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REFLECTION ON TAX REFORM
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PROLOGUE

There is no assignment that could give me greater pleasure than to contribute a paper as a memorial to John Chommie. Those of us who have labored in the academic vineyard attempting to communicate sense and rationality about federal taxation share a common bond which is somewhat different from that which exists among law teachers in other subject areas. Doctrines in contracts, torts, property, and procedure evolve more slowly and with greater coherence and logic. In such fields as business associations, partnerships, commercial code, security regulation and labor law, legislative and administrative rules continue to change, but with a consistency of purpose that adheres more nearly to traditional concepts of development of legal doctrine. No wonder that our colleagues on the faculty twit us that taxation is not really "law", but a mishmash of economic and political expediency, the results of pressure and counterpressure of various lobbying groups. Once the student has explored a few basic doctrines regarding what is income, whose income is it, and when is it income, the rest is a complex latticework of legislation amended again and again in almost every congressional session, the judicial interpretations of which, as Mr. Justice Frankfurter once said, become recondite niceties of distinction that do not remain in the mind long enough even to state them.

John Chommie was one of those who sought to clarify, explain, classify, and bring about a semblance of order in this chaotic area. His treatise on federal taxation has long been an excellent reference work, with a text and selection of key cases placed in an arrangement that permits one to move relatively easily from statute to regulation to judicial interpretation. John spent his time well, explaining the law as it is; we often discussed, as professors of taxation are wont to do, what

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tax law *ought* to be. It is with respect to the *ought* in complement to John's *is* that I present this paper as a memorial to him.

I. SUBSTANTIVE TAX REFORM—THE BEGINNING OF A PROJECT

In 1962 the Section of Taxation of the American Bar Association created a Special Committee on Substantive Tax Reform to engage in an extensive study of the subject of fundamental, long-range tax reform. This was the first time that a professional association, comprised principally of practicing tax lawyers, had undertaken to make a serious and critical evaluation of what the taxing system should be. Members long experienced in the field sought to examine both from a philosophical and from a practical, or operational, standpoint what would be the best system for an exceedingly complex economy involving two hundred million people, given the premise that a thorough overhaul and new beginning was necessary. Even among such a distinguished group of practitioners the pursuit of the project was not without difficulty. Pressures on the Committee, on the Section, and on the Association itself made demonstrably clear how sensitive such an undertaking could be among those with the best of wills to do the job.

In 1964, after two years of work, the Committee filed a lengthy report[1] in which it set out certain basic objectives of major substantive tax reform and various areas of inquiry which would have to be examined in depth before such major reform could be accomplished. The Committee then went on to state that it was not feasible for members of the bar, contributing their time on a voluntary basis, to do the extensive statistical compilations and critical analyses that should be done. Moreover, the Committee recommended that a broadgauged study would require the professional and technical skills of other disciplines, particularly those of economics, accounting and public finance.

The Committee's recommendation was adopted by the Section and the American Bar Association and resulted in an application for a grant to the American Bar Foundation, and its subsequent approval of a pilot study project, in which Southern Methodist University joined as co-sponsor. The design of the project was to assemble economists, lawyers and computer programmers to make a limited series of tests showing the effect on the income tax base of various assumptions concerning base broadening.[2]

II. THE COMMISSION TO REVISE THE TAX STRUCTURE

The pilot study, co-sponsored by the American Bar Foundation and Southern Methodist University, demonstrated convincingly the

1. ABA, Section of Taxation, REPORT OF THE COMMITTEE ON SUBSTANTIVE TAX REFORM, ANNUAL REPORT (1964).

2. American Bar Foundation and Southern Methodist University, STUDIES IN SUBSTANTIVE TAX REFORM (1969).

need for an ongoing study which would be an extension of and an elaboration on the work already done. The results were sufficiently impressive to obtain the support of the Fund for Public Research of Washington, D.C. An advisory panel was organized, known as the Commission to Revise the Tax Structure. It consisted of Arthur B. Willis, a Los Angeles tax attorney; Harvey Brazer, Professor of Economics, University of Michigan; Donald Burns, Certified Public Accountant of Los Angeles; John Mendenhall, Certified Public Accountant of Washington, D. C.; and this writer. Professors David J. and Attiat F. Ott, a husband-wife team of economists at Clark University, Worcester, Massachusetts, were the Chief Investigators. In addition, representatives of the Joint Committee on Internal Revenue Taxation, the Treasury, the academic community, and other research organizations were often in attendance at Commission meetings or were consulted on special matters.

As in the case of the pilot study, certain basic objectives of substantive tax reform were accepted as premises upon which the work would proceed; namely: that the income tax system would continue to provide the largest percentage of total revenue required for the federal fisc; that the tax base should be substantially broadened; that income tax rates should be reduced and the sharp progessivity of the rate structure leveled out as much as practicable; that the technical provisions of the law should be simplified; that vertical and horizontal equity should be achieved as completely as possible; and that taxation should be removed as a major factor in decision-making in exercising choices in business, investment, and resource allocation.

The Commission's Report, Reforming the Federal Tax Structure, was published in 1973.[3] The Report is in three parts: Part I—the primary effect on the income tax base of adopting certain base broadening assumptions; Part II—the secondary effect such proposals would have on national output, prices, and employment over a five-year period; and Part III—the effect of the Commission proposal on the reallocation of capital in three sectors of the economy: corporate, agriculture, and housing. I will deal mainly with Part I of the Report.

III. THE COMMISSION'S REPORT—BASE BROADENING PROPOSALS

As in the case of the pilot study, the Commission's Report presented the extension of the tax base to the maximum extent feasible within the resources and time available. That is, a number of sources of statistical information were employed for personal and corporate income; others were developed by methods described in the Report. There are other raw data, however, which are not available but which will have to be developed in later studies. Generally, the Commission

3. Fund for Public Policy Research, REFORMING THE FEDERAL TAX STRUCTURE (1973).

sought to apply to the income tax base the so-called Haig-Simons definition of income; i.e., income is the sum of (1) expenditures for consumption during the taxable year, plus or minus, (2) the money value of the change during the year of the taxpayer's net worth. From the theoretical "outer limits" of income, one can retreat to various levels of income definition.

The Commission's approach to the "outer limits" may be grouped under six major proposed changes to the present base:

1. Broaden the individual income tax base.
2. Eliminate the corporate income tax and include the income presently being taxed to corporations in the individual income tax base.
3. Eliminate estate and gift taxes and include the value of property received by gift or bequest in the individual income tax base of the recipient.
4. Establish the family as the taxable unit.
5. Allow a minimum credit to each family unit.
6. Lower the tax rates applicable to all taxable income levels.

The Commission's Report further describes the nature of the foregoing changes as follows:

"Broaden the Individual Income Tax Base

The following would accomplish a broadening of the individual income tax base:

1. Include the following cash and cash equivalent items of income presently excluded:
   —interest on state and local securities
   —social security, unemployment compensation, and veterans benefits in excess of cost
   —scholarships and fellowships
   —health, disability and accident benefits in excess of cost
   —death benefits paid on life insurance policies in excess of cost.
2. Include the value of the following employee fringe benefits presently excluded:
   —employer contributions on behalf of employees for OASDHI, group life insurance, hospital, surgical, medical and disability insurance, and retirement benefits
   —the annual earnings of employee pension, profit sharing and other retirement plans
   —other fringe benefits such as merchandise discounts, free meals and lodging, recreational activities.
3. Eliminate certain of the nonbusiness deductions and deductions for exemptions presently allowable:
   —Eliminate nonbusiness deductions and exemption deductions for the individual and his dependents except medical expenses in excess of 5% of adjusted gross income and casualty losses in excess of 5% of adjusted

gross income. Adjusted gross income is regarded as the same as under present law, i.e., generally, net trade or business income. All trade or business expenses and expenses in connection with earned income and property held for investment would be allowed.

4. Include income imputed to the individual in the following forms:
   —Interest on life insurance
   —Rent on owner-occupied dwellings
   —Interest subsidies on loans to college students.
5. Include the increase (decrease) in value of assets owned.

. . . .

Eliminate the Corporate Income Tax

Under the Commission Proposal, the income presently being taxed to corporations would be included in the individual income tax base of the corporate shareholders. There are various ways in which this could be done; however, for purposes of this report, the Commission has attributed corporate income to shareholders on the basis of the (1) dividends received, plus or minus the (2) annual appreciation or depreciation in the value of the corporate stock. In this latter regard, it has been assumed that the retained earnings or losses of the corporation are reflected in the stock values, whereas, in actuality, of course, the annual change in stock value may be more or less than corporate net profits or losses.

. . . .

Eliminate Estate and Gift Taxes

The annual value of gifts and estates presently subject to gift and estate tax . . . would be added to the individual income tax base of the transferees.

Use the Family as the Tax Unit

The Commission has used the family as the tax unit. The family is:

—The husband and wife and their eligible dependents; a single person;
—An eligible dependent is a child living in the family household who is less than 18 years of age and not married, or 18 years of age or over and less than 26 who is attending school full time and is not married.
—The first $500 of earned income of each eligible dependent would be excluded from the income of the family unit.
—Income splitting between spouses would not be allowed; a single return would be required from each family; and the same rate schedules would be used for each family unit as defined above.
—Intrafamily transfers (gifts, inheritances, etc.) would not be recognized as income at the time of the transfer. However,

> upon leaving the family unit, the individual would then recognize as income the value of property when it was transferred to him while he was a member of the family unit.
>
> *Allow a Minimum Credit to Each Family Unit*
>
> In a family unit in which the husband worked and the wife did not, the Commission used a credit equal to the tax on the first $3,000 of taxable income. In a family unit in which both the husband and wife work, an additional credit has been allowed computed at the lowest tax rate (4%) times the lesser of the wife's earned income or $2,000.
>
> . . . .
>
> *Lower the Tax Rates That Apply to Taxable Income at All Income Levels*
>
> A rate structure of 4 to 54 percent would be used instead of the present rate structure of 14 to 70 percent. . . ."[4]

The foregoing adjustments produced a revised income base for 1971 (the Commission's model year) of $882 billion as contrasted with the actual base for that year of $407 billion.

Total revenues collected in 1971 approximated $200 billion.[5] The following tabulations reflect the allocation and percentage of such revenue by sources, for 1971 and as such allocation would appear if the Commission's recommendations had been in effect for 1971.

	1971—Actual		1971—Commission Proposal	
	$ billion	%	$ billion	%
Individual Income Tax	87	44	116	58
Corporate Income Tax	32	16	0	0
Social Insurance Taxes	57	29	57	29
Estate and Gift Taxes	4	2	0	0
Tax on Tax-exempt Organizations	0	0	7	4
All other taxes	20	9	20	9
Totals (approx.)	200	100	200	100

With respect to the additions to the tax base, a series of tabulations were developed reflecting the effect on revenue of adding a particular item to the base as the *first* increment and the effect on revenue of deducting such item from the base as if all others had been added and it were the *first* decrement. This concept of "adding on" and "peeling off" is a valuable tool in demonstrating the dollar equivalent of each item, as if it were the *only* one that could be "sold" in a legislative package, and as if it were the only one that could *not* be "sold."

4. *Id.* at 7-9.

5. The precise amount is $198.1 billion. The $200 billion figure is rounded off for illustration purposes.

For example, suppose that of the six major recommendations *only* item 3 (adding gifts and bequests to income) were *accepted* in a legislative reform package. As gifts, bequests, devises, and inheritances are added to the present base of individual incomes, the effect is to increase income at various income levels with a corresponding increase in tax revenues at those various levels. These increases have been computed and set out in tabular form in the Report. Thus, this procedure has the effect of showing the dollar value of adding only this *one* item to the base. Suppose, however, that of the six recommendations *only* item 3 were *rejected* in a legislative reform package. Accordingly, the calculations were made by including in the base all items and then eliminating item 3 from the new base. Thus, this procedure has the effect of showing the dollar cost of "peeling" this item off the top of all items. Such computations are helpful in demonstrating the order of magnitude of a recommendation with respect to total revenues as if the particular recommendation were the *only one accepted* or the *only one rejected.*

IV. The Corporate Tax Proposals

One of the more controversial aspects of the Commission's Report is the proposal to eliminate the corporate tax. If the corporate tax as presently applied is not shifted, *i.e.*, borne entirely by the shareholders, then there is considerable merit in developing a taxing system that does not tax this stream of income twice. On the other hand, if the tax is passed on to the consumers of corporate products and services, then it partakes more of the characteristics of an excise tax added to consumer prices. Economists are divided on the issue of "no-shifting" versus "full shifting." Most agree that some of the corporate tax is shifted; therefore, a rough assumption is that about 50% of the tax is shifted to consumers and 50% is borne by shareholders. Various computations were made by the Commission based on these several assumptions of full shifting, no shifting, and partial shifting.

Quite aside from the shifting issue, however, the Commission had to decide on the mechanics by which a corporate tax could be eliminated and the stream of corporate income taxed once, either at the corporate level or shareholder level. Several proposals were considered.

A. *Dividends Paid Deduction*

Under this proposal the corporate tax would be continued but a deduction would be allowed for dividends paid. This would result in retained corporate income being taxed at the same rate of tax, whereas distributed income would be taxed at lower or higher brackets, depending on the shareholders' respective levels of income. Corporations reinvesting their earnings for growth could be disadvantaged as against those paying out a large share of earnings in dividends, for there would be a tilting of preferences towards a more generous dividend policy and away from growth and reinvestment in plant.

B. *Dividend Exclusion*

Under this proposal the corporate tax would be applied as a single rate on all corporate income, but dividends would be excluded from the shareholders' tax base altogether. This alternative would have the effect of taxing all corporate income at the same rate irrespective of whether distributed or not. It would be disadvantageous to shareholders whose incomes were taxed at brackets lower than the corporate rate.

C. *"Gross Up" and Credit*

Under this proposal the corporate tax would be continued as a single rate on all corporate income, but shareholders would be required to "gross up" dividends to an amount equal to the before-corporate tax level, and allowed a credit for the corporate tax. Thus, assume that the corporate tax is 50% and the shareholder receives a dividend of $100. He would "gross up" the dividend to $200 as his share of corporate earnings before corporate tax. Then he would claim a credit of $100 against his personal tax liability. This system would operate in the same way as the wage withholding system. The corporate tax would be a prepayment of the tax for the shareholder, to be credited to him when he receives and reports a dividend. This proposal would probably have the effect of creating great pressures in the corporate community towards dividend distribution instead of plant reinvestment.

D. *Expansion of Subchapter S*

Under present rules a limited number of corporations with shareholders may elect to be taxed under the partnership principle. The application of these rules could be expanded to all corporations. Under a perfectly working system all income of a large publicly held corporation would be reported by all shareholders and a tax would be paid by each one on his respective share. However, considering the administrative difficulties, some withholding system would be desirable as a protective measure for the national fisc.

E. *The Commission Proposal*

It would have been desirable to experiment with all the foregoing assumptions. But because of time and the lack of basic raw data, the Commission chose, for calculation purposes, to eliminate the corporate tax and to tax shareholders on dividends received, plus or minus the gain or loss in value of shares between the beginning and end of the year. This assumes that corporate earnings are approximately equal to dividends plus the enhancement of share value. Further research in this area should be done using the various techniques described together with shifting, no shifting, and partial shifting assumptions.

V. Reforming the Federal Tax Structure— Parts II and III

Parts II and III of the Report dealing with secondary, or "feed back" effects, provide new information from economic models relating to the path of gross national product and the reallocation of capital use in various sectors of the economy.

New data and new techniques for developing data on national income are used throughout the Report. All of these items should be the subject of continuous research and updating. Whether this is done by an independent research organization, the Treasury, or a bipartisan commission of the Congress, it must be done. For the Report demonstrates that rational, objective analysis of data, and the public dissemination of information about the tax system can be an extraordinarily valuable tool for the planning of the country's complex economy of the future. Although this has not been done in the past, it should now be done and given high priority.

A free market permits, insofar as is feasible and practicable, an unimpeded exercise of free choice among consumers and producers of goods and services, labor and capital. To the extent that through national policy we force allocations of capital and labor away from one activity into another, we tend to cause dislocations in the use of capital and the labor force and artificial price structures. This causes corresponding diseconomies in the activities from which capital and labor have been withdrawn. The taxing system has been misused as an alternative to the free market and has resulted in allocation of resources other than on the basis of sound business choice.

It is true, of course, that certain economic activities require market control (e.g., public utilities), but in general, whenever in the mainstream of economic activity we have sought to control prices, wages, capital investment, and profits, we have created maladjustments in the economy that are difficult to correct. If there is to be a subsidy to some particular enterprise, it is better that it be done by direct expenditure from the federal budget rather than by some abstruse technical provision in the taxing statute.

Consider, for example, the issue of the current energy crisis. For years, we have heard that the special deduction for percentage depletion was necessary to assure a supply of not only oil and gas but also other basic minerals necessary to the economy. Now we are experiencing a shortage in such materials. Why? Because supply is a function of price and not of tax deductions. To the extent that the percentage depletion deduction has been passed through to the consumer in a competitive market, the users of minerals have not paid the true value for the product. Thus, if the prices of natural gas had been allowed to move upward in the 1950's in a free market reaction to increased demand, and if oil prices had moved upward to reflect the true cost of inventory replacement, then higher prices would have induced greater allocation of capital to competing sources of energy. Oil shale, tar sands, solar energy, and geothermal and tidal experimentation would have come much earlier in time. Instead of the sharp dislocating upward adjustment of prices now experienced, we would have had a more gradual upward price movement and the corresponding entry of more competing suppliers of different sources of energy in a free market.

Tax benefits and special provisions in other areas have also been exercises in futility. Capital gains are supposed to induce greater capital investment in the production sector of the economy to combat inflation; excess depreciation and investment credits were to induce modernization of plants to compete effectively in the world market; the shelters for state and local bonds would provide sound financing in local government, and so on. It would be far better to allow a free market system to function in these areas than to create the inequities and diseconomies caused by a complex taxing statute.

EPILOGUE

The Commission's proposals are but one set of possible alternatives which would achieve horizontal and vertical equity and significant simplification in the law. It is, of course, idealistic to expect that the system can be radically altered in one legislative action. But change there must inevitably be. The 1969 Act, however timidly it moved forward, is an important signal for later action. Tax preferences, taxation of business income of churches, stricter rules on tax exempt organizations, lifting the ceiling on capital gains, tougher depreciation recapture rules—all are portentous of future action.

Louis Eisenstein wrote that the problem of reform is not that the American people cannot understand the tax law; rather, the problem is that they might understand it too well.[6] Bipartisan support for continuing research, accompanied by an orderly public debate over the resultant information may indeed lead us to the promised land.

John Chommie understood the potentialities for tax reform as he zealously sought to explain the system as it is. The regret is that he could not have stayed to see how it might come to be.

6. L. EISENSTEIN, IDEOLOGIES OF TAXATION 227-28 (1961).