehabilitation	45	60	70
Investment credit for rehabilitation of structures (other than historic)	295	360	460
<i>Education, training, employment, and social services</i>			
Exclusion of interest on state and local student loan bonds	115	175	240
Parental personal exemption for students aged 19 or over	1,065	985	945
Exclusion of scholarship and fellowship income	465	415	375
Exclusion of employee meals and lodging (other than military)	730	755	805
Employer educational assistance	55	55	15
Exclusion of contributions to prepaid legal services plans	20	25	25
Investment credit for ESOPs	2,455	2,220	2,405
Deduction for two-earner married couples	1,005	5,685	10,040
Deductibility of charitable contributions (education)	830	770	805
Deductibility of charitable contributions other than education and health	7,550	7,085	7,170
Credit for child and dependent care expenses	1,830	2,110	2,430
Exclusion of employer-provided child care	...	10	30
Credit for employment of AFDC recipients and public assistance recipients under work incentive programs	30	...	...
General jobs credit	115	35	5
Targeted jobs credit	360	495	705
<i>Health</i>			
Exclusion of employer contributions for medical insurance premiums and medical care	22,555	25,412	28,980
Deductibility of medical expenses	3,970	2,950	2,635
Exclusion of interest on state and local hospital bonds	730	925	1,115
Deductibility of charitable contributions (health)	1,240	1,155	1,185
Tax credit for orphan drug research	...	15	25
<i>Income security</i>			
Exclusion of social security benefits			
Disability insurance benefits	1,770	1,675	1,660
OASI benefits for retired workers	14,940	15,765	16,800
Benefits for dependents and survivors	3,735	3,765	3,890
Exclusion of railroad retirement system benefits	790	780	725
Exclusion of workmen's compensation benefits	1,735	1,875	2,105
Exclusion of special benefits for disabled coal miners	185	170	165
Exclusion of untaxed unemployment insurance benefits	2,615	3,330	2,940
Exclusion of disability pay	190	170	150

Millions of dollars

Item	1982	1983	1984
Exclusion of public assistance benefits	445	430	430
Net exclusion of pension contributions and earnings			
Employer plans	65,805	70,005	78,780
Plans for self-employed and others	5,150	5,875	6,480
Exclusion of other employee benefits			
Premiums on group term life insurance	2,890	2,910	3,095
Premiums on accident and disability insurance	165	160	160
Income of trusts to finance supplementary and unemployment benefits	10	5	5
Additional exemption for the blind	35	35	35
Additional exemption for the elderly	2,385	2,360	2,420
Tax credit for the elderly	135	135	135
Deductibility of casualty losses	1,295	705	520
Earned-income credit*	460	390	340
Exclusion of interest on state and local bonds for rental housing	425	580	770
Deduction for motor carrier operating rights	115	115	115
Deduction for certain adoption expenses	15	15	15
<i>Veterans' benefits and services</i>			
Exclusion of veterans' disability compensation	1,860	1,815	1,835
Exclusion of veterans' pensions	330	305	295
Exclusion of GI bill benefits	175	150	125
<i>General government</i>			
Credits and deductions for political contributions	185	195	295
<i>General-purpose fiscal assistance</i>			
Exclusion of interest on general-purpose state and local debt	7,215	8,335	9,430
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	19,085	20,000	21,755
Tax credit for corporations receiving income from doing business in U.S. possessions	2,365	2,150	1,830
<i>Interest</i>			
Deferral of interest on savings bonds	315	450	500

Sources: *Special Analyses, Fiscal 1984*, at G-26 to -28; and *Tax Expenditures*, at 20. All estimates have been rounded to the nearest \$5 million.

* Less than \$5 million.

^a Outlay equivalent estimates.

^b In addition, the exemption from the excise tax for alcohol funds results in a reduction of excise tax receipts of \$55 million in 1982, \$80 million in 1983, and \$90 million in 1984.

^c The figures in the table indicate the tax subsidies provided by the earned-income tax credit. The effect on outlays in \$1,280 million for 1982, \$1,205 million for 1983, and \$1,125 million for 1984.

Reproduced in J. PECHMAN, *FEDERAL TAX POLICY* 344-47 (4th ed. 1983).

The concept of the Tax Expenditure Budget has been criticized. Its opponents argue that the budget is presented as if all income belonged to the federal government and that which it permits one to keep is a form of largesse from the central authority.⁴⁸ This view misstates the purpose of the budget, for what it demonstrates is the gap between a comprehensive income tax base more nearly consistent with the Haig-Simons formulation and the tax law as it actually functions. Perhaps a more palatable view of the Tax Expenditure Budget would be to give it another title such as "Differences in Revenue by Categories between a Comprehensive Tax Base and the Congressionally Established Tax Base of the Internal Revenue Code." A cursory review of Table 8 will demonstrate the significance of these differences and the difficulty of seeking legislation to eliminate them.

48. See Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey and Hellmuth*, 22 NAT'L TAX J. 538 (1969); Kristol, *Taxes, Poverty and Equality*, 37 PUB. INT. 3, 14-15 (1974); McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C.D.L. REV. 79 (1980); Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C.L. REV. 225 (1979).

IX

TAX LEGISLATION IN THE REAGAN ERA

A. Economic Recovery Tax Act of 1981 (ERTA)

In his first presidential campaign President Reagan proposed reducing the size of government and reducing the tax burden on citizens. The Economic Recovery Tax Act of 1981 (ERTA)⁴⁹ was in large measure a fulfillment of the President's commitment. This legislation was estimated to produce a reduction in revenue of about \$750 billion for the years 1981-1986.⁵⁰ The principal items accounting for almost \$700 billion⁵¹ of this amount were: (1) the phased-in rate reductions,⁵² including the deduction for two-earner married couples;⁵³ (2) indexing;⁵⁴ and (3) the accelerated cost recovery system, including investment credits.⁵⁵ This last item represented a major move toward a consumption system by permitting liberal expensing of certain capital assets and the allowance of credits against tax liability for such investments.

The President also sought a reduction in federal spending, which was creating a deficit before the revenue reductions became effective. Although spending would have to be drastically cut if the budget was to be balanced, the three largest items in the budget—social security, the defense establishment, and interest on the national debt—continued to increase.⁵⁶ The deficit created by increased federal spending and diminishing revenues spurred Congress to try to change the tax system again to address the deficit and its concomitant problems.

B. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)⁵⁷

Within the year following the enactment of ERTA, Congress sought to reverse some of the reductions in revenue enacted in 1981. Because of the presidential threat to veto any rate increases, Congress had to deal with

49. Pub. L. No. 97-34, 95 Stat. 173.

50. H.R. REP. No. 215, 97th Cong., 1st Sess. 289, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 195, 377.

51. *Id.* at 290, 1981 U.S. CODE CONG. & AD. NEWS at 378.

52. I.R.C. § 1 (Lawyers Co-op. 1984).

53. *Id.* § 221 (Lawyers Co-op. Supp. 1985).

54. *Id.* § 1(f) (Lawyers Co-op. 1984).

55. *Id.* § 168 (Lawyers Co-op. Supp. 1985); *id.* §§ 46, 48 (Lawyers Co-op. 1984).

56. See UNITED STATES BUDGET IN BRIEF, *supra* note 37, at 67, which displays estimates for fiscal years 1985 and 1986 as follows:

	1985	1986
Social security and medicare	257.4	269.4
Income security	127.2	115.8
National defense	253.8	285.7
Net interest	130.4	142.5
Total listed items	768.8	813.4
All budget outlays	959.1	973.7
Percent to total	80%	83.5%

57. Pub. L. No. 97-248, 96 Stat. 324.

closing loopholes, tightening enforcement, and deferring the phasing in of certain capital recovery provisions. Of the \$750 billion revenue reductions through fiscal 1986 enacted in ERTA, Congress proposed to recapture about \$150 billion through 1986.⁵⁸ About \$65 billion of this amount was represented by amendments affecting capital cost recovery, withholding on interest and dividends, and other compliance safeguards.

By midsummer of 1983 the organized opposition to interest and dividend withholding had become so intense that, despite appeals by the President, Secretary of the Treasury, and the Chairman of the Senate Finance Committee, interest and dividend withholding was scuttled.⁵⁹ Therefore, TEFRA's recapture of the ERTA reductions in revenue had to be revised downward by about \$15 billion.

C. The Treasury Proposal of 1984

In President Reagan's State of the Union message of January 1984, he called upon then Secretary of the Treasury Donald Regan to develop a major overhaul of the tax system by December 1984. The Treasury's proposals are contained in the three-volume work: *Tax Reform for Fairness, Simplicity, and Economic Growth*,⁶⁰ otherwise known as Treasury I. The national policy objectives reflected in this document clearly constituted a reversal of the trend toward a consumption system and a return to an accretion system.

The document proposed an expanded tax base as explained under the accretion system, but with certain principal exceptions: unrealized gains and losses in taxpayer's net assets and income, gains, and losses attributable to the taxpayer's vested interests in qualified plans would not be recognized.⁶¹ Deductions for consumption expenditures, however, such as personal interest, state and local taxes, and charitable contributions would be limited or eliminated altogether.⁶² Investment tax credits would be eliminated and capital cost recovery would be based on real economic depreciation rather than the accelerated methods.⁶³ Various special industry preferences would no longer be available.⁶⁴ Additionally, Treasury I rejected the VAT in favor of the comprehensive income tax, although it acknowledged the VAT as a potential source of major revenue.⁶⁵ This document represented a nearly ideal proposal for a comprehensive income tax base.

58. H.R. REP. NO. 760, 97th Cong., 2d Sess. 691, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 1190, 1454.

59. I.R.C. § 3451, *repealed by* Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, § 102(a), 97 Stat. 369, 369.

60. U.S. DEP'T OF THE TREAS., REPORT TO THE PRESIDENT: TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984) (in three volumes, Vol. 1, Overview; Vol. 2, General Explanation of the Treasury Proposals; and Vol. 3, Value-Added Tax) [hereinafter cited as TREAS. REPORT].

61. These items are omitted from the detailed proposals, and, therefore, it must be assumed that they were considered and rejected for proposed change.

62. 1 TREAS. REPORT, *supra* note 60, at 77-84.

63. *Id.* at 105-09.

64. *Id.* at 125-44.

65. 3 TREAS. REPORT, *supra* note 60, at 1.

D. The President's Proposal of May 1985

Following the release of Treasury I, various interest groups consulted with the Treasury and the President, urging that proposals for tax reform not go so far. Accordingly, under new Secretary of the Treasury Baker, a second publication, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*,⁶⁶ was released. It reflected a substantial retreat from the positions of Treasury I; preferences and shelters were restored and the efforts toward achieving a comprehensive base were diluted.⁶⁷

President Reagan campaigned vigorously for the adoption of this proposal. The principal revenue gains and losses⁶⁸ contained in it as projected for the fiscal year 1988 were:

FISCAL YEAR 1988 REDUCTION IN REVENUES (IN BILLIONS)	
Rate reductions for individuals, increase in zero bracket and exemption deduction amounts	\$104.6
Rate reductions for corporations	35.9
Net effect of allowing dividends paid deduction	6.2
Total—principal items of reduction	\$146.7 ⁶⁹

FISCAL YEAR 1988 GAINS IN REVENUES (IN BILLIONS)	
Repeal deduction for state and local taxes	\$ 34.1
Taxing real economic income, the principal items of which consist of substituting a modified capital cost recovery system for the accelerated cost recovery system of ERTA, the repeal of the investment credit, and modification of the capital gains benefits	38.8
Requiring more taxpayers to conform to an accrual system of accounting	11.8
Recapture of previous deductions under the accelerated cost recovery system	20.7
	\$105.4 ⁷⁰

Miscellaneous other revenue gains projected for fiscal year 1988 would still leave a shortfall in revenue of \$7.3 billion.⁷¹ The proposal for a new capital

66. PRES. PROPOSALS, *supra* note 29.

67. A chart explaining the difference in tax treatment of items in the two reports may be found in PRES. PROPOSALS, *supra* note 29, at 26-30 (summary).

68. *See id.* at 453-61.

69. Taken from PRES. PROPOSALS, *supra* note 29, at 453-61 (app. C).

70. *Id.*

71. *Id.* at 461.

cost recovery system and the elimination of the investment tax credit indicate the Reagan Administration's willingness to reverse the trend toward a consumption system enacted in ERTA. Moreover, other major modifications listed above, such as the limitation of the capital gains benefits, the imposition of the accrual system on more taxpayers, and the denial of deduction for non-business related state and local taxes, are all indicative of a greater acceptance of the principles of an accretion system.⁷²

X

CONCLUSION

Treasury I, if enacted into law, would have provided a comprehensive tax base more nearly consistent with a pure accretion system. Such a reform measure would have been a fair system judged by the criterion that taxes ought to be imposed on the basis of the taxpayer's ability to pay. A broad based consumption system is arguably the fairest system based on the criterion of standard of living; that is, those who consume more in proportion to total income pay more than those who forego consumption to save and invest.

The President's proposals (Treasury II) do not advance either system; once again we are facing proposals for a hybrid. Moreover, the enormity of the deficit and the national debt suggests the need for supplemental taxes no matter what legislative changes are made in the income tax. The best prospect for supplemental revenue would seem to be a broad based VAT with appropriate credits against the income tax for the VAT paid by lower income families.⁷³

72. The willingness on the part of Treasury officials in the preparation of both Treasury I and Treasury II (Reagan I) to espouse a broadening of the income base and the elimination or modification of deductions for consumption expenditures, or living expenses, is a recognition of the basic fairness and vitality of a comprehensive income tax system.

73. As this issue goes to press, the House of Representatives has approved a new Internal Revenue Code of 1985 which would further dilute the base-broadening efforts of Treasury I and the President's proposals.