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THE DECLINE AND FALL OF TAXABLE INCOME

*Glenn E. Coven**

The basic function of any system of taxation is to distribute the costs of government over the general population according to a preconceived design or tax base.¹ Under the historic structure of the federal income tax, the basis for this cost distribution has been the taxable income² of each taxpaying individual or entity. But the Internal Revenue Code's highly refined computation of taxable income has never been the exclusive mechanism for allocating the burden of taxation,³ and over the past two decades Congress has, with increasing frequency, deliberately disregarded taxable income as the mechanism for allocating the burdens of taxation. Significantly, Congress has not replaced this traditional mechanism with another consciously evolved tax base. On the contrary, recent legislation has injected secondary allocation mechanisms into the tax structure on an entirely ad hoc basis.

The consequences of this erosion of the taxable income mechanism uniformly have been unsatisfactory. First, although the use of secondary mechanisms to allocate the burden of taxation is not inherently inequitable, in practice the mechanisms adopted by Con-

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1. It is important to distinguish between the purpose of a broadly based tax and the purpose of an income tax. The primary purpose of any broadly based tax is the production of revenue for the taxing authority; that is, the transfer of command over society's store of goods and services from the private to the public sector. The selection of the base upon which such a tax is to be imposed requires a judgment concerning who should bear the loss in the private sector and in what proportion. Although other criteria exist, the primary criterion for both the selection of that tax base and for the refinement or definition of that base is distributional equity. See R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 187-93 (1973). The primary purpose of an income tax is to allocate the aggregate loss within the private sector fairly with respect to the selected tax base, income.

2. Taxable income is defined with some circularity by I.R.C. §§ 61-63, as all income less all allowable deductions including the personal exemptions. To the extent that deductions are not permitted for expenditures for consumption, the subtraction should equal the taxpayer's consumption plus net change in savings — subject, of course, to definitional deviations from the ideal.

3. The best known, and perhaps most controversial, exception is the reduced rate of tax applied to capital gains. That preferred rate was introduced by the Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 233 (currently codified at I.R.C. §§ 1202, 1221), and has persisted to the present. See generally Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax 1913-1948*, 2 NATL. TAX J. 12 (1949). This circumvention of taxable income as the mechanism for allocating tax liability is subject to many of the same criticisms made herein of other Code provisions.

gress have significantly reduced the distributional equity of the federal income tax. Second, as the ultimate tax burden has become disassociated from the putative tax base, the income tax has become political and irrational. Finally, the introduction of alternative and supplementary mechanisms has substantially increased the structural complexity of the income tax.

After first exploring the intellectual climate that has facilitated the congressional disregard of taxable income, this Article will examine three areas in which taxable income is no longer the exclusive mechanism for allocating the burden of taxation. That examination will outline the undesirable consequences of the decline of taxable income, and demonstrate that Congress need not have disregarded taxable income to secure the desired pattern of taxation. Because the use of multiple rate schedules constitutes the most significant deviation from the concept of taxable income in terms of the number of taxpayers that it affects and the popular resentment against the tax laws that it produces, the propriety of those schedules will be examined most extensively. Thereafter, the Article will address more briefly the increasing role of the zero bracket amount and the unhappy history of the attack on the excessive use of tax preferences. In each instance, the use of a properly revised computation of taxable income rather than a secondary mechanism to allocate the burden of taxation would produce a superior pattern of taxation, and eliminate many undesirable side effects.

Before commencing, however, two definitional matters require attention. First, the Code's definition of taxable income obviously differs vastly from the classical theoretical definition of the appropriate income tax base. Requirements of administrative practicality, particularly those underlying the concept of realization, severely restrict current taxation of the aggregate net changes in wealth that are included in the Haig-Simons formulation of the tax base.⁴ Moreover, a long series of exclusions and deductions added to the Code for reasons of public policy or private preference result in failure to tax substantial accretions to wealth. Each of these theoretically improper modifications of the tax base deviates from an ideal computation of taxable income. Such modifications, however, are not the subject of the present criticism. Rather, by the disregard of taxable

4. The Haig-Simons definition of net income defines personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question." H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938). See R. HAIG, *The Concept of Income*, in *THE FEDERAL INCOME TAX* 7 (1921), reprinted in *AMERICAN ECONOMIC ASSOCIATION, READINGS IN THE ECONOMICS OF TAXATION* 54 (1959).

income, I refer to the computation of the income tax actually payable by reference to some mechanism other than taxable income as so modified.⁵

Second, the general configuration of taxable income traditionally employed in our tax laws is not the only sound basis for imposing a broadly based tax. Indeed, the persuasiveness of some current criticisms of a tax on income⁶ is one of the causes of the congressional disregard of taxable income. The present objection to that disregard does not imply a rejection of those criticisms, nor does it constitute a defense of the income tax.⁷ My criticisms are directed instead to the imposition of tax upon a proliferation of tax bases, each of which applies to only a limited segment of the population rather than upon a single, rationally designed tax base.⁸

I. THE INTELLECTUAL ENVIRONMENT OF TAX LEGISLATION

To understand why Congress has undercut the traditional mechanism for allocating the burden of taxation, we must consider, at least cursorily, the intellectual environment in which tax legislation is formed. Tax legislation, of course, emerges from the shifting and uncertain forces that constitute the political process.⁹ As a result, we can identify no single explanation for the gradual abandonment of taxable income as the sole mechanism for distributing the burden of taxation. Indeed, recent tax legislation has often been the almost ac-

5. These secondary mechanisms include the use of such alternative tax bases as adjusted gross income, alternative minimum taxable income, and the sum of specified items of tax preference. Multiple rate schedules further erode the role of taxable income as the mechanism for allocating the burden of taxation because more than one rate of tax can be applied to the same taxable income. The limited scope of this Article does not suggest that a bright line separates modifications of a tax base from mechanisms supplementing the tax base. A class of income such as capital gains may be favored either through the definition of the tax base (*i.e.*, permitting the exclusion of one half of the net gain), or through the use of a secondary mechanism (*i.e.*, subjecting net gains to tax under a separate rate schedule). In general, however, secondary mechanisms more greatly distort the proper allocation of tax liability because of their greater independence from the generally applicable tax base and rate schedule.

6. See notes 12-21 *infra* and accompanying text.

7. I should, however, admit to a bias in favor of the general configuration of the present income tax. The blanket deferral of tax upon unexercised accumulations of economic power that would occur under a consumption tax seems both unfair and socially undesirable. Moreover, to the extent that the personal deductions reflect material differences in the capacity for discretionary consumption, they appropriately refine a humane and equitable income tax.

8. This Article considers the decline of taxable income because taxable income, at least nominally, is the tax base employed in our system. If the present income tax were replaced by a tax upon consumption alone, disregarding that new tax base in subsequent tax legislation would be just as objectionable as the legislation considered herein.

9. For a discussion, see Sunley, *A Tax Preference Is Born: A Legislative History of the New Jobs Tax Credit*, in *THE ECONOMICS OF TAXATION* 391 (H. Aaron & M. Boskin eds. 1980); Surrey, *The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957).

cidental product of political compromise and expediency. For example, Congress adopted the alternative minimum tax,¹⁰ the most recent and least defensible erosion of the taxable income base, primarily to reduce the rate of taxation of capital gains.¹¹ But while the specific causes of the present trend are largely irrational, the compromises reached would not have so casually disregarded the taxable income mechanism if its value had been unquestioned. Challenges to income taxation, problems with the definition of taxable income, doubts about whether the choice of tax bases has any economic impact, and the ascendancy of objectives that compete with distributional equity have created an environment distinctly hostile to the concept of taxable income.

A. *Doubts Concerning Income Taxation*

There are many possible bases upon which a broadly based tax might be imposed. Taxable income is merely one possibility, and may not be the best among the competing options. Some theorists have always argued that mere accretions to wealth should not be taxed.¹² In their view, it is inappropriate to tax unexercised rights to obtain a greater share of society's production of goods and services; rather, we should tax only the exercise of those rights. Although it is not clear why it is morally or technically preferable to curtail consumptive capacity through taxation when the consumption occurs rather than when the potential for consumption arises, it is clear that an expenditure or consumption tax would exempt from tax the full amount of income dedicated to savings and investment. Thus, relative to a tax on income, a consumption-based tax should encourage the formation of private capital.¹³ Because the American economy currently appears unable to attract new investment capital, a tax based upon consumption is appealing.¹⁴

The proponents of consumption taxation, however, do not base their proposals upon supposed benefits to the economy, which would clearly be a matter of nontax policy. Rather, they assert the superi-

10. I.R.C. § 55.

11. See H.R. REP. NO. 95-1445, 95th Cong., 2d Sess. 122, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7046, 7150. The alternative minimum tax is criticized in the text accompanying notes 125-29 *infra*.

12. See, e.g., I. FISHER & H. FISHER, CONSTRUCTIVE INCOME TAXATION 48-55 (1942); N. KALDOR, AN EXPENDITURE TAX 37-41 (1955).

13. See R. GOODE, *The Individual Income Tax* 38-45 (rev. ed. 1976).

14. Serious consideration has been given to replacing taxable income as the mechanism for allocating the burden of taxation with consumption alone. For a government study, see U.S. DEPT. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977); for nongovernmental views, see notes 15-21 *infra* and accompanying text.

ority of a consumption tax both as a matter of economic efficiency and distributive justice. The argument rests not so much upon an asserted theoretical superiority of the consumption tax but rather upon a distaste for the existing definition of the income tax base and a pessimism about the possibilities for meaningful improvement of that definition.¹⁵ Thus Professor Andrews, the primary modern proponent of consumption taxation,¹⁶ argues that the realization requirement and numerous ad hoc exclusions and deductions from income dedicated to specified forms of savings cause gross disparities of treatment among similarly situated taxpayers. His suggestion that the taxing system's overall distributional equity would be improved by exempting from taxation all dedications of income to savings rests upon the assumption that the instances in which tax is presently deferred cannot rationally be distinguished from those instances in which tax is imposed immediately.¹⁷

A second major premise of the argument for the consumption tax is the allegation that savings are taxed twice under an income tax.¹⁸ That double taxation, it is said, is inequitable because those who defer their consumption are taxed more heavily than those who consume immediately, and is inefficient because it induces consumers to prefer consumption over savings.¹⁹ This double taxation argument has been disputed by those who prefer an income tax.²⁰ If interest earned on savings represents reimbursement for the loss of immediate consumption, then it is not truly a gain properly subject to taxation. But if that interest compensates for the deferral of consumption by engendering greater future consumptive capacity,

15. See Brown, *Comments*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 113-17 (J. Pechman ed. 1980); Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 399 (1979).

A similar pessimism may in part be responsible for the current interest in value added taxation. See H.R. 5665, 96th Cong., 1st Sess. § 301 (1979).

16. See Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

17. *Id.* at 1117-18, 1128-40. That assumption is not unchallenged. See Goode, *The Superiority of the Income Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE?, 63-70 (J. Pechman ed. 1980). For a general critique of the assertions of equitable superiority by consumption tax advocates, see Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980).

18. See R. GOODE, *supra* note 13, at 25-26; Andrews, *supra* note 16, at 1167-69; Gunn, *supra* note 15, at 372-78.

19. See Bradford, *The Case for a Personal Consumption Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? (J. Pechman ed. 1980); Mieszkowski, *The Advisability and Feasibility of an Expenditure Tax System*, in THE ECONOMICS OF TAXATION (H. Aaron & M. Boskin eds. 1980).

20. Gunn, *supra* note 15; Warren, *supra* note 17, at 1097-101. Professor Warren's preferences are less clear.

then it should be taxed like any other form of compensation. For present purposes, resolving these competing characterizations is not as important as recognizing that substantial doubts have been raised about the propriety of including a major component of taxable income in an ideal tax base.²¹

B. *Doubts Concerning Taxable Income*

Translating the Haig-Simons definition of income into a workable statutory formulation requires subjective judgments. It is not surprising that tax specialists have never reached a consensus on many of these judgments, and it is unlikely that they ever will. Congress, therefore, must make legislative decisions without the benefit of a clearly articulated theoretical underpinning. Although uncertainty is neither new nor unique to tax legislation, the period of reform that emerged in the 1960s significantly heightened the visibility and intensity of the debate. In particular, the Treasury Department's adoption of the Tax Expenditure Budget²² in 1969 sparked substantial debate over the form that an ideal income tax should assume. The scope of the current debate is well illustrated by two separate arguments about the judgments underlying the Tax Expenditure Budget.

The first argument concerns the propriety of deductions for expenditures that unquestionably derive from personal consumption, such as the medical expense, casualty loss, and personal interest deductions.²³ Not surprisingly, the Treasury Department consistently has included all of these allowances in its yearly Tax Expenditure Budget.²⁴ This characterization provoked one of the first attacks on the Treasury's definition of tax expenditures — Professor Andrews's defense of the medical expense deduction.²⁵ Arguing that health is a

21. Professor Andrews injected an additional ingredient in the debate by his recent suggestion that it might be preferable to use a consumption tax to supplement, rather than to replace, an income tax. Andrews, *A Supplemental Personal Expenditure Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 127 (J. Pechman ed. 1980).

22. U.S. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT, 1977-1981, at 183-212 (1980). For the history of the adoption of the Tax Expenditure Budget, see S. SURREY, PATHWAYS TO TAX REFORM (1973); and Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. REV. 225 (1979).

23. For a brief history of the emergence of these deductions, see R. GOODE, *supra* note 13, at 147-75; and Hellenbrand, *Itemized Deductions for Personal Expenses and Standard Deductions in the Income Tax Law*, in HOUSE COMM. ON WAYS AND MEANS, 86th Cong., 1st Sess., 1 TAX REVISION COMPENDIUM 375 (Comm. Print 1959).

24. See U.S. OFFICE OF MANAGEMENT AND BUDGET, *supra* note 22. Tax expenditures are classified in the budget by function under a relatively few, and somewhat debatable, headings. Thus, the casualty loss deduction appears under the heading "income security."

25. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

norm or zero base, rather than a gain, and that medical care is a form of forced consumption,²⁶ Andrews concluded that the medical expense deduction should be part of an ideal income tax rather than a tax expenditure budget. In response to Andrews's attack on the Treasury's position, Professor Kelman argued that because medical expenses, particularly of the relatively wealthy, are inseparable from pure consumption, the medical expense deduction was unjustifiable.²⁷ Kelman's closely reasoned analysis demonstrates that the deduction results in a loss of both vertical and horizontal equity to the extent that medical expenses represent consumption. But Andrews had conceded that imperfections accompany the deduction. Thus, although both authors present detailed arguments, in the end both concede that their conclusions rest on subjective preference.²⁸

Both efforts advanced our understanding of this and perhaps all personal deductions, but the message communicated to Congress is ambiguous. Perhaps a deduction is properly allowable for true medical expenses. But definitional and administrative problems preclude that optimal solution. Whether the next best solution is to allow or disallow deductions cannot be resolved without a subjective judgment. Academic debate has thus left unanswered the question whether certain personal consumption expenditures constitute taxable income.²⁹

A second major issue concerning the Tax Expenditure Budget — accelerated depreciation — illustrates dramatically the current debate over the definition of taxable income. For many, the investment incentive inherent in accelerated depreciation constitutes the prototypical tax preference. Permitting recovery of capital at a rate

26. Professor Andrews never expressly argued that income devoted to health maintenance should be exempt from tax because the expenditure was forced. Nevertheless, his view of expenditures for medical care as involuntary permeates his analysis and is critical to it.

27. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979).

28. Andrews observed that "[w]hat distinguishes medical expenses from other personal expenses at bottom is a sense that large differences in their magnitude between people in otherwise similar circumstances are apt to reflect differences in need rather than choices among gratifications." Andrews, *supra* note 25, at 336. And Kelman confesses that

[m]y hostility to an expenditure-oriented medical care deduction is sharpened by my feeling that a capitalist system encourages its members to disguise their ability to pay in order to avoid taxes. . . . While the government could interpret a "standard" ("deduct reasonable medical expenditures") to serve the ultimate purpose of measuring true ability to pay, standards are inevitably non-administrable and prejudicially enforced.

Kelman *supra* note 27, at 880-81 (emphasis original).

29. For a recent analysis of the propriety of the deduction for personal taxes, see Turnier, *Evaluating Personal Deductions in an Income Tax — The Ideal*, 66 CORNELL L. REV. 262 (1981). The author concludes, among other things, that it is unclear whether expenditures for state and local sales and property taxes represent consumption but that their deductibility should probably be retained for reasons of nontax policy. *Id.* at 295.

that exceeds its economic deterioration appears certain to understate taxable income. Yet Professor Kahn asserts that a highly accelerated method of depreciation is at least as defensible as any other method.³⁰ Arguing that the cost of a depreciable asset should be allocated over time relative to the present value of the annual rights to use that asset, Kahn suggests that the exhaustion of those rights need not be offset by the appreciation in value of the subsequent rights of use attributable solely to the passage of time. In essence, Kahn's argument is that such "built-in" appreciation is not different in kind from other sources of appreciation, and is not realized by the mere use of an asset.³¹ Because the present value of a future right to use an asset declines over time, Kahn's argument justifies a sharply accelerated method of depreciation.

Kahn contrasts his argument with Professor Chirelstein's position that the only theoretically accurate method of depreciation is the decelerated sinking fund method.³² Sinking fund depreciation starts from the unexceptional premise that depreciation should mirror the economic deterioration of the asset, and thus may not exceed the difference between the asset's fair market values at the beginning and the end of the year. Since that difference will equal the present value of the most distant right in time, the depreciation pattern produced will be decelerated. In fact, because the sinking fund computation automatically encompasses the appreciation in value of the remaining rights, the pattern of depreciation produced is precisely the opposite of that defended by Kahn.

Kahn's breach with orthodoxy drew an immediate and relatively (for the legal literature) harsh response. Rejecting both Kahn's refusal to offset the appreciation in the asset against depreciation and Chirelstein's use of an interest rate to project deterioration, Professor Blum concludes that the straight-line method produces the most defensible rate of depreciation.³³ As with the questions concerning the concept of income taxation, the validity of the competing arguments is not presently important. What is important is the lack of confidence that the arguments disclose in the definition of taxable income.³⁴

30. Kahn, *Accelerated Depreciation — Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1 (1979).

31. *Id.* at 51-54.

32. See M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 131-35 (2d ed. 1979).

33. Blum, *Accelerated Depreciation: A Proper Allowance for Measuring Net Income?* 11, 78 MICH. L. REV. 1172 (1980). But see Kahn, *Accelerated Depreciation Revisited — A Reply to Professor Blum*, 78 MICH. L. REV. 1185 (1980).

34. Needless to say, the text hardly exhausts the range of the current debate over the

*C. Doubts Concerning the Importance of the Configuration
of the Tax Base*

That doubts about the propriety of the existing definition of taxable income could result in indecisive and eroding legislation is understandable. If, in addition, Congress has reason to question whether disregarding the traditional tax base will in fact adversely affect the distributional equity of the tax laws, the erosion of the tax base in the face of conflicting pressures within the legislative process would seem inevitable. Recent scholarship, of course, has suggested precisely that.

The currently fashionable economic analysis of the law,³⁵ as applied to income taxation,³⁶ has provided — or perhaps merely popularized — several insights that have much improved our analytical tools. Economic theory suggests, for example, that the correct point at which to assess the distributional effect of a taxing system is after, rather than before, the application of tax.³⁷ Thus it is inappropriate to condemn a seeming favoritism within the Code without taking into account the economic responses that it produces. Tax preferences, for example, carry with them their own seeds of destruction. The increased rate of return on investment that a preference produces will be bargained away in the marketplace, and this process restores a competitive return and eliminates the preference.³⁸ In Professor Bittker's nicely turned phrase, the inequities are driven out by the (inefficient) misallocations.

This analysis, however, does not lead to the conclusion that the taxing system is supremely equitable or that revision is totally unnecessary. On the contrary, one can condemn the misallocation of resources that results from a preference with a vigor equal to the wrath of those who perceive the law as inequitable. But for a legislator who wishes to adjust the economy by guiding resources into favored projects, the economists' message is encouraging. In short, efficiency

proper definition of an income tax base. For another area of controversy, see Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978); Rudick, *A Proposal for an Accessions Tax*, 1 TAX. L. REV. 25 (1945).

35. For an indication of how currently fashionable, see *Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 487 (1980); *A Response to the Efficiency Symposium*, 8 HOFSTRA L. REV. 811 (1980).

36. For a brief but general discussion of the economic effects of income taxation, see J. DUE & A. FRIEDLAENDER, *GOVERNMENT FINANCE* (1977).

37. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735, 739-42; Buchanan & Brennan, *Tax Reform Without Tears*, in *THE ECONOMICS OF TAXATION* 33, 36-47 (J. Aaron & M. Boskin eds. 1980).

38. Bittker, *Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch?*, 28 NATL. TAX J. 416 (1975).

analysis suggests that the ideal structure of an income tax can be disregarded without introducing more than a transitory distortion of its distributional equity.

Then again, even fledgling students of economics appreciate the dangers of applying a theoretical model that assumes the existence of a perfect market and a hypothetical economically rational man.³⁹ And while the inefficiencies created by our countless preferences may drive out some inequities, they may also produce new inequities.⁴⁰ Despite these shortcomings, economic analysis, like the doubts about the propriety of income taxation and challenges to the definition of taxable income, has contributed to the recent decline of taxable income.

D. *The Ascendancy of Competing Objectives*

Like any complex legislation, the tax laws reflect a balance among several competing and often inconsistent objectives. Although distributive justice may be the most important objective of a system of taxation, it remains only one objective among many. Because the Code reaches into every corner of economic life, as well as into many aspects of nonfinancial life, Congress can use it as a tool for social engineering. Uses of the tax laws unrelated to the ideal allocation of the costs of government may be lamented, but it is unlikely that Congress will abstain from using the tax laws to pursue nontax goals.

Although Congress has long used the Code to implement nontax policy, a second competing objective recently has emerged in the "simplification" movement. Without question, simplicity and ease of comprehension are legitimate and important objectives of any law. Time unnecessarily spent in reporting income detracts from more productive endeavors, and is resented. That resentment can create taxpayer hostility, which can, in turn, impede the collection of revenues.⁴¹ Even in the absence of such taxpayer hostility, total preoccupation with distributional equity would prove counterproductive at some point. As the law becomes increasingly fine-tuned to allow for subtle distinctions among taxpayers, it unavoidably be-

39. See Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 297-306 (1979).

40. For an interesting demonstration that inefficiencies, or misallocations, may drive out some inequities but produce others, see Shreiber, *Inequality in the Tax Treatment of Owner-Occupied Homes*, 31 NATL. TAX J. 101 (1978).

41. See Blum, *Tax Policy and Preferential Provisions in the Income Tax Base*, in HOUSE COMM. ON WAYS AND MEANS, 86th Cong., 1st Sess., 1 TAX REVISION COMPENDIUM 77 (Comm. Print 1959).

comes more complex and difficult to understand. If the law cannot be comprehended, it can be neither obeyed nor enforced, and its subtle distinctions will be to no avail.

Although simplification is a legitimate goal, the optimum balance between the sometimes competing objectives of simplification and distributional equity is not self-evident. Clearly, simplification must not override distributional equity. The most simple income tax, a flat wage tax, would do substantial violence to the consensus expectations of distributional equity. But as doubts concerning the validity of the definition of taxable income and the importance of preserving that definition increase, Congress may tolerate increasingly greater sacrifices of the definition of taxable income to achieve "simplification" or to execute another nontax policy.

The point where the costs of a loss of distributional equity exceed the benefits of simplification is not susceptible to scientific measurement. However, there is some evidence for a concern that Congress has become willing to tolerate too great a sacrifice of equity in the name of simplification. The adoption of the zero bracket amount floor on itemized deductions is one example.⁴² Another is the substitution of a credit for the preexisting child care deduction.⁴³ Congress adopted the credit to permit taxpayers not itemizing their deductions to claim the allowance — a desirable result.⁴⁴ Yet the distributional effects of the credit are inferior to a deduction.⁴⁵ These amendments eroded the role of taxable income as the Code's distributional mechanism, and did so, in part, because of an excessive preoccupation with simplification. A third, and more significant deference to simplification partly explains the retroactive repeal of the carryover basis rule of section 1023.⁴⁶ That legislative retreat did not erode the taxable income mechanism, but rather perpetuated one of its most dubious definitional components, and thus it lies outside the primary focus of this Article. However, Congress's inability to sustain one of the most significant reforms of the Code since its adoption in the face of perceived administrative complexities dem-

42. See text at note 106 *infra*.

43. I.R.C. § 44A.

44. H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 147 (1975).

45. See note 83 *infra*.

46. Pub. L. No. 96-223, § 401, 94 Stat. 231 (1980). While many factors contributed to the repeal of carryover basis, the Senate Finance Committee explained its action in the following language: "The committee believes that the carryover basis provisions are unduly complicated. The Committee therefore believes that the carryover basis provisions should be repealed." S. REP. NO. 96-394, 96th Cong., 1st Sess. 122, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 410, 530-31.

onstrates the reversal of priorities that has accompanied the declining importance of the taxable income concept.

The following pages document this decline in the role of taxable income. It is noteworthy that none of these erosions is deeply embedded in the existing system of taxation. Except for the clearly unjustifiable head-of-household rate schedule, all originated in the Tax Reform Act of 1969.⁴⁷ A guarded optimism that the present trend is reversible, therefore, is not unreasonable.

II. EROSIONS OF THE TAXABLE INCOME BASE

A taxing system will lose a single basis for allocating the burden of taxation if it employs secondary allocation bases to supplement or replace the primary base, or if different rate schedules are applied to the primary base. The existing Code deviates from the exclusive use of taxable income in each of these ways, in one instance employing both a different base and a different rate schedule. Part II explores the principal erosions of taxable income and the difficulties that they have created. In addition, it attempts to demonstrate that the use of secondary allocation mechanisms was unnecessary, and that Congress could have achieved a superior result by an appropriate modification of the definition of taxable income.

A. *Multiple Rate Schedules*

1. *Historical Evolution*

Before 1948, the Code required all taxpayers to compute their tax liabilities by applying a single rate schedule to their individual taxable incomes.⁴⁸ Except in community property states, it addressed disparities in taxpaying capacity between married and single taxpayers solely through the personal exemptions. In community property states, however, spouses were entitled to divide community income and compute their tax liability separately, even though only one spouse had earned that income.⁴⁹ Income split in this way was taxed at a lower marginal rate than the same level of income earned by one spouse in a common-law property state.

In 1948, Congress eliminated this discrimination by permitting all married couples to treat their entire family income as if it had

47. Pub. L. No. 91-172, 83 Stat. 487.

48. For the history of the taxation of the family unit, see H. GROVES, *FEDERAL TAX TREATMENT OF THE FAMILY* 59-69 (1963); Bittker, *Federal Income Taxation and the Family*, 27 *STAN. L. REV.* 1389, 1405-16 (1975) [hereinafter cited as Bittker].

49. *Poe v. Seaborn*, 282 U.S. 101, 106 (1930).

been derived equally by the husband and the wife without regard to the actual source of that income.⁵⁰ As a result, the tax payable by most married couples equalled twice the tax payable by a single taxpayer who earned one half of the married couple's income. This adjustment of the tax burden was implemented through a second rate schedule applicable to the income reported on joint returns filed by married couples. But Congress adopted the second rate schedule solely for administrative convenience. The substance of the 1948 amendment was to reallocate income within the family unit, and taxable income, as so reallocated, remained the sole determinant of income tax liability.⁵¹

Three years later, and with no indication that Congress appreciated the significance of the step,⁵² it adopted an additional rate schedule that was not merely a matter of administrative convenience. Although the 1948 amendment had eliminated discrimination between married couples, it produced a new inequity. Splitting income between husbands and wives enabled married couples to pay less tax than single persons with the same level of income. This disparity of treatment was particularly acute for single taxpayers with dependents.⁵³ Rather than directly address the adequacy of the allowance for dependents, Congress responded to the plight of single parents by adopting a new rate schedule for so-called heads of households.⁵⁴ Somewhat arbitrarily, the tax liability for heads of households split the difference between the tax liabilities of married and single taxpayers with the same level of income.⁵⁵

Convinced that the discrepancy in tax burdens between married

50. Revenue Act of 1948, ch. 168, § 301, 62 Stat. 114 (now I.R.C. § 1(a)(1)).

51. McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573, 1584 (1977).

52. The 1948 amendment was correctly perceived as permitting the splitting of family income between husband and wife. Professor Bittker has reported that, notwithstanding the availability of the benefits of joint filing by childless couples, the reform was viewed as a tax allowance for family responsibilities. Single parents then asserted that they too were entitled to such an allowance, and Congress evidently agreed. See Bittker, *supra* note 48, at 1417. Thus the Senate Finance Committee Report discloses that the Committee viewed the adoption of the head-of-household rate schedule as extending a modified form of income splitting to single parent families. S. REP. NO. 817, 82d Cong., 1st Sess. 3, reprinted in [1951] U.S. CODE CONG. & AD. NEWS 1969, 1971. The nature of the 1951 amendment, however, was very different from that of the 1948 amendment. Income splitting among married couples is based upon a factual assumption concerning the pooling of family income that is rational if incomplete. See note 62 *infra*. The head-of-household schedule, by contrast, constituted an arbitrary rate reduction devoid of factual support.

53. S. REP. NO. 817, *supra* note 52, at 10-11, [1951] U.S. CODE CONG. & AD. NEWS at 1978-79.

54. Revenue Act of 1951, ch. 521, § 301, 65 Stat. 480 (now I.R.C. § 1(b)).

55. S. REP. NO. 817, *supra* note 52, at 10, [1951] U.S. CODE CONG. & AD. NEWS at 1978 (table 3); Bittker, *supra* note 48, at 1417.

couples and all single taxpayers was too great, Congress lowered the rate schedule for single taxpayers in 1969.⁵⁶ Again somewhat arbitrarily, the 1969 amendment reduced by approximately one half the excess of the tax liability of a single person over the liability of a married couple on the same level of income.⁵⁷ This rate reduction had a profound symbolic effect, for it formally disassociated the tax liabilities of married and single taxpayers. No longer could a married couple determine its tax liability by merely attributing family income equally to each spouse. Beginning in 1970, then, the Code contained three separate rate schedules — for single persons, married couples, and heads of households. But Congress also preserved the right of married couples to file separate returns under the pre-1970 rate schedule applicable to single taxpayers,⁵⁸ in effect creating a fourth rate schedule applicable to individual taxpayers.

The 1969 legislation redressed the inequity between a married couple and a single person with the same income, but it may have created an inequity between married couples and two single individuals whose combined income equalled that of the married couple. Since 1969 the combined tax payable by two single persons with approximately equal incomes has been less than the tax payable by a married couple with a family income equal to the combined income of the two single persons. As employed singles learned that marriage would increase their tax liability, substantial pressure emerged for relief from this "marriage penalty." Even today this pressure continues — providing a small reminder of the futility of attempts to eliminate inequities in the system by promulgating additional rate structures.

2. *Critique of the Multiple Rate Structure*

Congress disassociated the relative tax burdens of married and single taxpayers in 1969 because the previous approaches appeared inequitable. Pre-1948 law imposed an excessive burden on married taxpayers, while the post-1948 equal attribution rule excessively burdened single taxpayers. The need for a middle ground, however, did not mandate the adoption of separate rate schedules. For several reasons, that decision now appears questionable.

First, the 1969 amendment adopted a complex set of four rate schedules, which confuses both taxpayers and tax collectors. Since

56. Tax Reform Act of 1969, Pub. L. No. 91-172, § 803(a), 83 Stat. 487 (now I.R.C. § 1(b)).

57. S. REP. NO. 91-552, 91st Cong., 1st Sess. 262, reprinted in [1969] U.S. CODE CONG. & AD. NEWS 2027, 2297-98.

58. I.R.C. § 1(d) (amended 1977 and 1978).

several categories of taxpayers must be defined, fine and not wholly satisfactory lines must be drawn.⁵⁹ Taxpayers must then understand those definitions and apply them to their own varying circumstances. Because the categories depend on voluntary conduct, the system invites abuse and tax avoidance.⁶⁰ "Tax-divorces," although more a product of journalistic imagination than a social phenomenon, still constitute an attack on the integrity of the classifications that must be addressed. Such attacks require the administrators of the system as well as the courts to develop new doctrines of tax avoidance.

Second, the allocation of tax burdens imposed by the multiple schedules is inherently arbitrary. Before 1969, the Code allocated that burden logically, if not entirely satisfactorily. The pre-1948 rule attributed income to the individual responsible for its production. The income-splitting permitted by the 1948 amendment, while adopted for political reasons,⁶¹ was empirically justifiable. Tax specialists generally assume that spouses pool and divide family income.⁶² Although there are exceptions, that assumption probably represents the most accurate single model of family budgeting. By contrast, the existing allocation of the tax burden between single and married taxpayers lacks a foundation in either principle or fact. The Code generally takes differences in taxpaying capacity into account by adjusting the definition of the tax base to reflect those varying capacities. But implicit in the adoption of secondary mechanisms like the multiple rate schedules is the conclusion that material differences exist between the two classes of taxpayers that we cannot quantify with sufficient accuracy to adjust the tax base.

The arbitrary nature of multiple rate schedules has produced several undesirable consequences.⁶³ Perhaps most importantly, it has

59. Attempted, in the first instance, in I.R.C. § 2 (amended 1975 and 1976).

60. See Richmond, *The Marriage Penalty: Restructuring Federal Law to Remedy Tax Burdens on Married Couples*, 5 NOVA L.J. 31 (1980).

61. See Bittker, *supra* note 48, at 1412-14.

62. See H. GROVES, *supra* note 48, at 69-70; McIntyre, *Individual Filing in the Personal Income Tax: Prolegomena to Future Discussion*, 58 N.C. L. REV. 469, 469 (1980). That is not to say, however, that all theorists agree that such an expenditure pattern justifies a tax allowance for the married taxpayer such as income splitting. See, e.g., Pechman, *Income Splitting*, in HOUSE COMM. ON WAYS AND MEANS, 86th Cong., 1st Sess., 1 TAX REVISION COMPENDIUM 473, 479-81 (Comm. Print 1959) (arguing for a return to the pre-1948 system).

63. Not only has the structure been endlessly criticized, but it has also prompted countless proposed amendments. For summaries of recent proposals, see JOINT COMM. ON TAXATION, 96th Cong., 2d Sess., THE INCOME TAX TREATMENT OF MARRIED COUPLES AND SINGLE PERSONS (Comm. Print 1980); Moerschbaecher, *The Marriage Penalty and the Divorce Bonus: A Comparative Examination of the Current Legislative Tax Proposals*, 5 REV. TAX. INDIVIDUALS 133 (1981); Richmond, *supra* note 60, at 45-52.

Moreover, in the absence of a rational basis for the Code's discrimination, the debate over the allocation of the burden of taxation has focused excessively on emotional issues. See *gener-*

significantly impaired the integrity of the tax system. Undoubtedly, the decline in taxpayers' respect for tax laws is attributable in part to the apparent unfairness of an arbitrary levy. In the absence of any sound justification for the differential in tax liabilities imposed by the multiple rate structure, taxpayers have begun to resort to self-help to mitigate what they view as unacceptable inequities.⁶⁴ No alternative to the multiple rate structure will silence the complaints of those who appear more harshly treated by a system of taxation. But if harsher treatment is dictated by a good faith effort to apply rational criteria, it is reasonable to expect that treatment to be more broadly accepted than the essentially arbitrary multiple rate schedules.⁶⁵

Taxpayers are entitled to a system of taxation that allocates tax burdens as equitably as possible. The existing multiple rate schedules do not represent a good faith effort to achieve that fairness; they are a means of avoiding the necessity for producing an equitable allocation. It would, I think, be morally preferable to establish a differential in tax liabilities based upon an empirically derived formula that was doomed from the beginning to imprecision than to perpetuate the arbitrariness of the existing system.

3. *Feasibility of Sole Reliance upon Taxable Income*

Congress could eliminate the multiple rate schedules if there were no differences in circumstances between single and married taxpayers that the taxing system should take into account, or if such differences were sufficiently susceptible to accurate measurement that compensating adjustments could be made through the definition of taxable income. Either conclusion would require the prior identification of the differences in circumstance that are alleged to exist. Although there is substantial disagreement over the magnitude of those differences and whether they can be quantified, there is a gen-

ally Mess, *For Richer, For Poorer: Federal Taxation and Marriage*, 28 CATH. U. L. REV. 87 (1978). For an extreme example, see Comment, *Congressional Sanction of Illicit Cohabitation — The Tax Reform Act of 1969*, 1979 B.Y.U. L. REV. 940 (1979). The energies of those who would reform the system have not been directed toward obtaining a more equitable result, but rather toward achieving a politically expedient result. If the differential in tax liabilities were empirically based, the debate could be more productively channeled. Thus, the relative tax burden which is exclusively a question of household economics, might be addressed in economic terms rather than in terms of extraneous social and political issues.

64. See Richmond, *supra* note 60, at 31 n.2.

65. One recent commentator has asserted with some justice that "much of the unhappiness of the taxpaying public with current law stems from the fact that the present twenty percent formula for relating the Single and Joint Return rate schedules has no support whatsoever in any theory of an ideal income tax but is simply an ad hoc compromise." McIntyre & Oldman, *supra* note 51, at 1595.

eral consensus concerning their nature.⁶⁶

In a traditional family, where only one spouse earns income, there are two possible grounds for distinguishing a married couple from two single persons who each earn one half of the amount of the couple's income.⁶⁷ Both arguments suggest that married couples should incur greater tax liabilities. First, the self-performed services of the unemployed spouse may increase the couple's capacity to consume at any level of income. Since this imputed income is not taxed, the equal attribution rule undertaxes married couples. This argument, of course, does not justify a differential in tax burden between all single taxpayers and all married couples, but only between employed single taxpayers and one-worker married couples. The argument also justifies a differential in tax liability between employed and unemployed single taxpayers. Thus, the imputed income argument is both overinclusive and underinclusive, and adjusting tax liabilities to account for self-performed services could create greater inequities than it resolves. Moreover, the Code's failure to tax imputed income is a well-known defect of extensive proportions. That omission should be approached from a broader perspective than the relatively narrow question of the relative tax liabilities of single and married taxpayers. The Code has suffered enough from ad hoc amendments that ignore broader implications.⁶⁸

Although I reject imputed income as a general basis for subjecting married couples to a greater tax, the argument does have some merit. Many married couples benefit financially from the services of the unemployed spouse, particularly when the taxpayer must care for minor dependents. Because the more pronounced discrimination is an aspect of dependency, the question of imputed income will be treated in that context below.⁶⁹

The second principal argument supporting a heavier tax liability for married couples relies upon their economies of scale. But it is doubtful that many families achieve such economies in the sense of an ability to purchase goods in larger quantities at a lower unit price. Where these economies do exist, they reflect income level and personal traits more than essential differences between married and single taxpayers. On the other hand, the benefit that each spouse

66. R. GOODE, *supra* note 13, at 230; Bittker, *supra* note 48, at 1419-28.

67. The present discussion assumes that the two single persons live apart. The problem of unmarried cohabitation is treated below. See text at notes 84-87 *infra*.

68. For an illustration in another context, see Coven, *Liabilities in Excess of Basis: Focht, Section 357(c)(3) and the Assignment of Income*, 58 OR. L. REV. 61 (1979).

69. See notes 80-83 *infra* and accompanying text.

obtains from the income of the other is an economy of scale that reveals such an essential difference.

The theoretical base upon which an income tax is imposed is the sum of an individual's annual consumption plus accumulation of wealth. Because it is impractical to measure consumption directly, the tax actually is imposed upon financial receipts less production costs. For an individual, net receipts serve as a satisfactory proxy for consumption plus accumulation. If the deductibility of expenditures for the production of net receipts is properly limited, such receipts must equal the individual's consumption plus accumulation — at least if the deflection of that income to another person is regarded as consumption by the taxpayer and not by the donee. However, when a closely knit economic unit, such as a married couple, derives the financial receipt, the assumed equivalence between consumption and receipts is no longer valid because the receipt to some extent provides consumption for both husband and wife. Such dual consumption exists when a single purchase benefits both spouses and the benefit derived by one spouse does not impair the benefit derived by the other. And to the extent of that dual consumption, a rule attributing the family income equally to both spouses understates their taxpaying capacity relative to single taxpayers.

Thus, for example, the purchase of a waffle iron by one spouse benefits both equally, and the dual use will not materially reduce the benefit obtained by either.⁷⁰ In essence, the income spent to purchase that waffle iron provides consumption to both husband and wife in the full amount of the iron's cost. By contrast, two single persons living apart must spend twice that amount to obtain the same measure of consumption. The married couple can use the income not devoted to the purchase of a second waffle iron for other purposes. Accordingly, they can purchase a greater measure of consumption, at a given level of income, than can two single individuals.

It may be objected that one spouse may not like waffles, or, if given an unfettered choice, would have purchased a blender instead. But the taxation of forced consumption is an unavoidable aspect of the taxation of any family unit that pools financial resources. In-

70. If the useful life of a waffle iron were a direct function of the number of waffles it produced, the statement in the text would be in error, for the benefit derived by one spouse would reduce the benefit that could be obtained by the other. The useful life of consumer appliances, however, is a function of a variety of variables ranging from the care that it receives, to the changing tastes of its owners, to just plain luck, and the number of waffles produced is a minor element in the equation. Still, as observed below, the quantity of dual consumption attributed to such appliances properly should be something less than the entire cost of the article.

come devoted by one member of the unit to purely private consumption reduces the income available for the other, but nevertheless is fully taxed. If all household consumption provided purely private benefit for only husband or wife, and the couple divided its income equally, then the pre-1970 equal attribution rule would be precisely correct. But this is not the case. My suggestion is that a married couple's dual consumption has sufficient magnitude to be taken into account by the taxing system.

If the analysis of the relative economic positions of single and married taxpayers is correct, it follows that the tax imposed upon a married couple should exceed the combined tax imposed upon two single persons with relatively equal incomes that total the couple's income. This tax differential is justified primarily by differences in the consumptive capacities of married and single taxpayers. Because the market value of consumption is an ingredient of an ideal income tax base, greater consumption by married taxpayers should be reflected by adjusting the definition of their tax base — taxable income. Secondary allocation mechanisms, such as the multiple rate schedules, are plainly second-best solutions.

Other commentators have observed that dual consumption is a benefit of marriage,⁷¹ but have not relied upon this benefit to justify the differential in tax burdens between single and married taxpayers because it was thought too difficult to quantify accurately.⁷² This rejection, however, reduces the available options to the twin evils of arbitrary approximation by multiple rate schedules or the inequitable disregard of real differences in consumptive capacity. Perhaps those commentators who question the feasibility of quantifying dual consumption have set their standards too high. Admittedly, the most careful attempt to measure the financial consequences of marriage will fall far short of mathematical accuracy. The diversity of human conduct precludes complete success in this endeavor. However, even an imperfect quantification of dual consumption would permit specific adjustments to taxable income that allocate tax liability more equitably than do the multiple rate schedules.

Assuming that the differences in financial circumstances between married and single taxpayers consist primarily of dual consumption, it is entirely feasible to measure those differences empirically. Plainly it would be impractical to require individual taxpayers to report specific instances of dual consumption. But an adjustment

71. Bittker, *supra* note 48, at 1422.

72. Bittker, *supra* note 48, at 1422-28; McIntyre & Oldman, *supra* note 51, at 1595-96 n.80.

could be based upon a representative portrayal of family budgeting — just as the assumption that families pooled their income underlay the 1948 equal attribution rule. Substantial data are presently available about the expenditure patterns of American families at different levels of income.⁷³ Although much of the existing data concerns the lower portion of the income spectrum, inadequacies in the existing data base could be remedied. Indeed, the principal difficulty in quantifying dual consumption lies not in identifying how the typical family spends its incomes, but in making the judgments necessary to determine whether those expenditures support dual consumption.

Those judgments, however, will not be as subjective as one might think. Promptly consumed goods and services — such as food, clothing, and travel — generally do not benefit both spouses. On the other hand, most consumer durables — such as kitchen appliances and household furnishings — do provide dual benefits. Housing itself is more difficult to characterize. Since each adult probably requires some minimum private living space, there may be a little dual consumption until the couple has purchased some sufficient level of housing. But sharing a twelve-room single family dwelling should not curtail either spouse's benefit, and thus exemplifies dual consumption.

The accumulation of wealth, the other component of an income tax base, may also provide dual benefits, albeit difficult to measure. For many, savings are a form of insurance, a hedge against possible illness or injury. Until one spouse devotes those savings to private consumption, they provide a measure of security for both the husband and wife.

Even the wholly untailored data presently available provide a basis for making reasonable judgments concerning the extent of dual consumption in typical family budgets at various levels of income. The purchase of consumer durables is the primary, and most readily quantifiable, source of dual consumption. Expenditure studies suggest that the typical American family spends between five and fifteen percent of its pretax family income on such goods.⁷⁴ These studies also permit rough estimates of the value of dual consumption of housing by married couples. Although the data must be further re-

73. Most of this information is compiled by or for the Bureau of Labor Statistics. *See, e.g.*, BUREAU OF THE CENSUS, U.S. DEPT. OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES 327 (1975); BUREAU OF THE CENSUS, U.S. DEPT. OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 442 (1980); U.S. BUREAU OF LABOR STATISTICS, DEPT. OF LABOR, BULL. NO. 1997, CONSUMER EXPENDITURE SURVEY (1978) [hereinafter cited as CONSUMER EXPENDITURE SURVEY].

74. *See* CONSUMER EXPENDITURE SURVEY, *supra* note 73.

fined, it is reasonable to assume that ten percent of family income supports dual consumption.

That assumption could provide a basis for allocating the burden of taxation between married and single taxpayers through a specific adjustment to the definition of taxable income. Specifically, each spouse's taxable income would be deemed to equal fifty-five percent of the entire family income. Thus, a married couple whose taxable income under present law is \$40,000 would have the same tax liability, subject to the further adjustment for two-worker families suggested below, as the combined tax on two single taxpayers, each of whom earned \$22,000. Because this adjustment is empirically based, it would be considerably more accurate than the arbitrary allocation under the multiple rate schedules. Moreover, the very fact of a good faith effort to allocate the burden of taxation fairly rather than arbitrarily would materially improve the respectability of the taxing system.

The current sensitivities to the so-called marriage penalty make it politically difficult to implement an adjustment to taxable income by an addition to married couple's income — even if the adjustment were empirically based. Incorporating the adjustment into a separate rate schedule has precedent in the post-1948 law, but this would tend to obscure the factual basis of the adjustment. A more complete break with the arbitrariness of the existing schedules is preferable, and there may be a politically acceptable approach. Instead of increasing taxable income upon marriage, we could produce the same allocation of the tax burden by extending a deduction to single taxpayers. Although this solution is less direct than adjusting a married couple's taxable income upward, it is an appropriate adjustment to taxable income nonetheless and avoids the problems of secondary allocation mechanisms. Combining a deduction for singles with the repeal of the head-of-household rate schedule and a new allowance for two-worker families, both suggested below, might well produce a politically acceptable package.⁷⁵

75. The willingness and ability of Congress to pursue the factual investigation and evaluation required to implement the approach suggested in the text is evidenced by the recent amendments to those Code provisions that partially exclude from tax income earned abroad. Prior to 1976, certain United States taxpayers working abroad were entitled to a lump sum exclusion from tax of a portion of their foreign source earnings that ranged up to \$25,000. For a history of that exclusion and of the amendments thereto, see Postlewaite & Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for its Repeal*, 65 VA. L. REV. 1093 (1979). In that year, however, the House Ways and Means Committee determined that the arbitrary exclusion was inappropriate and should be repealed. In its place, the Committee recommended specific deductions designed to reflect the increased costs of living abroad to the extent that such increased costs were in fact encountered. H.R. REP. NO. 94-658, *supra* note 44, at 200-01. While the House proposal was not enacted in 1976, the substance of the propo-

4. *The Special Problem of the Two-Worker Household*

The principal criticism of the pre-1982 allocation of tax liability between married and single taxpayers is that tax liability increases upon the marriage of two single persons with relatively equal incomes.⁷⁶ This so-called marriage penalty has two separate aspects: the fairness of that increase in tax liability, and ability of taxpayers to avoid the increase by remaining single. The fairness of the marriage penalty is solely a question of the adequacy of the definition of taxable income. Tax avoidance, of course, poses other considerations. But if taxpayers are confident that the existing tax differentials are fair, the problem of avoidance may well become less acute.

Fairness requires that the tax imposed upon a married couple earning \$40,000 be greater than the combined tax imposed upon two single taxpayers who each earn \$20,000, to account for dual consumption. Present law imposes such a pattern of taxation when one spouse generates all of a couple's income. However, when both spouses are employed, this result has been widely criticized because the couple's tax liability is greater than if they were single. This criticism is groundless. The source of a family's income will not materially affect the allocation of consumption within the family. There is thus no rational basis in notions of distributional equity for imposing a lower tax upon a two-worker family than is imposed upon a one-worker family. Indeed, any such reduction would conflict with the generally accepted principle that all married couples with the same family income should incur the same tax liability.⁷⁷

This necessity for equal treatment in an ideal income tax, how-

sal with a detailed and expanded series of deductions was enacted two years later. Foreign Earned Income Act of 1978, Pub. L. No. 95-615, §§ 202-03, 92 Stat. 3097. The resulting I.R.C. § 913 was short lived; its tailored allowances were repealed just three years later. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 112(a), 95 Stat. —. That reversal of policy was attributable to the overwhelming objective of the 1981 legislation to assist American business and does not suggest that the 1978 approach was unworkable. See S. REP. No. 97-144, 97th Cong., 1st Sess. 34-38 (1981). In any event, the adjustment to taxable income proposed herein would be far simpler than the rather complex I.R.C. § 913 since the several bases for adjustment would be distilled into a single addition to taxable income.

76. For a clear tabular demonstration of the marriage penalty on different levels of income before 1982, see Brazer, *Income Tax Treatment of the Family*, in *THE ECONOMICS OF TAXATION* 245-46 (H. Aaron & M. Boskin eds. 1980).

77. The marriage penalty would be eliminated if each individual were subject to tax on his own individual income, as occurred prior to 1948. Individual filing would, of course, violate the principle of equal taxation of equal income couples. Some commentators have been willing to accept the sacrifice of that principle in order to eliminate the marriage penalty. See, e.g., Munnell, *The Couple Versus the Individual under the Federal Personal Income Tax*, in *THE ECONOMICS OF TAXATION* 278 (H. Aaron & M. Boskin eds. 1980). The individual filing rule thus is one of the least appealing solutions to the marriage penalty. See McIntyre, *supra* note 62.

ever, does not demonstrate that the present allocation of tax liability between one- and two-worker families is equitable. Equality of tax liability should be premised upon equality of taxable incomes. Present law overtaxes two-worker families relative to one-worker families because of traditional imperfections in the definition of taxable income. By correcting this definition and revising the differential in tax burdens generally imposed upon married couples, we could substantially reduce the marriage penalty. Indeed, those modifications would eliminate the unfairness contained in existing law. Although two-worker married couples would still pay higher taxes than two singles with the same aggregate income, that differential would merely reflect the improvement in consumptive capacity attributable to the formation of an economic unit.

The definitional defect that significantly affects two-worker couples is the failure of the Code's definition of taxable income to account for the costs of employment. Virtually all employed persons incur many costs solely because they are employed. Workers incur greater costs for clothing and meals, require briefcases or lunchboxes, and sacrifice a substantial amount of leisure time in which they could have substituted self-performed services for purchased services. Uniformly, however, the tax laws do not compensate workers for these added expenses; the costs of being an employed person are not deductible.⁷⁸ That imperfection in the taxing system does not create a greater inequity than can be justified by considerations of simplicity because the *necessary* costs of being employed, as distinguished from the *volitional* costs (*i.e.*, expensive suits, lunches, long commutes from the suburbs, leather briefcases), are relatively evenly distributed over the employed population. In effect, the taxing system accounts for the necessary costs of one employed person in the rate of tax imposed upon each taxable income.⁷⁹

Ignoring these costs does not discriminate between married and single taxpayers, or between a one-worker married couple and two employed single persons with a combined income equal to that of the couple. In each instance, nondeductibility of one individual's employment expenses produces uniform treatment. But ignoring those costs discriminates between one- and two-worker families. If both spouses are employed, the level of necessary employment costs rises and the rate schedule does not account for that increase in costs. Since the increase is not evenly distributed over the taxpaying popu-

78. M. CHIRELSTEIN, *supra* note 32, at 90-91.

79. *Id.*

lation, we cannot ignore it without discriminating against two-worker families.

The system of taxation should redress this discrimination by redefining taxable income rather than through secondary mechanisms. Because the discrimination is founded upon an overstatement of the taxable income of two-worker families, the remedy lies in deflating that overstatement by granting a deduction for the increased costs. The most accurate approach, of course, would be to permit the itemized deduction of these expenses. However, because many returns are involved and the additional expenses are relatively minor, simplicity and administrative convenience would likely suggest that we use a fixed allowance or standard deduction. The amount of this allowance should be empirically determined, but should not exceed the net income of the spouse with the lower income.⁸⁰

It is vastly more difficult to adjust properly for the loss of the second spouse's self-performed services. Reducing the two-worker family's tax to compensate for the loss of the second worker's loss of services is equivalent to taxing the self-performed services of the nonworker in a one-worker family. Although an ideal income tax might contain such a levy, the conceptual and practical difficulties in quantifying the value of self-performed services are so great that such an adjustment to the tax base has never been seriously considered.⁸¹ But it does not necessarily follow that we must accept the inequity of making no adjustment at all. Indeed, the Code currently allows a limited tax credit for household and dependent care expenses necessitated by employment, even though the services purchased merely substitute for self-performed services.⁸² Specific

80. For years beginning after 1981, precisely such an allowance has been adopted. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 103(a), 95 Stat. — (adding I.R.C. § 221). After a one-year phase-in allowance, the new section grants a deduction in computing adjusted gross income on a joint return equal to 10% of the earned income of the lower paid spouse to a maximum of \$3000. While that allowance is fully in accord with the observations in the text, the philosophy of the Senate Finance Committee, which proposed the reduction, is not entirely clear. Almost as an aside, the Committee Report cited the increased expenses of becoming employed and the loss of "free time" of the two-worker couple. The Committee's primary rationale appeared to be opposition to the marriage penalty itself for reasons unrelated to tax equity. Indeed, the Report stated that it was the goal of the Committee to eliminate completely the penalty in future years. Thus the Committee seemed to regard the deduction it was proposing as introducing an inequitable distortion of taxable income that was necessary to preserve respect for the family and the tax system. S. REP. NO. 97-144, 97th Cong., 1st Sess. 29-30 (1981). The suggestion here is that respect for the taxing system is best preserved by eliminating inequities.

81. See R. GOODE, *supra* note 13, at 142-43; H. SIMONS, *supra* note 4, at 110-11; McIntyre & Oldman, *supra* note 51, at 1607-13.

82. I.R.C. § 44A provides a credit against tax in an amount that ranges from 20% to 30% of specified household and dependent care expenses of certain employed persons. Prior to 1976,

deductions or credits may be imperfect substitutes for directly taxing the imputed value of services, but they are the only practical means of compensating two-worker families for this increased cost. The existing credit is merely a relatively inequitable form of tax relief to low-income households, and does not serve this purpose.⁸³ However, an expanded allowance, in the form of a deduction for a reasonable increase in the cost of purchased services, could.

The modifications of the definition of taxable income proposed here can best be illustrated graphically. The following chart compares the tax rate for married individuals at different taxable income levels under present law and as proposed with the tax rate presently imposed upon single taxpayers:

INCOME TAX CONSEQUENCES OF MARRIAGE
BY TAXABLE INCOME LEVEL

this allowance was an itemized deduction under the now repealed I.R.C. § 214. In that year the allowance was converted to a credit so that it could be claimed by taxpayers not itemizing their deductions. See H.R. REP. NO. 94-658, *supra* note 44, at 146-47.

83. Prior to 1975, the child care deduction was phased out for taxpayers earning over \$18,000 and disappeared entirely at \$27,600. These ceilings were briefly raised, but in 1976,

In the computations that underlie the chart, the tax presently paid by a married individual equals one half of the tax payable under the joint return schedule on twice the income indicated in the chart. The chart discloses that, under present law, the percentage increase in a married individual's over a single person's tax on the same income varies quite widely. At both quite low and high levels of taxable income, a married individual pays little additional tax. But in the middle-income range, the income tax consequences of marriage become burdensome. This confirms the arbitrariness of the multiple rate schedules, for there is no obvious reason why married individuals' relative tax burdens should vary so widely at different levels of income.

The proposed tax for a married individual from a one-worker household equals the tax that would be payable by a single person with 110% of the level of taxable income indicated on the chart. The resulting relative tax burden imposed on a married taxpayer would at some levels of income be greater and at other levels be less than under present law. However, quite desirably, the magnitude of the differential in tax is considerably more constant than under present law, reflecting the greater rationality of the proposed adjustment.

Finally, the chart shows the proposed tax liability for a married individual in a two-worker family if the two-worker family allowance were permitted. For illustrative purposes, the allowance equals ten percent of the first \$10,000 of net income earned by the second working spouse plus five percent of any additional income of that spouse to a maximum allowable deduction of \$3000. The relative tax burden was computed by subtracting one half of that allowance from 110% of the taxable income indicated on the chart. This comparison shows the effect of my proposals on the existing marriage penalty, for that "penalty" affects only households in which both spouses have substantial income. The assumed allowance reduces the additional tax paid by two-worker families at the middle income levels by approximately one half. However, at very high levels of

the allowance was converted to a 20% credit. As such, the allowance provides a full tax benefit for the actual costs incurred only to taxpayers in the 20% marginal bracket, which is surpassed under present law by a taxable income of \$11,900 reported on a joint return. For other taxpayers, the tax benefit of a credit is equal to the ratio of the rate of credit to the taxpayer's marginal bracket rate. Thus a taxpayer in the 50% bracket obtains only 40% of the tax benefit from a 20% credit as would be obtained from a deduction. Somewhat oddly, a taxpayer having a marginal rate below 20% is subsidized by the credit. See R. GOODE, *supra* note 13, at 155-56. Beginning in 1982, the low-income subsidizing aspect of the child care credit will be enhanced considerably. The credit has been increased to 30% of allowable expenditures for taxpayers having adjusted gross incomes of \$10,000 or less although such taxpayers will generally be subject to a marginal tax rate of only 14 to 16%. The allowable credit declines to 20% for those with adjusted gross incomes of \$30,000 or more.

income, where the combined family net income exceeds \$110,000, the amount of additional tax imposed increases.

Granting a special allowance to two-worker households would eliminate the existing inequity between one-worker and two-worker families, and thus should reduce the tax avoidance precipitated by the marriage penalty.⁸⁴ But tax avoidance through divorce or failure to marry is only part of a larger problem, which neither present law nor a simple adjustment to the definition of taxable income can solve. I have suggested that economic units benefit from pooling their members' financial resources to an extent that the taxing system cannot ignore. If that is so, the benefit is not limited to married couples, but rather accrues to all couples or even larger groups that engage in similar financial conduct. On the other hand, not all persons who live in the same residence pool their resources to an extent that would justify the imposition of a greater tax liability. Indeed, it is unlikely that all married couples so pool their resources.

Many commentators have noted the failure of the taxing system to address these economic realities, and concluded, no doubt correctly, that the definitional problem is insurmountable.⁸⁵ Lacking a better alternative, the federal tax system uses marriage as a proxy to define economic units that derive benefits from pooling financial resources to an extent that the taxing system cannot ignore. Conceivably, over time, changing patterns of social behavior will so erode the perceived correlation between marriage and pooling that a new approach to the allocation of the burden of taxation between single persons and economic units will be required. But until tax liability is based upon taxpayers' actual economic circumstances rather than their marital status, the system will err in that allocation. And, since that formal status results from volitional conduct, the potential for taxpayer avoidance will continue to exist.

Cohabitation by employed but unmarried couples of different sexes is only one aspect of this far larger problem, and likely represents only a minor fraction of the overall error in tax allocation. Proposals such as elective separate filing by married couples⁸⁶ attack the undertaxation of a subclass of unmarried cohabitants by inappropriately reducing the tax liability of a subclass of married taxpay-

84. Since two-worker families have in fact been unfairly taxed, it is not surprising that they have objected to that tax or that they have taken evasive action. Were those couples subject to tax in the manner suggested above, the amount of the tax would be lessened and the inequity substantially eliminated. There is no basis for supposing that in such an altered environment, tax avoidance by failing to marry would constitute a material concern.

85. See Bittker, *supra* note 48, at 1398-99; Brazer, *supra* note 76, at 242-43.

86. See Munnel, *supra* note 77, at 267-71.

ers. Such an approach would introduce a new inequity into the allocation of the burden of taxation without reducing the existing inequities. If tax avoidance by failing to marry requires attention beyond the elimination of the inequities of present law, that attention must be directed to the evolution of a workable definition of an economic unit that can entirely replace the proxy of marital status.⁸⁷

5. *The Special Problem of Dependency*

The adoption of the equal attribution rule in 1948 imposed a relative tax burden on single persons that was too great. That burden was felt heavily by those in the most pressing circumstances — single-parent families. In response to their demands for relief, Congress promulgated the head-of-household rate schedule.⁸⁸ It is doubtful that the adoption of a second rate schedule was ever a proper response to the financial circumstances of single-parent families. Regardless, in view of the 1969 adjustment to the relative tax liabilities of married and single taxpayers, and the adoption of the child care allowance, that erosion of the role of taxable income is completely unjustifiable.

The analysis of the propriety of the head-of-household rate schedule should commence with an effort to identify specific financial burdens encountered by single-parent families that distinguish those taxpayers from all others, and justify additional relief. Although several arguments favor single parents, in each instance the claim for special relief is either unwarranted or could be accommodated with far greater accuracy by adjusting the definition of taxable income rather than by a general rate reduction.

a. *Loss of self-services.* An employed single parent may be forced to substitute purchased services for self-performed services, and thereby suffer a decline in volitional consumption. However, that financial detriment does not materially differ from the additional costs incurred by a two-worker married couple. The proper approach to this aspect of dependency for both categories of taxpay-

87. Those who would arbitrarily reduce the tax liabilities of married couples in order to eliminate the marriage penalty have sought to justify their position by the need to preserve respect for the family and that argument has had its impact on Congress. The argument is frivolous. As long as a couple lives together as husband and wife, regardless of their formal status under state law, they are demonstrating their continued respect for the social institution of the family. By entering into a tax-motivated divorce (or failure to marry) while continuing to behave as if married, the couple is demonstrating its disrespect for the taxing system. It is impossible to understand how respect for the taxing system can be restored by eroding the equity of the system in order to ratify purely tax-avoidance conduct.

88. I.R.C. § 1(b). See notes 53-55 *supra* and accompanying text.

ers is to expand the existing allowance for child care and household expenses. That provision's inadequacy no more justifies a rate reduction for singles than it does a rate reduction for two-worker married couples.

b. *Inadequacy of other dependency allowances.* Providing for dependents unquestionably reduces the amount of income available to taxpayers for their own consumption. Although some commentators have suggested that the entire cost of dependents — or at least of minor children — is a pure consumption expense of the taxpayer,⁸⁹ the present consensus favors some allowance for the forced channeling of income to a dependent.⁹⁰ The more difficult problem lies in distinguishing between volitional and forced consumption. Volitional consumption — the indulgence of one's children — should be included in taxable income. But forced consumption — providing basic necessities — may justify a dependency allowance. The Code's solution is the personal exemption — a fixed, per capita deduction of \$1000.⁹¹

All taxpayers, of course, single and married, are entitled to the personal exemption for dependent children. If that exemption adequately reflected forced deflection of income attributable to the support of dependents, further adjustments would be unnecessary. But to the extent that the \$1000 exemption is inadequate, single taxpayers bear the burden of that inadequacy more heavily than married taxpayers. Of course, a married couple as an economic unit suffers the same decline in consumption as a single taxpayer. But the couple can distribute that decline over both spouses, while the single taxpayer must bear the entire burden. Accordingly, an inadequate dependency exemption discriminates against single taxpayers. Congress could remove that discrimination by generally increasing the allowance, or by permitting single taxpayers to deduct an amount equal to one half of the amount of the inadequacy.

Although the measurement of that inadequacy, if an inadequacy exists, would be highly imprecise and subjective, the general tax reduction extended by the head-of-household rate schedule is a totally unacceptable substitute for attempting that measurement. Because the same rate reduction applies regardless of the number of dependents, it constitutes a less accurate adjustment than would the

89. Simons himself so suggested. H. SIMONS, *supra* note 4, at 140.

90. See, e.g., Bittker, *supra* note 48, at 1449-53; McIntyre & Oldman, *supra* note 51, at 1602-07.

91. I.R.C. § 151.

roughest guess concerning the inadequacy of the dependency allowance. Moreover, the head-of-household schedule extends a pattern of relief that does not conform to the premise of the personal exemption. Under that schedule, the amount of the dependency allowance varies with the level of taxable income. This results in a dependency allowance arguably insufficient for lower-income taxpayers, but markedly excessive for wealthy taxpayers. The following table, which shows the tax payable under the rate schedules for single taxpayers and heads of households assuming that each claimed three personal exemptions of \$1000, illustrates the existing relationship:

Taxable Income	A Singles Rate	B Head-of- Household Rate	C Income Equivalent	D Deduction Equivalent
\$ 15,000	\$ 1,843	\$ 1,756	\$ 11,638	\$ 362
30,000	6,732	6,211	25,664	1,336
60,000	22,053	20,603	54,611	2,389
120,000	61,787	57,666	111,113	5,887

Column C represents the amount of income before personal exemptions required under the singles rate schedule to produce the amount of tax currently paid under the head-of-household schedule. By subtracting column C from the actual taxable income, the effect of the head-of-household rate schedule is converted into a deduction. That is, column D shows the amount of the deduction that an individual subject to the singles-rate schedule would need to limit his tax liability to that produced by the head-of-household schedule. Thus, if taxable income is \$15,000, using the head-of-household rate schedule rather than the singles schedule saves the taxpayer \$87 in tax, as would a deduction of \$362 claimed by a taxpayer using the singles schedule. As income rises, so does the deduction equivalent of the head-of-household schedule. By contrast, the personal exemption is not income sensitive, and remains at \$1000 regardless of the level of taxable income. If single taxpayers should be compensated for the discrimination that the inadequacy of the dependency allowance produces, the general configuration of that relief should conform to the configuration of the basic allowance. Thus, if the flat per capita personal exemption is appropriate, the head-of-household schedule is not.

It might, of course, be contended that the pattern of relief extended by the head-of-household schedule is more equitable than that extended by the personal exemption because it more nearly reflects the amount of family income devoted to the support of dependents. But that argument only suggests that Congress should change

the overall structure of the dependency allowance for both married and single taxpayers, and does not support the use of a multiple rate structure.

c. *Different expenditure patterns.* It may be that the typical pattern of expenditures varies materially between single-parent families and married couples with dependents. In the form most favorable to the head-of-household rate schedule, it might be argued that such households deflect a fraction of the family income to the dependents instead of to a second adult.⁹² Although this argument may be valid, it is similarly probable that married couples deflect increasing amounts of their income to their dependents as family income rises. In both contexts, the question turns not on the amount of income deflected to the dependents but rather on how much of that deflection represents forced rather than volitional consumption. If the Code ignores the rising pattern of expenditures for married couples, it must also ignore it for single parents.

In short, there is no special problem of dependency for single taxpayers. Although such taxpayers may equitably claim a larger dependency allowance than is granted to married couples, their claim does not extend beyond a relatively small per capita deduction. The head-of-household rate schedule is an unjustified erosion of the role of taxable income in allocating the burden of taxation.

6. *In Summary*

This section has delved rather deeply into the taxation of the family unit because the most significant use of secondary allocation mechanisms has occurred in that context. Although material differences in taxpaying capacity do exist among the several categories of taxpayers, the most accurate mechanism to compensate for these differences is the concept of taxable income. Congress's unnecessary use of such secondary mechanisms as the multiple rate structure has produced less equitable results than would an adjustment to taxable income. Moreover, abandoning the more precise and defensible mechanism of taxable income has reduced confidence in the fairness of the taxing system. Both the distributional equity of the taxing system and public confidence in that system would be improved for the present and preserved for the future if Congress abandoned the multiple rate structure in favor of a system of specific adjustments to taxable income.

92. This argument appears to underlie the original adoption of the head-of-household schedule. See note 52 *supra* and accompanying text.

B. *The De Facto Repeal of Personal Deductions*

The preceding section traced the ad hoc adoption of a multiple rate structure in an effort to improve the taxing system's horizontal equity. By contrast, the gradual emergence of the zero bracket and the attendant disallowance of deductions for most personal expenditures occurred for quite the opposite reason. The progressive elimination of the deductibility of these expenditures exemplified a conscious effort to subjugate distributional equity to competing objectives of tax policy. Thus the evolution of the zero bracket is both a cause of the declining role of taxable income and a reflection of that decline.

1. *Historical Evolution*

Congress first added a standard deduction to the Code in 1944⁹³ as part of a series of amendments designed to achieve the "simplification of the individual income tax."⁹⁴ This inaugural provision permitted taxpayers to elect a standard deduction of ten percent of adjusted gross income to a maximum of \$500 instead of several individually claimed deductions. Despite its relatively nominal impact, even this early provision partially tended to erode the equity of the income tax base. However, itemizing deductions involves certain costs and difficulties, and produces inaccuracies. An inequity is also created if individuals who are entitled to deductions are denied tax benefits because they failed to meet burdensome evidentiary requirements. If the standard deduction closely approximated the itemized deductions that most taxpayers would be entitled to claim, less distortion of tax burden would be introduced than would be eliminated. Thus, this simplification may have enhanced, rather than eroded, the overall equity of the income tax.

Twenty years after adopting the first standard deduction, Congress created the minimum standard deduction.⁹⁵ This minimum deduction, which could be claimed if it exceeded the standard deduction, was related to family size rather than to income, and bore little relationship to the actual deductions that might otherwise have been claimed. Indeed, the purpose of the minimum deduction was not to simplify, but rather to relieve "persons at or near the subsistence level of much or all of their tax liability."⁹⁶ It was estimated

93. Individual Income Tax Act of 1944, ch. 210, § 9, 58 Stat. 236.

94. H.R. REP. NO. 1365, 78th Cong., 2d Sess. 1 (1944).

95. Revenue Act of 1964, Pub. L. No. 88-272, § 112, 78 Stat. 19 (amending I.R.C. § 141).

96. H.R. REP. NO. 749, 88th Cong., 1st Sess. 24, reprinted in [1964] U.S. CODE CONG. & AD. NEWS 1313, 1333.

that this provision alone would eliminate 1.5 million individuals from the tax rolls.⁹⁷

The inequity resulting from the decision to extend tax relief through the standard deduction is evident. A taxpayer with an adjusted gross income of \$5000 could claim a standard deduction of \$500. If he were married and had three children, his minimum deduction would be \$700, even if his actual itemized deductions aggregated less than \$500. The five \$600 personal exemptions available in 1965 would reduce his taxable income to \$1300. If medical expenses increased his itemized deductions to \$700, his taxable income and his tax would remain unchanged. In fact, all taxpayers with the same number of dependents and with less than \$700 in itemized deductions were subject to the same tax liability even though their income after deductible expenditures, and thus their capacity to consume, varied widely. In effect, the minimum standard deduction denied taxpayers the right to itemize deductions below a specified floor. Somewhat oddly, that floor was based solely on family size.

Although the original standard deduction produced a similar result, there was a significant difference. The original standard deduction was designed to, and quite likely did, bear a reasonable relationship to the actual deductible expenditures of a broad class of taxpayers. The minimum deduction was not so designed. Accordingly, the degree of inequity produced by the minimum deduction was materially greater than the inequity produced by the standard deduction. More importantly, Congress produced that inequity by design.

The unfairness of the 1964 amendment is evident, but it is equally clear that the minimum deduction was not materially inequitable. The provision extended tax relief only to relatively low-income taxpayers — over fifty percent of the benefit accrued to taxpayers with adjusted gross incomes below \$3000⁹⁸ — and its impact was minimal. But the extension of tax relief through the standard deduction begun in 1964 paved the way for more substantial erosions, and the *de minimis* nature of the inequity did not long survive. Beginning with the Tax Reform Act of 1969, Congress progressively increased the minimum deduction.⁹⁹ Moreover, for years beginning with 1971, the same Act eliminated any remaining relationship between the minimum deduction and a taxpayer's actual

97. *Id.* at 24, [1964] U.S. CODE CONG. & AD. NEWS at 1333.

98. *Id.* at 24, [1964] U.S. CODE CONG. & AD. NEWS at 1333.

99. Pub. L. No. 91-172, § 802, 83 Stat. 487.

expenditures by converting the allowance to a flat amount. By 1976, this fixed allowance reached \$2100.¹⁰⁰ At the same time, Congress increased the standard deduction to sixteen percent of adjusted gross income, to a maximum of \$2800.

In part, of course, these progressive increases merely kept pace with inflation, but inflation was not Congress's primary concern. The increases were primarily designed to provide tax relief to low-income families.¹⁰¹ Each increase removed numerous taxpayers from the tax rolls and substantially reduced other taxpayers' tax liability. For taxpayers entirely exempted from tax, no inequity resulted because all such former taxpayers were treated equally. But many more taxpayers experienced a widening gap between their ideally computed taxable incomes and their taxable incomes computed with the increased allowances. Each increase obliterated more significant distinctions among taxpayers, and progressively reduced the equitable distribution of taxation.

Though Congress's primary concern may have been to provide tax relief for low-income families, in 1969 a second objective emerged. The preparation and audit of tax returns could be simplified by requiring more taxpayers to use the standardized allowance rather than to record their actual deductible expenditures.¹⁰² But the simplification sought by Congress in 1969 was significantly different from the new simplification sought by the introduction of the standard deduction in 1944. The original allowance was designed to eliminate unnecessary specificity in claiming deductions, and was not fashioned to alter the incidence of taxation. Indeed, the 1944 legislation may have enhanced distributional equity.¹⁰³ By contrast, the allowance provided in 1969 achieved simplification only by disregarding substantial distinctions among taxpayers, thus frustrating an equitable distribution of the burden of taxation.

These inflated standardized allowances prohibited many taxpayers from claiming itemized deductions, and imposed the income tax, not on taxable income, but rather on adjusted gross income — or,

100. Tax Reform Act of 1976, Pub. L. No. 94-455, § 401, 90 Stat. 1520.

101. The 1969 legislation, for example, was expressly designed to conform the level of income at which an income tax was first imposed to the nonfarm poverty level established by the Department of Health, Education, and Welfare. S. REP. NO. 91-552, 91st Cong., 1st Sess. 258, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2295. The merit of that objective is not questioned here; the means for achieving it, however, are.

102. S. REP. NO. 94-938, 94th Cong., 2d Sess. 118 (1976) ("The increase in the standard deduction represents a major simplification of the tax law because it will encourage taxpayers who file over 9 million tax returns to switch from itemizing their deductions to using the standard deduction.").

103. *See* text at notes 93-94 *supra*.

more precisely, on eighty-four percent of adjusted gross income. The extent of this shift in the tax base over the past decade is surprising. The 1969 legislation sought to permit an *additional* 11.8 million taxpayers to claim the standardized allowance.¹⁰⁴ After the 1977 increase, only twenty-five percent of all taxpayers were expected to itemize their deductions.¹⁰⁵

This erosion of the role of taxable income culminated in 1977 with the adoption of the zero bracket amount. The zero bracket concept fixes the allowance for all taxpayers, varying only with filing status. For example, all married couples filing joint returns now have an allowance of \$3400. This revision eliminated the last vestiges of any relationship between the standardized allowance and the actual level of deductions. Recognizing what had occurred, Congress repealed the standard deduction and expressly prohibited claiming itemized deductions unless they exceed the zero bracket amount.¹⁰⁶ To avoid a simultaneous change in tax incidence, Congress adjusted the rate structure so that no tax is imposed upon income below \$3400 on a joint return. However, there is no necessary relationship between this nondeductible amount and the size of the zero bracket. Should Congress desire to bar itemized deductions to an even greater proportion of the population it may increase the nondeductible amount. That change, of course, would increase the taxable incomes of all married taxpayers filing joint returns with itemized deductions in excess of \$3400. But there is no necessary reason why Congress must offset that increase in tax by a corresponding increase in the size of the zero bracket.

2. Critique of the Zero Bracket Amount

Like the multiple rate structure, the zero bracket amount concept erodes the role of taxable income in the allocation of the burden of taxation. Since the multiple rate structure exists only to distribute tax liability fairly among classes of taxpayers, the superiority of the taxable income mechanism depends upon the feasibility of making a more accurate discrimination among those classes of taxpayers than is possible under the multiple rate structure. With respect to the zero bracket amount, however, no such factual doubts are present. The

104. S. REP. NO. 91-552, *supra* note 101, at 259, [1969] U.S. CODE CONG. & AD. NEWS at 2296.

105. S. REP. NO. 95-66, 95th Cong., 1st Sess., 50, *reprinted in* [1977] U.S. CONG. & AD. NEWS 185, 230.

106. Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 102, 91 Stat. 126 (adding I.R.C. § 63(b)-(c)).

area of dispute involves the more fundamental question of the extent to which taxable income should be used in the allocation of tax liability. Although the use of the zero bracket amount concept in lieu of taxable income may be defended on three grounds, none is compelling.

a. *Tax reduction.* Granting tax relief to low-income taxpayers was one of Congress's principal objectives in both increasing the amount of the standardized allowance and in adopting the zero bracket amount. But there are more equitable ways to attain that result.¹⁰⁷ The zero bracket approach grants the greatest tax reduction to taxpayers for whom the standard allowance exceeds their actual deductible expenditures by the greatest amount. At each level of adjusted gross income, the greatest tax relief is extended to taxpayers with the fewest actual expenses, while those with the largest expenses and the smallest income receive the least relief. Thus, within the class of benefitted taxpayers — those having actual deductions aggregating less than the zero bracket amount — the distribution of the tax relief is precisely contrary to the legislation's stated objective. Moreover, the standardized allowance provides no benefit at all to taxpayers whose actual expenditures exceed the allowance — even though their taxable incomes may be far smaller than the incomes of those benefitted by the provision.

In short, the zero bracket approach, while extending tax relief to some low-income taxpayers, extends that relief in an irrational pattern and is thus an unsuitable vehicle for accomplishing tax relief. The standardized allowance not only reduces the distributional equity of the taxing system, but it is also a technically inferior method of achieving its intended purpose. Since Congress has available to it a wide variety of other methods for granting tax relief (*i.e.*, revisions of the rate structure or income sensitive deductions or credits), the use of the zero bracket amount to reach that result cannot be defended.

b. *Simplification.* Congress originally adopted the standard deduction to simplify the preparation of income tax returns. Although other objectives have dominated recent legislation, the desire to simplify remains strong and undoubtedly has contributed to the expan-

107. Indeed, the possibilities are almost limitless: a reduction of the rates in the lower brackets, an increase in the personal exemptions, an additional deduction or credit related to income or family size or both. For example, Tax Reduction Act of 1975, Pub. L. No. 94-12, § 203(a), 89 Stat. 26 (adding I.R.C. § 42), introduced a short-lived credit equal to the greater of \$35 per dependent or 2% of taxable income up to \$9000.

sion of the standardized allowance. But the zero bracket amount cannot be justified merely because it simplifies — no matter how worthy that objective. If simplification suffices to justify the elimination of any tax allowance, the income tax should be replaced with the simplest tax — a tax on gross receipts. Simplification, however, is not our sole objective.

Since the primary role of a taxing system is to achieve distributional equity, the benefits of simplification must be weighed against the resulting loss in fairness. In this respect, it is important to distinguish between simplification achieved by removing an essentially technical requirement¹⁰⁸ and simplification that alters the ultimate allocation of the burden of taxation. The former does not alter the equitable impact of the taxing system, but the latter plainly does. Through a series of barely perceptible steps, the original allowance has acquired a substantive impact that has not been adequately considered.

On the one hand, the zero bracket amount has not significantly simplified the preparation of tax returns. The amount of most itemized deductions — including interest,¹⁰⁹ state taxes,¹¹⁰ and casualty losses — is easily obtained and readily verifiable. The medical expense deduction is likely the most difficult to compute, but the three percent floor on the medical expense deduction eliminates that deduction for taxpayers with only routine medical or dental costs.¹¹¹ The standard allowance does eliminate the need to verify relatively small but numerous charitable contributions. Yet, somewhat ironically, there has been substantial pressure in Congress recently to remove charitable deductions from the category of deductions replaced by the standard allowance, and to permit the full deductibility of such expenditures.¹¹² The additional categories of itemized

108. An example would be eliminating the need to adopt a plan containing precise language as a prerequisite to the issuance of a § 1244 stock, accomplished by the Revenue Act of 1978, Pub. L. No. 95-600, § 345, 92 Stat. 2763.

109. In this computerized era, all banks and national consumer credit card companies routinely provide this information at year-end.

110. Actual state sales taxes paid are not so easily compiled, but the Internal Revenue Service provides a formula for computing an acceptable minimum sales tax deduction.

111. I.R.C. § 5213(a)(1).

112. S. 170, 97th Cong., 1st Sess., 127 Cong. Rec. S334 (daily ed. Jan 20, 1981). In the preceding year, an identical Senate bill obtained 42 cosponsors. *Id.* at S343 (statement of Sen. Moynihan). Indeed, a step in that direction was taken in the 1981 legislation. After 1981, taxpayers not itemizing their deductions will nevertheless be permitted a charitable contributions deduction. However, under an absurdly complex phase-in provision, the deduction allowed cannot exceed \$75 until 1984. The provision is scheduled to expire after 1986. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 121, 95 Stat. —.

deductions, such as certain employee business expenses¹¹³ and investment-related expenses,¹¹⁴ are generally available only to relatively sophisticated taxpayers.

Moreover, continual record-keeping requirements undercut potential simplification benefits. Not all taxpayers can predict at the beginning of the taxable year whether their total expenditures for which itemized deductions may be claimed will exceed the zero bracket amount at the end of the year. If individuals wish to minimize their tax liabilities, they must retain records of their expenditures and perhaps make a trial computation before they can determine whether they are eligible to itemize their deductions. Clearly, the zero bracket amount does not accomplish a simplification for these taxpayers.

This rather modest simplification must be balanced against substantial inequity. The level of the zero bracket amount was designed to prevent three quarters of the taxpaying population from itemizing deductions. For those taxpayers, the tax laws ignore distinctions in taxpaying capacity based upon personal misfortune and widely varying levels of state and local taxation, and represents a substantial retreat from the equitable fine tuning of the taxing system that inspired those allowances.

It is particularly significant that the zero bracket amount concept primarily affects the low-income taxpayers. The net effect of the allowance is to authorize only relatively wealthy taxpayers to itemize deductions. If the nondeductible zero bracket amount remains no greater than the rate schedule zero bracket, the Code's vertical equity is unimpaired by so limiting itemized deductions; only horizontal equity is affected. Nevertheless, low-income taxpayers are as entitled as wealthy taxpayers to be distinguished from their peers. Granting that privilege only to the rich must breed disrespect for the fairness of the taxing system.

Identifying the proper balance between simplification and equity in tax legislation is a highly subjective matter. Although others may dispute this conclusion, it appears that the present zero bracket

113. Expenses deductible under I.R.C. § 162 but not allowable under I.R.C. § 62 in computing adjusted gross income such as union dues.

114. I.R.C. § 212. In any event, the continued classification of such expenses as personal or itemized deductions is improper. In its reconstruction of expanded income for comparative purposes, the Treasury uses adjusted gross income (expanded by the amount of tax preferences) less investment related expenses. *See* INTERNAL REVENUE SERVICE, U.S. DEPT. OF THE TREASURY, STATISTICS OF INCOME — 1976, INDIVIDUAL INCOME TAX RETURNS 198 (1979). Accordingly, it is particularly improper to disallow deductions for such expenses through the zero bracket amount device.

amount creates a greater loss of distributional equity than is offset by the gains of simplification.¹¹⁵ An allowance tailored to the actual level of itemized deductions claimed by a substantial number of taxpayers at different levels of income would be a justifiable compromise with a rigorous definition of taxable income, but the present allowance is not.

c. *Superiority of adjusted gross income.* One suspects that Congress would not have imposed the distributional inequity inherent in an inflated standardized allowance unless it believed that adjusted gross income measures taxpaying capacity as well as does taxable income, or that most itemized deductions were inappropriate. There is a substantial basis for dissenting from that view.¹¹⁶ And even accepting the superiority of adjusted gross income does not justify a dual tax base. If adjusted gross income is preferable for some taxpayers, it must be preferable for all.

The gradual adoption of an inflated standardized allowance represents a shift from full deductibility of specified personal expenditures to the deductibility of only extraordinary expenditures. So limiting the deductibility of certain itemized deductions, such as investment-related expenditures, is clearly inappropriate. But even if the objective were reasonable, the zero bracket amount fails to approximate extraordinary expenditures. The zero bracket amount defines "extraordinary" in absolute terms. Accordingly, for some taxpayers, personal expenditures must consume the bulk of their adjusted gross income to be deductible. For other taxpayers, those expenditures become deductible even though they represent only a minor fraction of adjusted gross income.

Furthermore, the arbitrariness of the zero bracket amount concept may produce, like the multiple rate structure, complex and irrational offspring. The zero bracket amount concept conflicts with Congress's desire to grant specific deductions to achieve distributional equity or nontax objectives. To prevent the dilution of the desired tax benefit, Congress has in the past reclassified itemized deductions as deductions from gross income.¹¹⁷ There is presently

115. Those who question the propriety of the allowance of most personal deductions will, of course, discount the loss of distributional equity. The Musgraves, for example, suggest that the standard allowance improves the horizontal equity of the Code by muting the inequities of the personal deductions. They acknowledge, however, that the better approach would be to eliminate the deductions they find objectionable. R. MUSGRAVE & P. MUSGRAVE, *supra* note 1, at 245. This defense of the zero bracket amount is addressed in the next section.

116. See notes 22-29 *supra* and accompanying text.

117. The deduction permitted by I.R.C. § 215 for alimony paid was so altered by the Tax

pending a bill that would similarly recast the charitable contributions deduction.¹¹⁸ Expenses deductible under section 212 also might be favored.¹¹⁹ The taxing system will become increasingly irrational as Congress makes more such adjustments. Surely a return to a viable definition of taxable income would be preferable to such nonproductive tinkering.

C. *Limitations on Tax Preferences*

Although the zero bracket amount concept primarily affects lower-income taxpayers, limitations on tax preferences primarily affect wealthy taxpayers. Since the Tax Reform Act of 1969, Congress has repeatedly addressed the tax reduction produced by conscious tax shelters and by excessive use of the Code's economic incentives. The enacted results of this extended consideration flagrantly disregard the taxable income mechanism. In the decade beginning in 1969, at least one house of Congress passed no fewer than six proposals for reducing the abuse of tax incentive provisions. Three of those proposals were related to the computation of taxable income, and three eroded the taxable income mechanism. Each proposal that was compatible with the taxable income concept was passed by the House but rejected by the Senate; each erosive proposal was enacted.

Circumventing taxable income to attack tax preferences is remarkable since the very evil addressed is the excessive distortion of taxable income. Tax incentive provisions exist to create inequities. Congress seeks to stimulate targeted activities by increasing their after-tax profitability. If the incentive is successful, a taxpayer responding to the incentive will pay less tax than similarly situated taxpayers who do not respond to the incentive. There are, however, limitations on the tax reduction that Congress will accept as the cost of its economic interventionism. To some extent, the benefits of tax incentives may have been claimed by taxpayers who only pretended to engage in the desired activity. For example, Manhattan doctors drilling dry holes in Oklahoma do not relieve the oil shortage. Perhaps more importantly, some taxpayers used a variety of tax incentives to reduce their taxable incomes to levels too far below their ideal taxable incomes — calculated in the absence of the incentive provisions — to be tolerated. The need to design limitations that

Reform Act of 1976, Pub. L. No. 94-455, § 502j(a), 90 Stat. 1520. Similarly, the child care allowance was converted from an itemized deduction to a credit. See note 83 *supra*.

118. See note 112 *supra*.

119. See note 114 *supra*.

would not destroy the incentives that Congress wished to extend complicated the attack on the perceived abuses. Nevertheless, the general form that such limitations must take would seem obvious. Because the vice is the excessive depression of taxable income, the remedy should be its limited restoration.

1. *The Enacted Provisions*

In 1969, Congress adopted a tax on items of tax preference.¹²⁰ As it was subsequently amended, this preference tax consisted of a flat fifteen percent excise-type on the sum of a specified list of preferences reduced by one half of the taxpayer's regular federal income tax. The Senate's stated purpose in proposing the preference tax was to ensure that all individuals with high ideal taxable incomes paid at least some income tax. Whether that tax bore any defensible relationship to either the amount of ideal income or the relative amount of the preferences claimed evidently was not important. It is thus not surprising that the distributional consequences of the preference tax, as modified over the years, have been both regressive and arguably irrational.¹²¹ These unsatisfactory consequences stem primarily from the decision to impose a penalty under a separate flat rate schedule, thereby distributing the penalty in a pattern inconsistent with the general distribution of the tax burden.

The regressive character of the preference tax was most pronounced before 1978, when the tax applied to the exclusion from tax of fifty percent of capital gains. Assuming that the preference tax was otherwise payable because additional preferences had exhausted the exemption, the effective preference tax rate on additional capital gains income for a taxpayer in the seventy percent bracket was just under five percent. However, for a taxpayer in the twenty percent bracket, the effective rate was almost seven percent. In absolute amounts, the lower-bracket taxpayer paid a greater penalty than the upper-bracket taxpayer. The inequity is even more dramatically illustrated by the amount of these penalties relative to the regular tax paid. For the taxpayer in the seventy percent bracket, the preference tax penalty amounted to fourteen percent of the effective regular tax rate on capital gains of thirty-five percent. But for the taxpayer in the twenty percent bracket, the penalty amounted to nearly seventy

120. I.R.C. §§ 56-58.

121. A detailed critique of the preference tax and of the alternative minimum tax, in which a demonstration is undertaken that a modification of the definition of taxable income would have been preferable to either, appears in Coven, *The Alternative Minimum Tax: Proving Again That Two Wrongs Do Not Make a Right*, 68 CALIF. L. REV. 1093 (1980).

percent of his regular tax rate on capital gains of ten percent. As a deterrent to converting ordinary income into capital gains, the preference tax was effective only for relatively low-bracket taxpayers.

Particularly with respect to capital gains but also generally, the preference tax impaired the vertical equity of the rate structure.¹²² However, because the tax caused those subject to its penalty to pay an amount of tax more nearly resembling the tax that they would pay under an ideal income tax, the preference tax might appear to have promoted horizontal equity. Vertical and horizontal equity, however, are related concepts. The preference tax may move both seventy percent-bracket taxpayer *A* and twenty percent-bracket taxpayer *B* closer to their ideal tax burden. If the correction applied to *B* is greater than the correction applied to *A*, vertical equity is distorted. But *A* and *B* may also be compared with seventy percent-bracket taxpayer *C* and twenty percent-bracket taxpayer *D*, neither of whom claimed any tax preferences.

In light of the relationship between *A* and *C* after the application of the preference tax, *B* is overtaxed relative to *D*. Conversely, given the relationship established between *B* and *D*, *A* is undertaxed relative to *C*. Before the preference tax was imposed, *A* and *B* stood in a position relative to *C* and *D* that was explainable, and perhaps justifiable, in terms of the response by *A* and *B* to the tax incentive that Congress deliberately granted. But the preference tax arbitrarily distorted the relationship between taxpayers claiming preferences and those not claiming preferences. That result is incompatible with the notion of horizontal equity.

Since 1978 the preference tax has only applied to preferences resulting from the deferral of tax by accelerated methods of depreciation. The effect of the preference tax upon such deferments is highly complex. Indeed, one substantial objection to the preference tax is that it requires sophisticated financial analysis to determine whether accelerated depreciation remains beneficial in light of the penalty imposed.¹²³

The preference tax is also objectionable because it bears more heavily upon the less preferential accelerations than it does upon the longer, or more preferential, accelerations. Accelerated depreciation reduces the taxpayer-investor's real after-tax investment by the proportion of his nominal investment equal to his tax bracket. For example, for a taxpayer in the sixty percent bracket, a deductible

122. See *id.* at 1096-97 n.18.

123. See Brogdon & Fisher, *Accelerated Depreciation v. the Minimum Tax*, 56 TAXES 530, 530 (1978).

expenditure of \$100 has a net after-tax cost of only forty dollars since the deduction creates tax savings of sixty dollars. By producing a higher real rate of return, this reduction in net investment presumably encourages investment. To the investor, the accelerated deduction has an actual value of the after-tax return derived on the tax savings between the point in time that he took the accelerated deduction and the time when the deduction would have been proper under an ideal income tax. That is, the benefits of the deferral of tax persist while the deduction remains accelerated. The amount of the preference tax, however, is determined by the size of the reduction in taxable income produced by the acceleration and, to a lesser extent, by the investor's tax bracket.¹²⁴ Thus, one of the major determinants of the value of the preference, the deferral period, is not taken into account in establishing the preference penalty. As a result, shorter accelerations are taxed more heavily.

In 1978, Congress removed capital gains and itemized deductions from the preference tax, and subjected them to a new form of penalty — the alternative minimum tax.¹²⁵ The alternative tax represents the most extreme movement to date from the use of taxable income as the primary distributional mechanism in the taxing system. The tax is truly an alternative since it is computed on a different tax base and uses a different rate schedule. In general, the alternative tax base comprises three components: (a) gross income less all deductions, which resembles taxable income computed without regard to the nondeductibility of the zero bracket amount, except that the subtraction may produce a negative amount; (b) the excluded portion of capital gains; and (c) the amount by which the sum of most itemized deductions exceeds sixty percent of adjusted gross income less the limited itemized deductions.¹²⁶ The alternative tax was designed to exempt capital gains from any penalty unless the taxpayer reduced his regularly computed taxable income below an amount equal to the taxable portion of the capital gain.¹²⁷ This pe-

124. *Id.*

125. I.R.C. § 55.

126. This "preference" nicely illustrates congressional ambivalence toward taxable income in general and the itemized deductions in particular. For the minority of taxpayers entitled to claim such deductions, a penalty is imposed if too great a deduction is claimed. While many itemized deductions, like many other deductions, contain a preferential component and the claiming of substantial amounts of such deductions may correlate with tax sheltering activities, the arbitrariness of this preference item is intolerably great.

127. Coven, *supra* note 121, at 1102-03. Congress sought to preserve this relationship in the wake of the 1981 tax rate revisions. Beginning in 1982, the maximum tax rate is to be reduced from 70% to 50%. With the preservation of the exemption of 60% of capital gains from tax, the effective maximum rate of tax applicable to such gains is to be reduced from 28%

nalized taxpayers for offsetting capital gains income with ordinary losses — an entirely reasonable objective and one that quite easily could have been reached within the existing framework of the taxing system.

The alternative tax, however, is irrational and inequitable. These problems have been sufficiently detailed elsewhere,¹²⁸ and need only be summarized here. The tax reaches a quite simple result through an absurdly complex mechanism. It absolutely bars itemized deductions, regardless of the presence of capital gains, if those deductions reduce taxable income below approximately ten percent of adjusted gross income. As a side effect, the alternative tax penalizes the claiming of some credits and bars the claiming of others.

But the penalties imposed by the alternative tax bear no rational relationship to its primary objective, which is to penalize taxpayers who offset the taxable portion of a capital gain with ordinary deductions in excess of ordinary income. If that offsetting occurs, and the alternative tax becomes payable, the penalty imposed is the reduction of the tax benefit attributable to claiming further deductions. The amount of that penalty is a function of the difference between the taxpayer's regular marginal rate and the lower alternative tax rate, which normally is the maximum twenty-five percent rate. Thus high-bracket taxpayers are subject to a disproportionately greater penalty than are low-bracket taxpayers. The amount of the penalty is unaffected by either the amount or proportion of taxable capital gains offset by ordinary deductions. As a result, taxpayers in high brackets are penalized relatively more severely than are taxpayers in low brackets even if the absolute amount of capital gains sheltered from tax by a high-bracket taxpayer is smaller than the amount sheltered by a low-bracket taxpayer, and thus represents a far smaller proportion of his entire capital gain.

2. *Solutions Compatible with Taxable Income*

Although the alternative tax and the preference tax produce very different patterns of taxation, the unsatisfactory results obtained under both penalties are directly attributable to attacking abuses of the tax incentive provisions outside of the existing taxing system. Under both taxes, a tax rate that is unrelated to the taxpayer's regular rate is imposed on a separately defined tax base. As a result, the penalty is not rationally related to either the tax benefit derived from

to 20%. Accordingly, the maximum alternative tax is to be reduced from 25% to 20%. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(a), (d)(1), 95 Stat. —.

128. Coven, *supra* note 121, *passim*.

the perceived abuse or the magnitude of the abuse. The adoption of the alternative tax is particularly difficult to understand since Congress could have imposed a quite similar penalty within the existing framework with greater simplicity and rationality. The tax benefit attributable to deductions applied against capital gains could have been reduced in a number of ways that would, in effect, require such deductions to be offset against capital gains income before claiming the capital gains exclusion. Since only forty percent of the capital gain would be subject to tax, this approach would eliminate the tax benefit of sixty percent of the deductions so used at any level of income. In the reverse situation under present law — offsetting capital losses against ordinary income — an analogous penalty is imposed that requires two dollars of a capital loss to offset one dollar of ordinary income.¹²⁹

Two of the proposals that Congress ultimately rejected demonstrate the feasibility of limiting preferences consistently with the taxable income mechanism. In the first serious legislative attempt to address the excessive claiming of tax preferences, the House of Representatives attempted to fashion an appropriate response to the inequities caused by the undue depression of income.¹³⁰ This proposal limited the aggregate benefits of a specified list of preferential deductions and exclusions to fifty percent of a taxpayer's income before reduction by those preferences.¹³¹ The Senate Finance Committee rejected this proposal in the belief that preferences would impose unequal penalties on taxpayers claiming the same amount of preferences because their other income would place them in different tax brackets.¹³²

That objection, of course, was frivolous. Any disallowance of a deduction or an exclusion, such as interest expenses incurred to carry tax-exempt bonds¹³³ or the capital loss limitations,¹³⁴ has that effect. The loss of a tax benefit to a high-bracket taxpayer invariably costs more than the loss of the same benefit to a low-bracket taxpayer because the high-bracket taxpayer derives a greater tax benefit from the allowance. But when the expenditure does not constitute a proper reduction of the tax base, it is appropriately disallowed re-

129. I.R.C. §§ 1211(b)(1)(C)(ii), 1212(b)(2)(B).

130. H.R. REP. NO. 91-413, 91st Cong., 1st Sess., *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 1655.

131. H.R. 13270, § 301(a)(1), 91st Cong., 1st Sess. (1969).

132. S. REP. NO. 91-552, *supra* note 101, at 113, [1969] U.S. CODE CONG. & AD. NEWS at 2143.

133. I.R.C. § 254(2).

134. I.R.C. § 1211.

gardless of that after-tax impact. Indeed, if the after-tax consequences of the disallowance or other penalty did not vary with the taxpayer's marginal rate, the provision would be inequitable. Some taxpayers would lose the entire tax benefit of the expenditure subject to the disallowance provision, but others would lose only a portion of that benefit.

In 1971, the Senate again rejected a House limitation on preferences that was consistent with taxable income. In its proposed "limitation on artificial losses"¹³⁵ (LAL), the House adopted a schedular approach to limiting preferences, in contrast with the generalized approach of the earlier bill. Under the LAL, deductions attributable to specified preferences could only offset income produced in the activity in which the incentive was claimed; these deductions could not be used to reduce taxable income from unrelated sources. On balance, the more focused attack of the LAL may have generated too many undesirable side-effects;¹³⁶ the earlier proposal was safer. Both proposals, however, demonstrated that it is feasible to limit preferences within the mechanism of taxable income consistently with the notions of distributional equity that inhere in that concept.

Congress's effort to restrict tax preferences¹³⁷ thus provides a third illustration of the material erosion of the role of taxable income in the allocation of tax liability. Like the adoption of the multiple rate structure and the multiple tax base created by the zero bracket amount, the use of secondary mechanisms to accomplish Congress's general objective was unnecessary. A more equitable and efficient result could have been obtained through direct modifications of the definition of taxable income.

The use of secondary mechanisms that actually constitute independent systems of taxation, such as the preference and alternative

135. H.R. 10612, § 101(a), 94th Cong., 1st Sess. (1975).

136. The schedular approach, for example, might have favored established, diversified taxpayers and prejudiced legitimate but new or single-purpose businesses as well as tax shelter operations.

137. The third enacted provision was the so-called maximum tax contained in I.R.C. § 1348. The general effect of this provision was to exempt earned income from progressive tax brackets in excess of 50%. The purpose of this rate relief was to reduce the incentive for highly compensated taxpayers to claim the benefits of tax incentive provisions. H.R. Rep. No. 91-413, *supra* note 130, at 208, [1969] U.S. CODE CONG. & AD. NEWS at 1725. To the extent that the maximum tax imposes a different rate of tax upon a class of income, it is as erosive of the role of taxable income and as objectionable as the provisions discussed in the text. Indeed, the congressional resort to the use of a tax preference to discourage the use of other tax preferences is the epitome of irrational tax legislation. When the maximum generally applicable rate of tax was reduced from 70% to 50%, there was no inclination on the part of Congress to perpetuate the preference for earned income. Accordingly, I.R.C. § 1348 was repealed. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(c), 95 Stat. —.

taxes, unnecessarily complicates the tax laws. Currently each of these secondary levies is relatively simple in comparison with the regular income tax. The absence of discrimination that produces such simplicity is acceptable because of the relatively low rate at which these taxes are imposed — a maximum of twenty-five percent. But if Congress increases the rate of either tax, it may become necessary, given the realities of the legislative process, to adjust the equitable or incentive-retarding impact of the more burdensome tax through a series of detailed inclusions and exclusions. Indeed, it is conceivable that the alternative tax will rival the existing Code in length and complexity.

CONCLUSION

Over the last decade, Congress has substantially eroded the role of taxable income in the distribution of the burden of taxation, and has increasingly relied upon the less refined concept of adjusted gross income, or upon a reconstructed measure of taxable income. When recourse is made to adjusted gross income, the tax laws “merely” become less fair. It is difficult to know the extent to which this unfairness is perceived by the general taxpaying population, or the extent to which the unfairness — if perceived — is resented. Taxpayers without significant actual itemized deductions undoubtedly appreciate the simplification that the zero bracket amount approach produces. My suspicion, however, is that taxpayers with material expenditures — otherwise deductible — for which they cannot obtain a tax benefit will perceive the law as essentially unfair and resent that unfairness. The extent to which this resentment results in tax evasion is unknown and might profitably be explored, but is essentially beside the point. Taxpayers are entitled to a system of taxation that has not been simplified to the point of essential unfairness.

When Congress has moved outside of the existing tax structure and invented new forms of taxation, the results uniformly have been unsatisfactory. The multiple rate structure, for example, created distinctions that cannot be rationally justified. Worse still is the sorry history of Congress’s inability to legislate rationally about tax preferences. Unwilling to address the exploitation of tax incentives directly, Congress created a second, and then a third, level of taxation to undertake that task. This complex approach would be questionable if it performed perfectly. But the alternative tax, and to a lesser extent the preference tax, perform horribly, and may create greater inequities than they eliminate.

Moreover, the use of secondary mechanisms has unnecessarily

complicated a statute not noted for its simplicity. Continued congressional ambivalence toward the concept of taxable income unavoidably will generate greater complexity in the future. The complexity of the existing Code derives not so much from its elaborate detail as from its fragmentation and irrationality. Because of the complexity of taxable transactions, any equitable system of income taxation will be complex. But if the complexity represents detail imposed upon a rational substructure, it can be managed — at least by those capable of managing the underlying business transactions that are taxed. However, as the law begins to treat similar transactions dissimilarly, comprehending its provisions and predicting its consequences become more difficult.

Unquestionably, taxable income as it has evolved in the United States is not the only mechanism that can equitably allocate the tax burden. But the ad hoc modifications that have occurred over the past decade are not calculated rationally to improve the existing structure. The tax base now consists of adjusted gross income for seventy-five percent of the taxpaying population. Meanwhile, wealthy taxpayers continue to benefit from itemized deductions. However, taxpayers that avail themselves too heavily of the overly generous exclusion of capital gains income are denied a fraction of the benefit from their deductions. Then again, only the very poor may claim deductions in excess of roughly ninety percent of their adjusted gross income. And all of these variously computed tax bases are subject to one of three different rate schedules, and may become subject to a fourth — the alternative minimum tax — should the taxpayer claim too many allowances.

One is left with the impression that the system lacks a harmonizing theme. The suggestion here, of course, is that such a theme exists in the traditional concept of taxable income. Until careful consideration produces a comprehensive alternative, the overall equity of our tax laws will be greatly enhanced if amendments restore the integrity of that concept rather than assume its irrelevance. On the other hand, if the trend of the post-1968 legislation continues, the capacity of the taxable income mechanism to allocate the tax burden equitably surely will be destroyed. Lacking an alternative mechanism, the taxing system can only become increasingly arbitrary and, in turn, increasingly unacceptable to the taxpaying population.