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Personal Deductions – An "Ideal" or Just Another "Deal"?

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PERSONAL DEDUCTIONS — A TAX "IDEAL" OR JUST ANOTHER "DEAL"?

Jeffrey H. Kahn*

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INTRODUCTION

The allowance of many personal deductions, such as the deduction for medical expenses or charitable contributions, has been criticized on the contention that such deductions are not appropriate elements of an income tax system, but rather are merely devices by which Congress has expended federal funds to further some nontax program or other goal. The tax revenues that are not collected because of these provisions have been characterized as "subsidies" or as camouflaged direct expenditures of the government. This view has attained such prominence that Congress requires the federal government to publish annually a "budget" that lists those tax provisions that the issuing department concludes are so-called "tax expenditures." The premise of these tax expenditure budgets is that the provisions listed in them do not implement the principles that justify using income measurement as the basis for allocating the federal tax burden among the populace. This view rests on a notion that there are immutable principles that underlie the adoption of an income tax system and that some agreement can be reached as to the identification of those principles. The adoption of the tax expenditure concept has had enormous effect on the inclusion and deletion of provisions in the tax law.

This article examines four personal deductions that have been characterized in the publication of "budgets" by several government agencies as tax expenditures, and therefore as not conforming to income tax principles. The four deduction are: medical expenses, theft and casualty losses, charitable contributions, and the interest deduction for mortgages on a personal residence. The thesis of this article is that all of those deductions, in fact, do conform to progressive income tax principles and therefore cannot properly by characterized as governmental expenditures. In other words, each of those deductions performs a useful task in the proper measurement of income for tax allocation purposes when the entire structure of the income tax and the principles that underlie it are taken into account.
While the determination of whether the deductions discussed in this article are expenditures is not conclusive of the issue of their survival in the tax law, it can have a significant impact on their survival or on the terms on which they might survive. Moreover, the validity and usefulness of the entire tax expenditure concept is open to question, and a demonstration that a number of items have been wrongly identified as expenditures by the government agencies that list those items weakens whatever confidence one might otherwise still have in the concept.

I. BACKGROUND

A. The Meaning and Criticisms of "Personal Deductions"

Subject to limitations, the Internal Revenue Code\(^1\) allows individual taxpayer deductions for certain nonbusiness and noninvestment expenditures and losses. These deductions are commonly referred to as "personal deductions." Examples of personal deductions include the deductions for medical expenses,\(^2\) theft and casualty losses,\(^3\) certain state and local taxes,\(^4\) alimony payments,\(^5\) charitable contributions,\(^6\) and qualified residence interest.\(^7\) Critics of personal deductions\(^8\) contend that the deductions do not implement the goals and purposes of a progressive income tax system,\(^9\) but rather are employed as a device to subsidize taxpayers for programmatic purposes. The critics maintain that, as a result, these deductions will erode the tax base,

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1. The Internal Revenue Code (Code or I.R.C.) refers to the Internal Revenue Code of 1986, as amended.
9. See infra Part I.B for definitions of the terms “progressive income tax system” and “graduated rate system.”
reduce progressivity, and contravene the principles of horizontal and vertical equity. The classification of a personal deduction in such manner places a heavy burden on those who advocate its retention to demonstrate that there are compelling reasons to obtain the objective at which the deduction is aimed, and that the tax system is the optimum vehicle for implementing that objective. The latter requirement is especially onerous because the employment of a deduction as a means of channeling dollars for a programmatic function favors high-bracket taxpayers and provides no benefit to those persons who have no tax liability or, in the case of itemized deductions, to those who do not itemize their deductions. Under a graduated tax rate structure, a deduction has a greater dollar value to a high-income taxpayer because that taxpayer is subject to a higher marginal tax rate. For example, assume A earns $5000 and B earns $10,000. The tax regime to which A and B are subject is structured so that the first $5000 of income is taxed at a 10% rate and all other income is taxed at a 20% rate. A and B each have a personal deduction of $100. Without the deduction, A’s tax would be $500. The deduction lowers A’s taxes by $10. Without the deduction, B’s taxes would be $1500, but the deduction reduces B’s tax by $20. The deduction is worth twice as many dollars to B as it is to A.

The extent to which personal deductions are characterized as aberrations unsupported by the principles of income taxation is illustrated by the inclusion

10. Horizontal equity requires that persons in like income positions pay the same amount of tax. Vertical equity requires that persons in dissimilar income positions pay appropriately dissimilar taxes. See STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 72 (1985) (“Not only are the tax expenditure provisions the primary cause of perceived tax inequity, but it also seems safe to say that they fail to achieve what most Americans would perceive to be a fair distribution of funds.”). Professors Surrey and McDaniel also argue that since tax expenditures are not needed “to implement a normative tax on net income . . . they add unrelated complexity to the code.” Id. at 91.

11. Itemized deductions are available only to those taxpayers who do not utilize the standard deduction. See I.R.C. § 63 (1994).

12. See infra Part I.B for an explanation of a graduated tax rate schedule.

13. Personal deductions also favor the wealthy because most, e.g., the deduction for state and local taxes, are itemized deductions and thus are of no use to those who utilize the standard deduction. Since most low income taxpayers use the standard deduction, the personal deductions are of no value to them. See Thomas D. Griffith, Theories of Personal Deductions in the Income Tax, 40 HASTINGS L.J. 343, 352-53 (1989). In his article, Professor Griffith notes, however, that there are alternative ways to test progressivity. See id. at 355-60. For example, in the A and B hypothetical described in the text, if no personal deduction was provided in the tax system, then B would pay three times as much in taxes as A. However, under a tax system that allows a personal deduction, B would pay 3.02 times the taxes paid by A. See id. at 355-56.
Personal Deductions

of many personal deductions in various tax expenditure budgets. Several governmental entities promulgate so-called tax expenditure budgets, each of which states the estimated revenue that is lost due to the existence of designated “nonneutral” tax provisions and characterizes those revenue “losses” as government expenditures. Tax provisions which are deemed to conform to the principles of taxation are sometimes called “neutral” provisions. All others are termed “nonneutral,” and the failure to collect the revenue that would have been collected if the nonneutral provision had not been adopted is characterized as equivalent to collecting that revenue and then distributing it directly to the selected persons. If a nonneutral provision causes a significant reduction of the government’s revenue, it may be listed as a “tax expenditure.” As already mentioned, many personal deductions are so listed.

For example, in the Budget of the United States Government, Fiscal Year 2002, the list of tax expenditures includes the deductibility of medical expenses, charitable contributions, casualty and theft losses, state and local taxes on nonbusiness income or property, and interest on mortgages on a personal residence.


15. The word “neutrality” is sometimes used in a tax context to denote a tax provision that will not alter market behavior. See e.g., John K. McNulty, Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform, 88 Cal. L. Rev. 2095, 2135-36 (2000) (noting the argument put forth by consumption tax advocates that a consumption tax is more tax “neutral” with respect to the consumption versus savings decision). In this article, the terms “neutrality” and “nonneutrality” refer to whether the tax provision does or does not conform to the principles of income taxation. This is the manner in which the terms are used in the tax expenditure budgets.

16. See Surrey & McDaniel, supra note 10, at 25 (“According to the tax expenditure concept, the beneficiary of a tax expenditure has paid the tax due under the normative structure, absent the tax expenditures, and then is paid the amount of the tax reduction effected by the special tax provisions . . . ”).

B. Thesis of the Article

It is important, at the very outset of this article, to state its thesis and its contributions to the resolution of the issues discussed herein. To avoid confusion, it is also important to expressly disclaim certain positions that are not asserted herein.

As explained in Part I.C below, the tax expenditure concept rests on the notion that there is an ideal structure for an income tax system which conforms to principles on which the income tax system is based. While there is controversy as to whether an ideal structure for the income tax exists and, if so, as to the identity of the principles on which it rests, this article does not directly address either of those issues. Instead, this article addresses the question of whether, assuming arguendo that the tax expenditure concept is correct in dividing tax items into neutral and nonneutral categories, certain personal deductions have been improperly classified as nonneutral and therefore as tax expenditures. This article contends that several of the personal deductions listed in the tax expenditure budgets have been wrongly classified as tax expenditures and therefore should be removed from the lists and not subject to the taint that goes with that classification.

The neutrality of several of the personal deductions on which this article focuses has been examined in several earlier articles. The two most significant of those writings are the article defending the neutrality of the alimony payment deduction and the resulting income to the payee, I.R.C. § 71, constitute an income-splitting scheme so that income is divided between two taxpayers. See I.R.C. § 71 (1994). The alimony payment deduction may be a desirable provision to provide relief for the financial burden of a taxpayer who is maintaining the cost of two households. Indeed, some such taxpayers may be maintaining the costs of multiple households. Providing relief can be viewed as serving a programmatic function. One should note that alimony income is not excluded from taxation; rather the deduction merely changes the identity of the person who is taxed on that income. However, it is far from clear why that fact is sufficient to exclude the deduction from the tax expenditure budget. If one subscribes to the tax expenditure viewpoint, at the very least, some amount should be included in the tax expenditure budget, since the income is likely being shifted to a taxpayer with lower marginal tax rates. One possible justification is that the alimony deduction scheme provides a benefit to divorced parties similar to that enjoyed by married couples, and thus moves towards equalizing their tax positions. The manner in which "tax expenditures" are determined, and the requirement that the government promulgate tax expenditure budgets, are briefly described in Part I.C.

medical and charitable deduction written by Professor Andrews in 1972, and the critical response from Professor Kelman in 1979. Parts V.A.1 and V.C.1 of this article summarize Andrews’ positions on medical and charitable deductions respectively, and Parts V.A.3 and V.C.2 set forth a response to the contentions that Professor Kelman made concerning those deductions. While not disagreeing with the points made by Professor Andrews, this article presents an independent and entirely different reason for classifying those two deductions as neutral. The exposition and analysis of that independent justification is the principal contribution of this article.

The income tax system in this country has utilized a progressive tax structure for taxing individuals since it was adopted in 1913, although the degree of progressivity has varied greatly over the years. A progressive income tax structure is a system in which the greater the taxpayer's income, the greater the percentage of that income that is required to be paid to the government as an income tax. Under such a structure, the income taxes payable by individuals with greater incomes will be a larger percentage of their income than the taxes payable by individuals with less income.

The principal device for creating a progressive income tax system is to have a tax rate schedule that employs graduated rates. A graduated rate system is a system in which, as a taxpayer’s amount of taxable income increases, the tax rate that is applied to an additional dollar of taxable income is increased. For example, take a graduated rate system in which the first $5000 of taxable income is taxed at a 10% rate, the next $10,000 of taxable income is taxed at a 20% rate, and the taxable income in excess of $15,000 is taxed at a 30% rate. If A has taxable income of $5200, $5000 will be taxed at a 10% rate ($500 of tax) and $200 will be taxed at a 20% rate ($40 of tax). As a result, A’s total tax bill will come to $540. If B has taxable income of $18,000, $5000 will be taxed at a 10% rate ($500 of tax), $10,000 will be taxed at a 20% rate ($2,000 of tax), and $3000 will be taxed at a 30% rate ($900 of tax). B’s total tax will be $3400. The result is that A pays income tax consisting of approximately 10.4% of her income while B pays income tax consisting of approximately 18.9% of her income.

20. See Kelman, supra note 8.
21. See Tariff of 1913, ch. 16, 38 Stat. 114, 166-67 (1915). The Underwood-Simmons Tariff Act of 1913 established a rate of 1% on both individual and corporate income above what was then a high exemption amount, $3000 in the case of single individuals. See id. at 166. The tax also had a graduated surcharge for incomes above $20,000. See id.
22. In this article, the terms “graduated rates” and “progressive rates” are sometimes used interchangeably.
23. Note that graduated rates are applied to brackets of income. One of the most
The tax expenditure budgets that have been promulgated reflect the view that applying a progressive rate structure to individuals is a normal part of our tax system. None of the tax expenditure budgets include in their lists of tax expenditures the lower tax rates that are applied to individuals, i.e., the tax expenditure budgets do not consider an ideal tax system to be one that employs a flat rate in which event the lower rate of a graduated tax schedule would be nonneutral. Indeed, the budget that is promulgated by the Joint Committee on Taxation lists the lower income tax rates on corporations as a nonneutral item, and expressly contrasts lower corporate income tax rates with individual lower rates, which the Joint Committee on Taxation considers to be neutral.\textsuperscript{24} The Joint Committee on Taxation states:

The corporate income tax includes a graduated tax rate schedule. The lower tax rates in the schedule are classified by the Joint Committee staff as a tax expenditure \ldots because they are intended to provide tax benefits to small business and, unlike the graduated individual income tax rates, are unrelated to concerns about ability of individuals to pay taxes.\textsuperscript{25} The contrast could not be more striking.

Since a progressive rate structure constitutes an integral and normal part of our income tax system as applied to individuals, a characterization of specific tax provisions as neutral or nonneutral must take into account the principles on which the adoption of a progressive rate structure is grounded, along with the principles for using income as the taxable base. Because progressive rates are neutral, tax provisions that serve to further the purposes and ideals of progressivity must perforce be neutral as well. In other words, a provision that implements the progressive tax rate system is no less neutral than a provision that implements the system of taxing income, as contrasted to taxing consumption or wealth. There have been several writings on the question of the theoretical justification for progressive rates. In Part III of this article, the alternative justifications that have been proposed are summarized and their relative strengths evaluated.

This article maintains, and will subsequently demonstrate, that certain personal deductions serve to implement the goals of progressivity and so are elements of the income tax system itself rather than subsidies or incentives for some nontax purpose. Consequently, those deductions cannot properly be classified as nonneutral as that concept is used in the tax expenditure budgets.

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\textsuperscript{24} See JCT TAX EXPENDITURES, supra note 14, at 24.

\textsuperscript{25} Id. at 7.
It is important to note just what significance the characterization of neutrality has and what it does not. If a provision is deemed neutral, it does not necessarily follow that it should be retained in the Code. The fact that a provision is consistent with tax principles is not a reason to adopt or retain it; however, the fact that a provision is inconsistent with tax principles is a factor favoring its removal or rejection. The retention, deletion or modification of a tax provision should rest on value judgments regarding a wide range of considerations, e.g., economic, social, and political concerns. The significance of a provision's being labeled nonneutral is that it places a heavier burden of persuasion on those who would retain the provision in the Code than otherwise would be the case. On the other hand, if a provision is deemed to be neutral, it does not affect the burden of persuasion of those who seek to repeal or to retain the provision. A neutral classification removes the question of nonneutrality from the scales and leaves the question of retention exclusively to a weighing of the various values that the provision either supports or hinders, unencumbered by consideration of the extent to which the provision fits within an ideal income tax.

Part IV of the article explains the role that personal and dependency exemptions and the additional standard deduction have in implementing the principles that underlie a progressive rate structure. Understanding the role of these provisions helps to illuminate the roles that the medical and charitable deductions have, as discussed in Part V.A and V.C of this article, and supports the thesis of this article.

In addition to the article's discussion of the neutrality of the medical and charitable deduction, Part V.B of the article contends that the deduction for casualty and theft losses is a neutral provision. Unlike the contentions set forth with regard to the medical and charitable deductions, the neutrality of the casualty and theft loss deduction rests primarily on a consideration of the principles of taxing income rather than the special principles for progressive rates. However, as we shall see, the principles underlying progressivity add support to that contention.

Finally, in Part V.D, the case for treating the deduction for qualified residence interest as neutral is examined. While a case for neutrality can be made on the ground that the provision mitigates an economic bias, it is more tenuous than the arguments made in support of the other provisions examined herein.

C. The Determination and Significance of Tax Expenditure Budgets

Professor Stanley Surrey, the father of the tax expenditure concept, was Assistant Secretary of the Treasury for tax policy during the Kennedy administration. Surrey believed that a number of provisions of the tax code
constituted a disguised form of government spending. However, since those provisions were hidden in the forest of a complicated tax structure, consisting of a vast number of provisions, they did not receive the same type of attention and scrutiny that direct expenditures received. Thus, Surrey believed politicians used the tax code as a vehicle to subsidize programs that perhaps would not be feasible if proposed as direct outlays.

In order to bring attention to those types of subsidies, Surrey campaigned for a requirement that Treasury publish a list of what he called “tax expenditures.” The Congressional Budget and Impoundment Control Act of 1974 now requires the administration to report annually on tax expenditures in its budget. The law also requires that estimates of tax expenditures be published with all bills reported by congressional committees.

In its recent release of the federal tax expenditures estimates, the Joint Committee on Taxation stated:

"Tax expenditures" are defined under the Congressional Budget and Impoundment Control Act of 1974 ("the Budget Act") as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” Thus, tax expenditures include any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers.

Special income tax provisions are referred to as tax expenditures because they may be considered to be analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives.

The tax expenditure concept rests on the notion that there is a “normal” or “ideal” income tax, that provisions which conform to that ideal tax are neutral, and that the revenue lost from those that do not are governmental expenditures. In other words, proponents of the tax expenditure concept argue that the loss of revenue attributable to nonneutral provisions is a direct expenditure that is made through the tax system and is camouflaged as an element of the mechanism used to determine the proper amount of a person’s tax burden.

Professors Surrey and McDaniel explain it as follows:

The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement

27. See id.; see also Bruce Bartlett, The End of Tax Expenditures as We Know Them?, 92 TAX NOTES 413, 414 (2001); Jonathan Barry Forman, Origins of the Tax Expenditure Budget, 30 TAX NOTES 537 (1986).
28. JCT TAX EXPENDITURES, supra note 14, at 2 (quoting Congressional Budget and Impoundment Control Act of 1974, § 3(3)).
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a normal income tax . . . . The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class of persons.29

The identification of nonneutral provisions (i.e., tax expenditures) requires the determination of a "baseline" that comprises the ideal tax. There are several governmental tax expenditure lists or budgets. While there is overlap among those budgets, they are not identical because they employ different baselines. For example, the staff of the Congressional Joint Committee on Taxation utilizes a "normal income tax" baseline;30 while the Treasury uses the "reference tax law" baseline.31 Under the normal income tax baseline, the Joint Committee's staff makes a determination as to which tax provisions lie within "normal" comprehensive income tax law and which do not. If a provision does not lie within what the staff considers to be the normal tax law, and if it causes a reduction in revenue collection of sufficient magnitude, the provision is listed as a tax expenditure.32 On the other hand, as explained in greater detail below, Treasury's reference tax law baseline relies on the subjective purpose that Congress had in adopting a provision, and its list of tax expenditures are limited to "special exceptions in the tax code that serve programmatic functions."33

There is far more at stake than semantics in choosing among the various baselines that are employed in tax expenditure lists. The several baselines reflect very different standards for classifying provisions as neutral or nonneutral. One approach, the reference tax law baseline, is to classify a provision as a tax expenditure if the classifying agency determines that the Congressional purpose for adopting that provision was to carry out some program that Congress wished to support. Under that approach, it does not

29. SURREY & MCDANIEL, supra note 10, at 3.
30. JCT TAX EXPENDITURES, supra note 14, at 2, 9-10; see also OMB BUDGET 2002, supra note 17, at 76.
31. See OMB BUDGET 2002, supra note 17, at 76.
32. See JCT TAX EXPENDITURES, supra note 14, at 2.
33. OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2001, ANALYTICAL PERSPECTIVES 123 (2000) [hereinafter OMB BUDGET 2001]. As discussed in more detail in the Conclusion of the article, in its most recent budget, the Bush Administration has questioned the value of the tax expenditure budget. The Bush budget refers to "so-called" tax expenditures and states "that the concept of 'tax expenditure' is of questionable analytic value." OMB BUDGET 2002, supra note 17, at 61; see also Heidi Glenn, Bush Administration Questions Value of Tax Expenditures List, 91 TAX NOTES 535 (2001). The 2002 budget also removed the tax expenditure budget language quoted in the text with regard to how Treasury determines tax expenditures, but stated that the budget was determined by using the same standard that was applied in previous budgets.
appear to matter whether the provision actually serves one or more of the principles of the income tax system. The test is a subjective one, turning on the purpose that Congress is deemed to have had for adopting the provision.

The other approach, the normal income tax baseline, attempts to apply a more objective standard. Under that approach, the classification of provisions as tax expenditures is made by determining whether a provision actually serves one or more principles of the income tax system, regardless of the purpose that Congress had for adopting the provision. In this article, the objective approach of the normal income tax baseline is adopted. If one accepts the tax expenditure concept, the standard should be whether the provision does or does not fit within a "pure" income tax system, regardless of whether the legislature's motives for adopting the provision were equally as pure. If a useful and appropriate provision was adopted for a programmatic reason, it still should be considered a neutral provision. Consequently, there is no speculation in this article as to what purposes Congress may have had in adopting the tax provisions discussed herein.

Even for those who adhere to the tax expenditure concept, the listing of a provision as a tax expenditure does not necessarily mean that it should be repealed. Professors Surrey and McDaniel themselves stated that having a Code provision classified as a tax expenditure does not require its repeal. Such classification does mean, however, that the proponents of retaining that provision have a heavy burden not only to demonstrate that the provision serves a desirable purpose but also to show that it is the optimum device to implement that purpose.

34. Query whether the reverse is true, that is, should a provision be considered nonneutral if Congress mistakenly believed that the provision would act in a neutral manner and that was the purpose of adopting the provision? This article does not address that issue as the article focuses solely on the neutrality of an item that promotes tax principles.

35. In its report, the Joint Committee on Taxation claims, "[t]he Joint Committee staff emphasizes, however, that in the process of listing tax expenditures, no judgment is made, nor any implication intended, about the desirability of any special tax provision as a matter of public policy." JCT TAX EXPENDITURES, supra note 14, at 2-3.

36. See SURREY & MCDANIEL, supra note 10, at 5 ("The classification of an item as a tax expenditure does not in itself make that item either a desirable or an undesirable provision; nor does it indicate whether the inclusion of the item in the tax system is good or bad fiscal policy."). But compare Surrey's statement that "most tax incentives have decidedly adverse effects on [horizontal and vertical] equity as between taxpayers." SURREY, supra note 14, at 136; see also Bartlett, supra note 27, at 414 ("Surrey clearly intended the term 'tax expenditure' to be pejorative, undermining political support for tax preferences."); Victor Thuronyi, Tax Expenditures: A Reassessment, 37 DUKE L.J. 1155, 1155 (1988) ("Surrey hoped that if policymakers acknowledged that tax expenditures were spending programs, many would be repealed as an ineffective means of providing a federal subsidy.") (citing SURREY, supra note 14, at 179-80).
Adherence to the tax expenditure concept shifts the nature of the debate over the question of whether a particular provision should be retained or repealed to focus more on the role of the provision within a hypothetical ideal tax system than on the extent to which the provision promotes a desirable social or economic goal. The tax expenditure budgets have had great influence on the legislative process.

D. Application of the Tax Expenditure Concept to Personal Deductions

The tax expenditure concept has both proponents and critics. The tax expenditure concept itself is not under review in this article, albeit the thesis of this article does cast a shadow over the efficacy of that concept. The focus of this piece is to demonstrate that, even given a tax expenditure approach, many of the personal deductions that typically are listed as tax expenditures implement principles that underlie a progressive income tax, and therefore should not be classified as expenditures. Acceptance of that thesis, however, does not require that those deductions be retained in the Code. There are many provisions that could be included in the tax law in furtherance of the principles of taxation, but which could be properly omitted from the tax law if there are policy reasons for doing so or if those principles could be better served by using a different approach. The point is merely that many of the personal deductions currently labeled as tax expenditures cannot be repudiated on the basis that they do not serve tax principles. If they are to be repudiated, it must be for some reason other than that they are outside of a neutral or ideal tax structure.

When discussing the question of whether personal deductions fit within an ideal income tax system, the same issue arises in connection with the allowance of certain statutory exclusions from income and with the allowance of certain tax credits. This article does not address tax credits at all, and deals

37. See Thuronyi, supra note 36, at 1181 ("[Under Surrey's concept,] provisions identified as tax expenditures become virtually indefensible. Classification of a particular provision therefore becomes critical . . . .").

38. See id. at 1170-81 (also noting the indications that Congress has not taken the concept "fully to heart."); see also Joseph A. Minarik, How Tax Reform Came About, 37 TAX NOTES 1359, 1361 (1987).

[Surrey] likened the tax savings from a preference for a particular purpose, say encouraging business investment, to a government outlay for the same purpose. Thus was coined the term, "tax expenditures." This concept was institutionalized on an illustrative basis in the Federal budget in the mid-1960s, and has had a powerful influence on virtually all deliberations on the Federal income tax ever since.

39. See supra note 18 for examples of such proponents and critics.
with only one of the exclusion provisions, the exclusion of certain medical expense reimbursements. The focus of this article is on the role of personal deductions in an income tax system. However, the roles that personal and dependency exemptions and the additional standard deduction for the aged and blind play in the income tax system are discussed.

A number of commentators have offered various reasons for concluding that some of the personal deductions are consistent with the purposes of an income tax system and therefore do not constitute departures from normal tax treatment, but other commentators have rejected those arguments. This article will revisit and weigh the merits of some of those discussions and will examine some of the personal deductions to determine whether there are previously uncharted grounds that justify treating them as implementations of the principles that underlie progressive income taxation.

E. Progressivity

As previously noted, the tax system currently employed in the United States, which has been employed since the modern income tax was first adopted in 1913, is one which utilizes a progressive rate structure—that is, the greater the amount of one's income, the larger the percentage of that income that is payable as a tax. Also, as previously noted, even the promulgators of tax expenditure budgets treat progressive rates for individuals as a normal part of the tax law. The decision to use a progressive rate structure rests on principles that are separate from those that underlie the decision to tax income rather than taxing something else, such as consumption. In light of the current and historical linkage of progressivity to the taxation of income, the principles supporting the adoption of a progressive rate system must be taken into account in determining whether a deduction is a neutral provision to the same extent that the principles supporting the taxation of income must be taken into account.

Before examining specific personal deductions, it will be useful to explore the principles that commentators have concluded underlie progressive income taxation. One of the difficulties encountered in seeking to characterize tax provisions as neutral or nonneutral is that there is not


41. See supra text accompanying note 24.

42. You will recall that progressivity is implemented by employing graduated tax rates.
universal agreement as to the principles that support income taxation and those that support the imposition of graduated tax rates. It is necessary therefore to set forth the premises on which the analysis in this article is grounded. Also, it is useful to examine the role that the personal and dependency exemptions serve in the progressive system, because understanding the role of those provisions helps to illuminate the contention that personal deductions are neutral.

II. THE DEFINITION OF INCOME

The most commonly quoted definition of income is the so-called Haig-Simons definition: a person’s income equals the amount of increase in wealth accumulated by that person during a specified period, typically one year, plus the market value of the person’s personal consumption during that period.\(^4\) But taxation is a practical matter, and the abstract model set forth in the Haig-Simons definition must be modified to accommodate other goals and considerations. For example, administrative convenience and the adverse effect that the imposition of taxes may have on behavior and investment must be taken into account. Nevertheless, the Haig-Simons definition is often cited as a starting point for determining the “ideal” tax.

The Haig-Simons definition rests on the notion that the costs of government should be apportioned among those persons who use societal goods which thereby become unavailable to other members of the public. The accumulation of wealth is taxed because it represents the power to consume at future dates. In effect then, the income tax is a tax on personal consumption and on the present value of future personal consumption.

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43. See HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (Univ. of Chi. Press 1980) (1938) ("Personal income may be defined 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 end of the period in question."). While the Haig-Simons definition is a useful starting point, no one contends that it accurately describes the United States tax system—for example, our current system has a realization concept and does not tax imputed income. See e.g., John S. Nolan, The Merit of an Income Tax Versus a Consumption Tax, 12 AM. J. TAX POL’Y 207, 210 (1995). Thuronyi observed:

Surrey had no desire to entangle his tax expenditure concept in disputes over the interpretation of Haig-Simons income. Moreover, he intended the list of tax expenditures to serve at least in part as a realistic “hit list” for reform. Identifying all departures from the Haig-Simons definition as tax expenditures would have been overbroad and ineffective, implicitly advocating reforms that would be administratively infeasible or politically untenable. Thuronyi, supra note 36, at 1165 (citations omitted).
But there is a question as to what constitutes personal consumption. For example, should a person be taxed on the consumption of goods only when they are used for the private benefit of that person? Does the consumption of goods that benefits a large segment of society (as contrasted to the private benefit of the consumer) fit within the concept of "personal consumption"? For example, Professor Andrews argues that charitable contributions should not be treated as personal consumption because they benefit a larger group than the person making the contribution. Professor Kelman, while not disputing the principle on which Professor Andrews' argument rests, contends that the contributor obtains extensive private benefits from a charitable contribution and should not escape taxation merely because there is a public benefit as well. We will return to this issue when the charitable deduction is examined later in this article.

III. THE THEORETICAL BASIS FOR PROGRESSIVE TAXATION

Progressive taxation, as implemented by a graduated rate schedule, has been incorporated into federal income tax law since the passage of the first Revenue Act in 1913, after the Sixteenth Amendment was adopted. Progressivity has always had its detractors, and proposals for a flat tax have received increased attention in the last few years. To date, however, the graduated rate system has been retained and continues to constitute an integral part of the country's income tax system. It appears that there remains majority support for progressivity, both in the body politic and in academia. In any event, unless and until Congress dispenses with graduated rates, progressivity remains one of the fundamental blocks of this country's income tax system.

The broad-based acceptance of a progressive income tax might lead one to surmise that there is general agreement as to the theoretical justification for that system. To the contrary, that is far from being the case. There are several different justifications for graduated rates that have been proposed, and the proponents of progressivity differ as to which they choose. Since the several theories are not all compatible with each other, the proponents of progressivity

44. See Andrews, supra note 19.
45. See Kelman, supra note 8.
46. See infra Part V.C.
47. See supra note 21.
typically select one of them rather than relying on the cumulative thrust of several rationales.\textsuperscript{49}

A person's choice and acceptance of one of the several justifications depends at least partly upon that person's view of distributive justice.\textsuperscript{50} There can be no empirical test or syllogistic appraisal to determine whether progressivity is appropriate or to determine which justification provides the stronger case for it. Professors Galvin and Bittker correctly stated that the choice of the appropriate rate structure depends upon "faith, personal preference, or fiat."\textsuperscript{51}

In order to decide whether a tax provision, such as a personal deduction, is justified under "normal" tax principles, one must first (1) assume that normal tax principles exist, and (2) determine just what those principles are. The author does not seek in this article to join the debate as to whether one can truly argue that a normal or ideal tax structure exists; although, as noted in the conclusion, a logical extension of the direction of this piece casts doubt on this issue and the effectiveness of the tax expenditure concept. The thesis of this article is that, assuming that the tax expenditure concept is valid, many personal deductions do not constitute such expenditures. To the contrary, those deductions promote principles that are part of the foundation of a progressive income tax system. Since one of the tax principles on which this thesis rests is the principle that underlies the choice of progressivity, it is necessary to disclose which of the several justifications for progressivity the author adopts.

*The Uneasy Case for Progressive Taxation*, the 1952 article by Professors Blum and Kalven,\textsuperscript{52} is still one of the most significant efforts to analyze the merits of the various grounds both for and against a progressive tax system.\textsuperscript{53}

\textsuperscript{49} See Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952). However, as noted later in the text, the "wealth maximization" principle can operate together with one of the other justifications for progressivity.


\textsuperscript{52} See Blum & Kalven, \textit{supra} note 49.

The principal theoretical justifications for progressivity, as discussed in that piece, can be classified into four distinct types. These four types are briefly summarized as follows in the ascending order of their strengths, as viewed by the author.

A. Coordination with Benefits Enjoyed

All taxpayers receive benefits, both direct and indirect, from the federal government and the benefits that the government provides are not enjoyed equally by everyone. The benefits-received theory asserts that taxes should be allocated among the populace in rough proportion to the extent to which each individual derives benefits from the government. Thus, the contention is that wealthier members of the populace derive greater benefits from government than do others and therefore the tax rate should be progressive. This belief relies heavily on faith, and perhaps on a political orientation. In any event, even if a flat tax rate were employed, the wealthier will pay a greater amount of tax than those with smaller incomes. In order to support progressive tax rates, it is not enough to show that benefits increase as income increases, but instead it must be proven that benefits increase more rapidly than income, thus justifying the graduated tax rate schedule. It is far from obvious that the tax rates for larger amounts of income must be greater if those taxpayers are to pay taxes that are proportionate to their share of the benefits.


54. See Blum & Kalvin, supra note 49, at 451-55.
55. See id.

The more traditional place to begin the affirmative case for progression is with the simple notion of estimating the benefits which the taxpayer purchases with taxes. No one regards taxes as a completely one-sided transfer. Since it is obvious that each taxpayer derives some benefits from the operation of government, the magnitude of such benefits suggests itself as a standard for distributing the tax burden. If it can be shown that the benefits increase as income increases, and that at some levels of income benefits increase more rapidly than income, a compelling justification for progression will have been established.

Id. at 451.
provided to them by the government.\textsuperscript{56} The benefit theory is grounded on questionable assumptions as to how government benefits are allocated and is more fragile than the other justifications.\textsuperscript{57}

B. Wealth Maximization

The wealth maximization theory contends that the tax system should be designed to maximize the amount of aggregate wealth of the entire populace.\textsuperscript{58} This approach elevates economic efficiency over egalitarian goals. Another version of this approach is the view that the tax system should be one that provides the greatest benefit for the largest number of people.\textsuperscript{59}

It is questionable whether wealth maximization is served by utilizing progressive tax rates. It can be contended that graduated rates will induce taxpayers to work more hours or invest more dollars to produce greater after-tax income. To the contrary, it may instead discourage additional hours of work or investment because the net return will be valued less than the benefits from employing those hours, or, in the case of investing, using funds, in leisure activities. It would seem that wealth maximization is better served by manipulating substantive tax provisions than by choosing a tax rate structure.\textsuperscript{60}

The categorization of the four types of rationales described herein is not watertight. The fact that the wealth maximization theory emphasizes economic efficiency makes it one that is compatible with the other justifications for a progressive tax rate system. Economic efficiency is one of the primary goals of general tax policy, regardless of the rationale that is chosen for a progressive tax rate system. Legislators do not wish to have the


[The question [of whether people ought to be taxed in proportion to the utility that they derive from public goods] is probably completely unresolvable, both because of the impossibility of measuring the relative utility levels each income class derives from public goods, and because of conceptual problems in deciding what one ought to be measuring.

\textit{Id.} at 166.

\textsuperscript{57} See \textit{id}. Even at the time of the article by Blum and Kalven, most public finance textbooks mention the theory but treat it "as being only of historical or academic interest." Blum & Kalven, \textit{supra} note 49, at 451 n.92.

\textsuperscript{58} See Blum & Kalven, \textit{supra} note 49, at 456-66.

\textsuperscript{59} See \textit{id}.

\textsuperscript{60} Wealth maximization does appear to relate to progressivity in that it may provide the ceiling for the top marginal tax rate. For example, the marginal utility of Bill Gates earning another dollar may be zero, but it would not be advisable to have a tax rate of 100%, as that would discourage any person in that bracket from earning that additional dollar, and society thus would lose the goods or services that otherwise would have been produced.
tax system adversely impact the economic well being of the nation. The degree of progressivity that is incorporated in the tax rate schedules reflects that concern, although, as stated, the consequence of implementing a policy of wealth maximization seems more likely to lead to a reduction in progressivity rather than an increase. Many of the deductions, credits, and exclusions in the Internal Revenue Code are intended to promote economic efficiency. Such provisions serve as a means of reducing the applicable tax rates for certain activities in order to maximize national wealth. As a result, national wealth maximization is one rationale that can operate in conjunction with one of the other justifications, but it does not provide, on its own, a convincing case for a progressive tax system.

C. Redistribution of Wealth

One might take the position that the earnings that a person obtains legally should belong to that person. This sometimes is referred to as an entitlement theory. But, many persons believe that there are unfair or arbitrary elements to the market's allocation of wealth. The redistribution of wealth theory, relying on one of several theories of distributive justice, requires that the tax system should redistribute wealth from those with too much to those with too little. A progressive tax system provides some redistribution of wealth.

61. See Fried, supra note 56, at 183. In a world with perfect information, each person would have her own optimal tax schedule, with rates set very high on inframarginal earnings, and declining, ultimately to zero, on the last (marginal) dollar earned. In our actual world, where we cannot observe people's true preferences, a degressive tax structure might best approximate that ideal result.

Id. But see Martin J. McMahon, Jr. & Alice G. Abreu, Winner-Take-All Markets: Easing the Case for Progressive Taxation, 4 FLA. TAX REV. 1, 80 (1998) (using the declining utility of income as a premise, and arguing that when efficiency is measured by "after-tax private utility rather than absolute dollars," progressive tax rates are more efficient than proportional rates).

62. See Blum & Kalven, supra note 49, at 497. There are also the disturbing influences of fraud and duress which affect the distribution of rewards and which have not been and cannot be perfectly policed. Another factor is the periodic shifts in the value of money and in the level of economic activity which have had a pronounced impact on the distribution pattern. And there is always the element of sheer luck or chance which sometimes is the best explanation of success or failure. Taking these factors together there undoubtedly is a large amount of "undeserved" income distributed by our contemporary market system.

Id.

63. See id. at 491-501. A critic might describe this approach as the "Robin Hood" theory of taxation.
Of course, if one believes that only the unwarranted or undeserved income that a person receives should be redistributed, a progressive tax rate structure is too crude an instrument to reach only the undeserved amount of a taxpayer’s income. But some believe that virtually all income is obtained because of external conditions, such as education, social position and other attributes given one by the accident of birth, so that the disparity between incomes should be reduced to the extent that it is feasible to do so. Some believe that an earner’s merits have no bearing on entitlement to wealth, and that a healthier society is one in which there are not large disparities in the allocation of wealth regardless of how the wealth was earned.

A tax system will necessarily redistribute wealth as an incident of collecting money from persons different than those who receive the benefits of governmental expenditures. It does not follow, however, that the tax system should be designed to maximize the redistribution of wealth. One can accept redistribution as an unavoidable element of taxation without embracing the idea and enthusiastically embarking on maximizing the extent to which the tax system has that effect. Nevertheless, redistribution is an important justification in that a significant number of people believe that it is a proper function of a tax system. Therefore, in examining personal deductions, the redistributive justification will be considered.

D. General Equalization of Sacrifice

The equal sacrifice theory is built on the premise that taxation is the means by which a government obtains the funds to conduct its governmental functions. The theory itself is that all members of the populace should bear part of that cost to the extent that they are able to do so, and that there should be some general equality in the degree of sacrifice that is required of each

64. See id. at 497 (“Of greater importance is the difficulty of correlating the ‘undeserved’ income with the rates under a progressive schedule.”).
65. See id. at 498.
From this perspective everyone’s income is equally underserved, and the market, however important its other functions, is an amoral distributor of rewards. If one confesses to knowing nothing about who is entitled to the goods of the world then the most prudent and sensible thing to do is count each man as one.
Id.
66. See Blum & Kalven, supra note 49, at 499. (It is also sometimes argued that any person’s “production requires the cooperation of many others [i.e.,] [b]ecause all of these efforts are indispensable to the final product it has seemed to some not possible to differentiate, except arbitrarily, between the contributions of each to the final result.”).
67. See id. at 421.
member. The system of taxation that is chosen determines how the burden of paying for the cost of operating the government is allocated among its populace.

At first blush, this approach might seem to support a flat tax rate on all taxpayers. But not all dollars of income are of equal value to their owner. The amount of income that a person requires in order to pay for her subsistence, or for the subsistence of her family, has greater value to that person than dollars greatly in excess of that amount. It is a reasonable assumption that once the need for an amount equal to the cost of subsistence has been satisfied, the value or "utility" of additional dollars earned will decline. Such is the case with commodities, and there seems to be no reason why the same phenomenon would not occur when money is accumulated. This declining curve of marginal utility means that the sacrifice incurred by the taking of a dollar from someone who has $500,000 is less in utility terms than the sacrifice suffered when a dollar is taken from someone who has only $20,000. A progressive or graduated rate reflects the differences in marginal utility of dollars of income to persons with different amounts of income.

Of course, the tax law's graduated rate structure cannot actually equalize the sacrifice incurred by taxpayers with differing amounts of income. One reason for this failure is that there are competing values to be satisfied in setting the tax rate structure that prevent a true equalization of sacrifice. For example, too high a marginal tax rate could deter the performance of additional services or investment. Another consideration is that it may be deemed important to have a large portion of the populace bear a share of the cost of government so that they feel that they have contributed to the general welfare and that there will be some constraint on the extent to which they will support expensive governmental projects.

Practically speaking, it is difficult, if not impossible, to precisely implement equal sacrifice since the marginal utility of dollars differs among different persons. Obviously, it is not feasible to design a separate utility

68. See id. A subpart to this argument is that progressive taxation in the federal system merely compensates for the regressivity of other taxes in the overall tax system, which makes the total burden of all taxes proportionate to the taxpayer's income.

69. See id. at 456-57 ("A convenient shorthand for these assumptions is to say there is a general utility curve for money which has a downward slope."). Commentators have noted that while the declining utility of income is difficult to prove empirically, it likely is still a valid theory. See McMahon & Abreu, supra note 61.

70. Note that the curve does not take into account a taxpayer's relative wealth. That is, the utility of earning $100,000 will be different for a wealthy person than the utility of earning that amount by a taxpayer with very little wealth. However, this country has adopted an income tax, and therefore wealth considerations do not affect that tax rate schedule. Also, while far from a perfect correlation, those who have larger income often have greater wealth.
curve for each individual, and, even if it were feasible, it would not necessarily be desirable to do so. Instead, the tax rates are set for the entire populace. The tax rate schedule can be described as reflecting a standardized crude utility curve for the nation.\textsuperscript{71}

In the author's opinion, the equal sacrifice theory provides the most compelling argument for progressivity.

IV. THE ROLE OF EXEMPTIONS AND THE ADDITIONAL STANDARD DEDUCTION

The Internal Revenue Code provides a personal exemption for each individual.\textsuperscript{72} This exemption constitutes an income tax deduction of a specified amount.\textsuperscript{73} The effect of allowing this deduction is the application of a zero rate of tax to that amount of income. The personal exemption is merely part of the tax rate schedule, although it is framed in the form of a deduction. Labeling it a deduction does not change the fact that it is actually part of the rate schedule.\textsuperscript{74}

In addition to a personal exemption, an individual may be given an exemption deduction for a spouse if the two do not file a joint return. An

\textsuperscript{71} See Blum & Kalven, supra note 49, at 456 ("[I]n a fashion reminiscent of the law's use of the reasonable man standard, the doctrine [of equal sacrifice] seeks to abstract out individual differences and to make assumptions about the reactions to money that men have in common.").


\textsuperscript{73} See I.R.C. § 151(d).

\textsuperscript{74} Section 151(d)(3) purports to phase out the exemption deduction if the taxpayer's adjusted gross income exceeds a specified threshold amount. While couched in the form of a reduction, or even elimination, of the exemption deduction, the so-called phaseout is actually an increase in the tax rate for income above the threshold amount. The effect of this provision is exactly the same as providing that the tax rate on income above the threshold amount is increased by $X$ percent until the income reaches a specified level, after which the tax rate on income above that level reverts to the prior rate. The so-called "reduction" constitutes a bubble in the tax rate structure so that income within that bubble is taxed at a higher rate than both income that is below the threshold level and income that is above the figure at which the phaseout is complete. Congress employed the device of a "reduction" of the exemption deduction as a cloak to disguise a marginal increase in the rate of tax on income within specified brackets. This phaseout provision itself is scheduled to be phased out in the years beginning after 2005. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-84, § 102(a), 115 Stat. 44 (June 7, 2001) [hereinafter EGTRRA] (adding I.R.C. § 151(d)(3)(E),(F)). The amount of the personal exemption that is phased out under current law is scheduled to be reduced for the years between 2006 and 2009, and is scheduled for complete repeal after 2009. However, due to a sunset provision, this repeal of the phaseout will itself terminate after 2010 unless Congress extends the repeal.
individual also is allowed exemption deductions for certain dependents. The addition of these exemptions constitutes an increase in the taxpayer's zero bracket. In other words, a larger amount of the taxpayer's income is taxed at a zero rate. These exemptions are provided because the standardized utility curve, as reflected in the tax rate schedule, does not reflect the reality that the amount needed for subsistence for an individual who is supporting a spouse and dependents is greater than the amount needed by an individual who has neither a spouse nor dependents. The additional exemptions are adjustments to the tax rate schedule in order to reflect the difference between the utility curve for such persons and the curve for those who have no such expenses. These exemptions constitute a modest modification of the rate schedule in recognition of the need to make a crude adjustment to the standardized utility curve on which the rate schedule is based.

It is noteworthy that the Code provides an addition to the standard deduction that is allowed to a taxpayer who is blind or who is older than sixty-four, and an addition if the taxpayer's spouse is blind or over the age of sixty-four. The Joint Committee on Taxation treats these additional standard deductions for being blind or aged as tax expenditures. But, these additional deductions serve the same function as described above for the spousal and dependency exemptions. They reflect the fact that when a person or her spouse is blind or aged, she has greater subsistence expenses than do those who are sighted or young. The additional deduction is merely an alteration of the rate schedule to provide a larger zero bracket for persons whose utility curve does not conform to the standardized norm. While it is not feasible to structure individualized utility curves for every individual, rough adjustments can be made for identifiable circumstances which are fairly common occurrences. The fact that the additional standard deduction is not available to taxpayers who choose to itemize their deductions does not change the nature of that additional deduction. It is merely one more demonstration that when Congress decided to raise tax rates on higher incomes, it sought to disguise the fact that it was doing so.

75. See I.R.C. § 151(b), (c).
76. See Turnier, Evaluating Personal Deductions, supra note 40, at 280 ("Personal exemptions, dependent deductions, and the zero bracket amount provide an adequate means of allowing for basic expenditures for food and shelter.").
77. See I.R.C. § 63(f) (1994).
78. See JCT Tax Expenditures, supra note 14, at 23.
A. Medical Expenses

1. The Andrews Article

Medical expenses are itemized deductions to the extent that the aggregate amount of such unreimbursed expenses in a taxable year exceeds 7.5% of the taxpayer’s adjusted gross income. Thus, there is a statutory floor for the allowance of a medical expense deduction, and only the unreimbursed medical expenses in excess of that floor are deductible. These expenses are not miscellaneous itemized deductions, and therefore are not subject to the 2% of adjusted gross income floor imposed by section 67(a).

Also, the medical expense deduction is not subject to the overall limitation on itemized deductions that is imposed by section 68.

The medical expense deduction is listed as a tax expenditure in the Joint Committee on Taxation’s report. In his 1972 article, Professor Andrews argued that the deduction is consistent with tax principles. Andrews argued that while the Haig-Simons definition of income is accumulation of wealth plus consumption, a deduction for certain types of personal expenditures

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79. See I.R.C. § 213(a) (1994). Note that medical expenses may be deducted for alternative minimum tax purposes only to the extent that they exceed 10% of the taxpayer’s adjusted gross income. See I.R.C. § 56(b)(1)(F) (1994).


81. See I.R.C. § 68(c)(1) (1994). The overall limitation on itemized deductions is scheduled to be phased out for years beginning after 2005 and completely eliminated for years beginning after 2009. See EGTRRA § 103(a) (adding I.R.C. § 68(f), (g)). However, due to a sunset provision, this phaseout will itself terminate after 2010 unless Congress votes to extend the repeal.


83. See Andrews, supra note 19.
brings the tax system closer to the ideal tax base. With respect to the medical expense deduction, Andrews stated:

I believe we can come to a better understanding of this deduction, and of what an ideal personal income tax would be like, by asking whether there are good, intrinsic reasons for elaborating the notion of taxable consumption—the consumption component of taxable personal income—in a way that excludes medical services, so that the medical expense deduction is a device for approaching the ideal, not a departure from it.

Andrews began his examination of the medical expense deduction by noting that the tax expenditure budget treats medical services in an inconsistent manner. At the time of the article by Andrews, the tax expenditure budget included in its list of tax expenditures the medical expense deduction and medical services provided as a fringe benefit for employment. However, the benefit derived from the receipt of medical services provided by charity or government welfare programs are excluded from the budget. Andrews also notes that a tort victim is not taxed on medical service expenses that are reimbursed by the tortfeasor.

Professor Andrews used the example of the reimbursement of expenses by the tortfeasor as the proof of his main argument. The tort victim is not taxed on such receipts because they merely return the taxpayer to the position the taxpayer held before the injury occurred. Andrews believed that the same considerations apply when the taxpayer himself bears the cost:

The critical nexus between injury and treatment does not depend on the fact that the tortfeasor provides the treatment, but on the fact that the treatment only puts the taxpayer back where others are who have suffered no injury. If we are willing to say that one has had no taxable gain when he suffers an injury and then receives treatment, we should say it in every case, whatever the source of payment for the

84. See id. at 331. But if we take it seriously that the ultimate purpose is to apportion tax burdens in uniform, graduated relation to real consumption and accumulation, then we must be willing, in principle at least, to consider whether there are some expenditures for which a deduction should be allowed because the concept of consumption can be better elaborated as part of an ideal tax base if the item purchased with the expenditure is excluded than if it is included.

Id.

85. Id. at 333.
86. See id. at 314.
87. See I.R.C. § 104(a) (1994). This exclusion is not listed in the current tax expenditure budget. See I.R.C. § 104(a) (1994). This exclusion is not listed in the current tax expenditure budget. See I.R.C. § 104(a) (1994).
treatment—whether or not the tortfeasor pays, whether or not there is a tortfeasor, indeed whether the taxpayer's malady is a traumatic injury or an organic disease.\textsuperscript{90}

Therefore, while Andrews notes that medical expenses have the characteristics of personal consumption expenditures since the person is using up scarce resources,\textsuperscript{91} he stresses that use of consumption as a tax base is an attempt to measure "material well-being and taxable capacity."\textsuperscript{92} A person who incurs medical expenses is not in good health and the expense is meant to put the taxpayer back to a healthy well-being.\textsuperscript{93} For example, assume $A$ earns $80,000 and is perfectly healthy. $B$ earns $100,000 but is unwell and must spend $20,000 in order to get back to the healthy state that $A$ already enjoys. If we ignore the floor, the medical expense deduction allows these two taxpayers to be treated equally for tax purposes. Putting it differently and bringing to bear the doctrine of progressivity, the amount that $B$ spent on medical costs can be viewed as part of her subsistence cost to which a zero tax rate should be applied. Thus, $B$'s subsistence cost is greater than $A$'s who has no medical needs. It is appropriate to apply a different tax schedule to $B$, and the medical deduction accomplishes that.

2. Implementing the Principles of Progressivity

The medical deduction has been defended on several grounds: the approach taken by Andrews, the involuntary nature of the expenditure, and the reduction of ability to pay, which is related to the involuntariness ground.\textsuperscript{94} All of these have merit. In addition to these, the principles that underlie the adoption of a progressive rate structure strongly support the allowance of a medical expense deduction.

In theory, the tax rate structure is designed to permit the retention of sufficient income to meet the subsistence needs that an individual has plus a

\textsuperscript{90} Andrews, supra note 19, at 334.

\textsuperscript{91} See supra Part II. Recall that the income tax is a tax on personal consumption and the present value of future consumption.

\textsuperscript{92} Andrews, supra note 19, at 335.

\textsuperscript{93} Other authors have argued that medical expenses are similar to casualty losses, which are deductible under §165. See Marvin A. Chirelstein, Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts 167, 170 (8th ed. 1999). The theory is that a deduction is proper because the medical expense, like the casualty loss, is unexpected and involuntary. Professor Andrews also refers to the involuntary nature of medical costs in his defense of the deduction. See Andrews, supra note 19, at 336.

\textsuperscript{94} See Turnier, Personal Deductions and Tax Reform, supra note 40, at 1730 ("Because of the significant involuntary nature of medical expenses . . . continuation of the deduction indeed is of great significance if one wishes to design an income tax system predicated upon ability to pay.").
portion of the amounts in excess thereof. Thus, the personal exemptions provide a zero tax rate to the income needed for subsistence. While that amount is not adequate for subsistence, other provisions, such as the earned income credit, combine with the exemptions to insulate a larger amount from taxation. The utilization of a standardized utility curve as a reference for the tax rate schedule results in applying graduated rates to income above the insulated amount, thereby reflecting the declining utility of added amounts of income. Because the utility curve that the statutory rate structure represents is necessarily crude and standardized, it is appropriate to make adjustments for events that commonly occur, are readily identified, and result in a very different set of financial needs than those of the average taxpayer. Since most individuals suffer minor illnesses from time to time, a certain amount of medical expense is accommodated in the rate schedule as part of ordinary living expenses. However, a serious illness that requires large expenditures cannot be considered part of ordinary living expenses. It is reasonable to alter the tax rate schedule for persons who incur such large expenses in order to mitigate the harshness that applying a standardized utility curve would impose. The medical expense deduction is a rough adjustment to the rate schedule to reflect the greater utility that the dollars so expended have for a taxpayer in that condition. The adoption of a floor on the deduction of 7.5% of the taxpayer's adjusted gross income is the method by which Congress ensures that only expenses greatly in excess of everyday medical costs are deductible.

This analysis rests on the equal sacrifice justification for progressive tax rates. One might be tempted to argue that this analysis proves too much and that it would justify a change in the tax rate schedules for anyone who spent a sizeable amount of money. That is, any time a person spends money and does not thereby acquire an asset that could be liquidated for an equal amount, that person's utility curve for unspent income is altered. For example, A and B each earn $100,000. A spends $80,000 to take a pleasure cruise around the world, and B stays home and spends nothing on vacations. On account of A's expending so much on a vacation, A's utility for the remaining $20,000 of income he received is greater than B's utility for the same amount of dollars. Should a deduction be provided to reflect the change in utility? Obviously, the answer is "no," and the analysis above does not suggest otherwise. A's purchase of the vacation is merely an allocation of dollars that the rate schedule leaves to A for personal consumption purposes. The utility curve on

95. See Laura E. Cunningham, National Health Insurance and the Medical Deduction, 50 Tax L. Rev. 237, 245 (1995) ("In utilitarian terms, the deduction is necessary to equalize the marginal utility of income of a sick taxpayer and a healthy taxpayer who are otherwise similarly situated but for large medical expenses, that is, to put them on the same curve.").
which the rate schedule is based is a standardized curve that does not reflect
the appetite that any single individual might have for consumption.
Adjustments are to be made only for those events or conditions that elicit the
view that the application of the standardized curve in those circumstances
would be grossly inappropriate. For example, if a taxpayer has greater
subsistence expenses than the rate schedule contemplates because of certain
events such as the birth of a child or the need for medical treatment, that can
warrant making an adjustment to the rate schedule. It is a value judgment as
to whether the event or condition is one that merits a rate adjustment. But,
this adjustment is made on the basis of providing an equitable rate schedule
that carries out the principles of progressivity; it is not made to finance a
desired program. The equitable implementation of the principles of
progressivity do not create tax expenditures; instead, they are integral parts of
the progressive income tax system itself.

The medical expense deduction also is consistent with the redistributive
justification for progressivity. Persons who incur large medical expenses have
less disposable income available for redistribution, and therefore it is not a
departure from that principle to take those expenses into account in
determining how much of a taxpayer’s income to redistribute.

As discussed in more detail below, by utilizing a percentage of adjusted
gross income as a floor, rather than adopting a specified floor amount, the tax
law reflects the fact that persons with higher incomes, and thus with larger
disposable income, likely will spend more on medical matters than will those
with fewer resources.\footnote{Professor Andrews, while noting the existence of the 3% of adjusted gross income
floor that was in place at that time, did not use the floor to justify his conclusions.} Also, by utilizing a percentage of adjusted gross
income, the Code deals with the fact that medical expenses can include items
that have some pleasurable attributes and that high income taxpayers are more
likely to expend more for such items. In the author’s opinion, the adoption of
7.5% of adjusted gross income as the floor is too high, but the principle of
using a percentage of adjusted gross income as a floor is valid.

3. The Kelman Response

In his 1979 article, Professor Kelman raised several objections to
Professor Andrews’ defense of the medical expense deduction.\footnote{See Kelman, \textit{supra} note 8.} For example, Professor Kelman objected to Andrews’ resort to the involuntariness of
medical expenses as a defense for the deduction. Kelman argued that there is
a considerable degree of voluntariness in the taxpayer’s choice of how much
to spend on medical treatment and the type of treatment to seek. According to Kelman, this problem is aggravated by the fact that some medical expenses can also provide pleasurable benefits. For example, the addition of an air conditioning unit to relieve a medical condition also can provide comfort in hot weather, and the addition of a swimming pool to the taxpayer's house can provide pleasurable as well as therapeutic benefits.

The short answer to this objection is that the medical expense is in the same position in that respect as are business expenses that are clearly deductible. A taxpayer can choose how much to expend on her business ventures. The taxpayer's power to control the amount expended does not change the business character of the expense or its deductibility. If a taxpayer travels on business, she can travel first class or she can travel economy class. She can dine at McDonald's or she can dine at an upscale restaurant, so long as it is not lavish or extravagant. Business is conducted by human beings, and consequently it is not always possible to disentangle the personal element of an expense from the business element. That is not true of all business expenses, but it is true of some of them. Similarly, many medical expenses provide no pleasurable benefits while others do. Those that do have the same characteristics as business expenses that provide some pleasure.

Professor Kelman discounted the business expense/medical expense analogy for two reasons. First, he believed that the tax system must allow some deduction for business expenses because the determination of net income, as a general rule, incorporates a reduction for the cost of earning income. Second, he believed that the administrative cost of determining whether the taxpayer had mixed motives for expenses incurred in her business is too great to require that that differentiation be made. Kelman argued that these same two reasons do not apply to medical expenses. Concerning his first point for business expenses, Kelman classified the medical expense deduction as, "at best an unusual attempt to refine the tax base to account for psychic income" and therefore not integral to the tax system. As to his second consideration, Kelman believed that the administrative difficulties of separating personal from medical motives are not as great as those in the business expense area. He suggested that allowing a deduction of a specified amount for specific ailments could solve that problem.
Professor Kelman’s arguments do not contravene the thesis of this article. His arguments concern the question of whether, as a matter of good policy, the medical expense deduction should be retained rather than whether the deduction is nonneutral. Kelman does imply that the deduction of some medical costs cannot be justified as neutral. Even if that were so, that does not make the allowance of a deduction for all medical costs nonneutral. Congress could decide that the amount of such expenses that are nonneutral, assuming arguendo that there are any, are relatively minor, and that the administrative costs of segregating such items from those that are neutral are too great to warrant an individualized identification of them. Instead, Congress has dealt with this matter by imposing a floor on the deduction which can be seen as an administratively feasible way of disallowing a deduction for personal expenses that are disguised as medical costs. Whatever one thinks of the merits of those Congressional choices, that does not go to the question of whether the deduction is a tax expenditure. Indeed, although it is a bit unclear, there is some reason to believe that Kelman himself does not regard medical expenses as tax expenditures.\textsuperscript{104} Regardless, the author has addressed Kelman’s arguments in this article because they are commonly considered when this issue arises and because Kelman did raise baseline issues concerning some medical expenses.

Moreover, the use of a percentage of adjusted gross income as the floor for medical expense deductions addresses Kelman’s concern. As discussed above, the use of a floor based on adjusted gross income, rather than a flat amount, takes into account the fact that wealthier taxpayers are more likely to have medical expenses that may have some pleasurable aspects. The justification for using such a crude adjustment is the avoidance of administrative cost—the same justification that Professor Kelman had for his

\textsuperscript{104} See id. at 833. Near the beginning of his piece, Kelman states:

In place of the tax expenditure concept, Professor Andrews approves the charitable and medical deductions for reasons “intrinsic” to the tax system: The government can measure the taxpayer’s very capacity to pay taxes, and the extent of the claims the tax system can justly make on her, only after excluding certain categories of uses from the tax base. My basic dispute with Professor Andrews concerns what constitutes the appropriate tax base.

Id. (citation omitted). Later in the piece, Kelman states that he explicitly rejects the “tax expenditure argument[].” Id. at 855. The fact that Kelman disputes the tax base of Andrews suggests that Kelman does not believe that these deductions should be considered nonneutral.
proposed substitution of a standardized amount of deduction for specified ailments. 105

Professor Kelman also argued that a medical expense deduction should not be allowed to taxpayers because he believes that some medical conditions are a result of a voluntary past action of the taxpayer. Kelman uses an example of two smokers, A and B. A quits smoking, does not contract cancer, but loses the pleasure that she had when she was smoking. B, on the other hand, continues to smoke, contracts cancer, and takes medical expense deductions for the cost of the resulting medical care. Kelman thus suggested that perhaps the ideal baseline proposed by Andrews should be modified "to include ordinary taxable consumption and health and pleasure from . . . risky activities: A deduction for the loss of health without inclusion of the gains from risky activities will mismeasure how relatively well-off the two taxpayers are." 106

The implication of Professor Kelman's points is that either the exclusion from tax of the value of the pleasure obtained from engaging in excessively risky activities 107 should be listed as a tax expenditure or the current allowance of a deduction for medical expenses that are attributable to risky behavior should be so listed. Obviously, there would be enormous administrative difficulties and cost in classifying which activities are risky and which are not, in determining whether a taxpayer has engaged in such excessively risky activities, and, in the case of taxing the pleasure obtained from such activities, in placing a dollar value on that pleasure. It would not be feasible to enforce either of those provisions, i.e., the taxation of pleasure or the denial of

105. For a comparable resolution of a similar issue in the business expense area, see I.R.C. § 274(n), which limits the deductibility of business meals and business entertainment expenses to 50% of the cost. See I.R.C. § 274(n) (1994). Thus, Congress recognized that while those expenses had valid business purposes, the taxpayer also had personal enjoyment therefrom, and the meal consumed substituted for a personal expense that the taxpayer otherwise would have incurred.

106. Kelman, supra note 8, at 869. It is interesting that Professor Kelman used the smoking example since one could argue that, with such a high cigarette tax, the government is taxing risky behavior just as Professor Kelman urged. This is especially so since the settlement between states and the cigarette manufacturers effectively amounts to a tax on the sale of cigarettes, since the settlement costs will be passed through to consumers in the form of higher prices. See also Hanoch Dagan & James J. White, Governments, Citizens, and Injurious Industries, 75 N.Y.U. L. REV. 354 (2000).

107. Kelman refers only to "risky" activities, but it is inconceivable that he means thereby to include the normal risks that attend everyday activities. If A walks to the local market four blocks from her New York apartment, she incurs traffic risks and is exposed to a risk of assault even if she lives in a safe neighborhood. Kelman cannot refer to these risks, but rather must mean risks that go beyond those that are part of ordinary life. He does not indicate how far beyond ordinary risk an activity must be to fall within his classification.
deductions for selected medical expenses. Professor Kelman does not suggest that the tax system should undertake that task. To the contrary, his point is that in light of those tax expenditure items and the administrative infeasibility of reaching them in the tax system, no deduction should be allowed for any medical expenses. But, since risky activities cannot be singled out due to administrative difficulties, the failure to tax those items is not a tax expenditure. Tax expenditures refer to provisions in the tax law that aid specific persons or industries; they do not refer to provisions that serve functions which are integral elements of the tax system itself. Taxation is a practical scheme, and adjustments made to the tax system because of administrative costs or difficulties are part of that system and not departures to carry out an unrelated program.\footnote{108} In the case of excessively risky activities, the administrative difficulties that would accompany any effort to tax them, or to deny deductions for medical expenses attributable to them, would not merely be costly; it would not be feasible to administer.

Professor Kelman concluded that the practical inability to single out medical expenses that are attributable to risky behavior contravenes Andrews’ argument that a medical expense deduction is justified under an ideal tax system.\footnote{109} As noted above, administrative difficulties are not a tax expenditure issue. They do, however, raise a legitimate legislative issue as to whether the difficulty warrants eliminating the deduction entirely, as Kelman would have it, or ignoring the problem as a relatively minor element. Reasonable people can disagree on that issue, but it is not a question of tax neutrality and has no bearing on the tax expenditure issue.

While there can be little doubt that the segregation of risky activities for tax purposes would pose horrendous administrative costs, there are other valid reasons that a distinction should not be made. An identification and application of different tax treatments for medical expenses that are attributable to risky behavior would contravene an important principle of government, which includes the tax system. It is undesirable to have a government agency, i.e., the Internal Revenue Service, inquire into a person’s private life to determine whether medical expenses were caused by some type of past behavior or to tax that behavior for the pleasure derived thereby. It would be highly intrusive for the Internal Revenue Service to examine the type of food that taxpayers with heart disease had previously consumed, to see if the taxpayer had eaten high cholesterol foods, or the way that taxpayers

\footnote{108. For example, unrealized appreciation that occurred during a year would fit under the Haig-Simons definition of income. Yet, all of the tax expenditure budgets accept that the realization requirement is an integral part of our tax system and is not nonneutral. A major reason is the administrative difficulties that an attempt to tax that appreciation would generate.}

\footnote{109. See Kelman, supra note 8.}
conducted their private lives. Government inquiry of that sort raises the specter of George Orwell's "Big Brother." The concern for protecting privacy is reflected in numerous tax provisions. For example, consider the criteria for determining whether a noncompensated transfer of property constitutes a gift. The determination could have been made to rest on the basis of the actual relationship between the transferor and the transferee, i.e., how friendly or intimate they are. But, that would have required the government to inquire into a very private aspect of peoples' lives. Instead, the determination was made to rest on the intention that the transferor had for making the transfer—a subjective, but less intrusive, inquiry. Similarly, consider the tax law determination of whether stock holdings of certain taxpayers should be aggregated and treated as if held by a single person. Instead of examining the actual relationships of the parties, the Code applies stock attribution rules which turn on the objective status of the parties, regardless of how hostile or friendly they may be. Thus, a rule to disallow deductions on the basis of past activity of a very personal nature, or to tax the pleasure derived from that activity, would contravene one of the basic principles of the tax system, and indeed of the operation of government itself.

As noted above, taxation of excessively risky activities raises another concern. In order to implement such tax treatment either to tax risky activities or to deny deductions for their consequences, the government would need to determine what activities should be classified as overly risky. Would skiing be considered an overly risky activity so that a person who broke her leg while engaging in the sport would not qualify for the medical expense deduction? If a person is injured in an automobile accident while riding in a car that possesses less than the best safety record, would no deduction be allowed? How much variance from the maximum safety conditions is permissible? The setting of such standards necessarily invokes arbitrary line drawing and is inappropriate for a governmental body to utilize in passing on the conduct of citizens in their everyday life.

This discussion is not meant to argue the conclusion that Congress must allow a deduction for medical expenses. Nor does it advocate the position that if Congress allows a deduction, it should not impose limitations on the amount thereof in order to accommodate the concerns expressed by Professor Kelman or to accommodate other concerns. Those issues should be considered and resolved on their merits. However, they have no relevance to the question of whether medical expense deductions are part of a normal income tax system—i.e., whether the medical expense deduction conforms with the

110. See GEORGE ORWELL, 1984 (1949).
principles that underlie the progressive income tax structure. The consequence of characterizing the medical expense deduction as a nonneutral provision or, in other words, as a tax expenditure, is to impose a greater burden of persuasion on those who would retain the deduction in the Code. There is no reason to impose a heavier burden on persons on either side of that issue. The question of the retention of the medical expense deduction should be resolved in the light of social, political, and economic policies. The analysis should not be skewed by branding the deduction with a scarlet letter by listing it in the tax expenditure budget.

4. Medical Insurance Receipt

In addition to a medical expense deduction, the Code also excludes from income amounts received because of an illness or injury through a medical insurance policy.\(^{113}\) The exclusion of such amounts is comparable to allowing a deduction for the medical expenses that the insurance company reimburses, except that there is no floor imposed on the amount excluded. The conclusion that the medical expense deduction does not lie outside of tax principles applies equally to the exclusion of medical insurance proceeds for the same reasons. The absence of a floor does not alter the character of the exclusion as being within tax principles; instead it raises a question as to why such medical reimbursements are given more favorable tax treatment than is accorded to the taxpayer’s direct payment of the medical expenses, which is subject to a 7.5% floor. One possible justification for the difference in treatment between medical expenses and medical reimbursements is that medical reimbursements are subject to the scrutiny and veto of an independent third party, the insurer, and that check on the amounts expended minimizes the risks of expenditures being greater than needed. Still, there is a question of whether no floor, rather than a lower floor than that used for medical expenses, is appropriate. This question of the difference in treatment should be examined and resolved on its merits, but the resolution of that issue should not be influenced by characterizing the exclusion as being outside of the ideal or normal tax structure.

Another issue is whether the fact that medical insurance premiums paid by the taxpayer may have been deducted as medical expenses, if the aggregate amount of taxpayer’s medical expenses exceeded the floor and the taxpayer itemized her deductions, should cause some of the insurance proceeds to be taxed as a kind of recapture of the prior deductions. One aspect of this issue


is that, because of the floor, premiums often are not deducted, and there is a substantial administrative cost to determining if deductions were taken and in what amounts. An even more important obstacle is the difficulty of determining the extent, if any, to which current insurance receipts are attributable to premiums paid in prior years. For example, if X received $100,000 in medical reimbursement payments from a policy that she had held and paid premiums thereon for thirty-five years, arguably none of the insurance proceeds is attributable to premiums paid in prior years. If X had changed insurers for the current year and had bought a new medical insurance policy, there would be no basis for treating part of the insurance proceeds as a recapture of payments made to the previous insurer. The most that could be said to be recaptured is the premium paid for coverage in the period in which the cost was incurred. The result should be the same when no change of insurer has been made. This issue also should be resolved on its merits. The same issue arises when the insurance premiums were paid by the taxpayer’s employer and excluded from the taxpayer’s income under section 106. There are arguments to be made on both sides of those issues, but the tax expenditure concept does not provide any help in resolving them.

The exclusion from an employee’s income of premiums paid by the employer also is akin to allowing a deduction for the premium payment without any floor on the amount that is deductible.114 What justification is there for imposing a floor on the deduction for premiums that are paid directly by an individual when no floor is imposed when the premiums are paid by the employer? There seems to be no justification for the difference in treatment. It is noteworthy that prior to 1983, the tax law allowed an itemized deduction, not to exceed $150, for one-half of the medical insurance premiums that were paid by an individual, and there was no floor on the deductibility of those payments.115

Note that the statutory exclusion from income of payments received on medical insurance coverage because of an illness or injury is not listed in the Joint Committee on Taxation’s tax expenditure budget. As shown above, there is no real difference between a deduction for medical expenses and the exclusion of medical reimbursements. Therefore, the Joint Committee on Taxation, in determining what should be considered nonneutral for purposes of the tax expenditure budget, appears to be acting arbitrarily by labeling the medical deduction nonneutral and the exclusion of medical reimbursements neutral. This unwarranted difference in treatment adds support for opponents of the tax expenditure concept.

B. Casualty and Theft Losses

Section 165(c)(3) grants a deduction for a casualty or theft loss suffered by property that was not connected with a trade or business or with a transaction entered into for profit. The losses from such casualties and thefts are sometimes referred to as "personal casualty loss[es]." In most cases, the deduction for personal casualty losses will be an itemized deduction, but it will not be a miscellaneous itemized deduction and will not be subject to the section 68 overall limitation on itemized deductions.

There are limitations on the amount of deduction that is allowable for personal casualty losses. One limitation is that no deduction is allowable to the extent that the taxpayer is reimbursed for the loss or has a reasonable prospect of being reimbursed. Also, there are two floors that limit the amount of deduction that can be taken. For each personal casualty or theft, $100 of the loss is not deductible. The remaining amount of such losses can be deducted to the extent that the taxpayer has personal casualty gains. The aggregate personal casualty loss in excess of the taxpayer's aggregate personal casualty gain is deductible only to the extent that the amount of that excess exceeds 10% of the taxpayer's adjusted gross income.

The Joint Committee on Taxation's 2001 report lists the deduction for personal casualty and theft losses as a tax expenditure. The rationale for that characterization is that, since the property that was damaged or destroyed was not used in a business or profit-oriented activity, the loss can be viewed as attributable to the consumption of a good that was acquired and held for noncommercial reasons. In other words, part of the cost of possessing an asset for personal reasons is the risk that it might be damaged or stolen, and so the loss can be seen as attendant to the consumption of that item.

However, a stronger case can be made that these deductions are not tax expenditures. A taxpayer's purchase of an asset for personal use is a nondeductible expenditure. The exhaustion of the asset by the taxpayer's use does not create any deductions because the taxpayer is consuming the

118. To the extent that a taxpayer's personal casualty losses do not exceed his personal casualty gains, they will be nonitemized deductions. See I.R.C. § 165(h)(4)(A).
119. See I.R.C. §§ 67(b)(3), 68(c)(3).
121. See I.R.C. § 165(h)(1).
124. See JCT TAX EXPENDITURES, supra note 14, at 23. The tax expenditure budget also includes casualty loss deductions that offset casualty gains.
asset within the meaning of the Haig-Simons definition of income. But, if the
value of the asset is reduced or destroyed by a casualty or theft, that loss is not
attributable to the taxpayer's use of the asset. Rather, it is the consequence of
the intervention of an external force. It is true that the taxpayer would not
have incurred that loss but for her acquisition of the asset for personal use; but
it was not the use itself that caused the loss. Even if the loss from the casualty
or theft was treated as a consumption by the taxpayer of that asset, it would
not be a consumption from which the taxpayer derived any benefit.

Putting it another way, if the exhaustion of a societal good is attributable
to a taxpayer's use of the item, there is a justification for taxing the taxpayer
for having used up that portion of society's goods. But, when an item is
destroyed by a casualty or theft, while it is lost to society, it is not lost due to
the taxpayer's enjoyment of the item. The societal loss would have been the
same if the item had been owned by a museum when it was destroyed. The
happenstance that the item was owned by a taxpayer when it was destroyed
was not a factor in the loss that society incurred.¹²⁵

There is an additional compelling reason that the deduction for a loss due
to theft is not a tax expenditure. As previously noted, the tax on income is a
surrogate for taxing the depletion of societal goods, or the power to consume
and thereby use up goods in the future, but stolen items are not removed from
the pool of society resources. When a taxpayer transfers cash or other
property to someone for the performance of a service, the loss to society is the
services that the taxpayer received and used up. Society has not lost the
property received by the service provider since that property remains intact.
In the case of a theft, the stolen property remains intact, and no services were
provided to the taxpayer so none were used up.

The proper tax treatment of theft or casualty losses can be put into focus
by comparing the relative positions of two taxpayers, A and B. A and B have
the same amount of income, the same amount of wealth, and each purchases
a painting for $100,000. The purpose of their acquisitions is personal
enjoyment rather than investment. Both A and B utilize earnings that
previously have been taxed to purchase their paintings. Since each has paid
tax on the $100,000 of income that is used to purchase the painting, each is
entitled to consume that amount without incurring any additional tax. A and
B each displays the painting in her home. A fire in A's home, caused by a
faulty electrical wire, destroys A's painting, which is uninsured and which still
had a value of $100,000 at the time of its destruction. This is a personal

¹²⁵ See Treas. Reg. § 1.165-7(a)(3)(i) (2001). If the loss was caused by a negligent act
of the taxpayer, tax law nevertheless allows a deduction, provided that the taxpayer's negligence
was not willful. While the case for a deduction is weaker when the damage is not caused by an
external force, the societal loss is not attributable to a benefit that the taxpayer enjoyed.
casualty loss. A has no personal casualty gains for that year. B continues to possess her painting, which has the same value of $100,000. In determining the tax rates to be applied to the incomes of A and B, should the rate schedule for both be based on the same utility curve? A has lost the opportunity to consume the $100,000 that she invested in the painting, but B still can sell the painting and use the proceeds to purchase consumable goods or services. The fire altered A's financial position so that she and B no longer occupy similar economic status. It is appropriate for some adjustment to be made to the rate schedule that is applied to A to reflect the fact that she has less disposable wealth than does B and therefore will attach greater value to additional dollars of income than will B. One way to alter the tax rate schedule for A is to provide A with some amount of deduction for her loss. The tax law limits A's deduction to the amount by which the loss exceeds the sum of 10% of her adjusted gross income and $100. Thus, only unusually large casualty losses are deductible and only to the extent that such losses exceed a substantial floor. This reflects the fact that some casualty loss is expected in everyday life and is accounted for in the standardized rate schedule.

One could argue that the loss of wealth due to a casualty or theft should not be taken into account for tax purposes because this country's tax system is an income tax rather than a wealth tax, and so no adjustment is made to income tax rates because of the disparities of wealth among taxpayers. If tax rates were adjusted for disparities of wealth, that would incorporate a wealth tax system. A casualty or theft loss, however, raises additional considerations. The lost item represents an investment of after-tax dollars—that is, the taxpayer, or her predecessor, paid income tax on the dollars that were lost and so the taxpayer is entitled to consume those dollars without incurring any additional tax. The loss of that item due to an unexpected and sudden event disables the taxpayer from further consumption of the lost items or money. By allowing a deduction for the lost item, the taxpayer is able to consume an amount equal to that which was lost without incurring any additional tax. In other words, the deduction insulates that amount of income from taxation and thereby allows the taxpayer to use that amount for consumption purposes just as the taxpayer could have used the lost item for such purposes. The taxpayer never got to partake of the consumption, the right for which she had paid a tax, and the deduction protects the taxpayer's right to that consumption. It is a matter of policy whether the taxpayer's right to use that amount for consumption should be protected by the income tax system, but that is an issue that goes to the structure of the tax system rather than to a programmatic purpose.

126. See supra note 70 for an explanation.
Another example is worth considering. A, a cash method taxpayer, provides services for which she is entitled to be paid $100,000. Payment is to be made by a cashier at the employer's office building. A goes to the cashier and collects $100,000 in cash. When A collects the $100,000, it is included in her gross income for that year. As A leaves the building, she is mugged, and the thief takes A's $100,000. If no deduction is allowed A, she will be taxed on the $100,000 income that she held for less than a minute. In no sense can A be said to have consumed the $100,000.

If the theft of the cash had not occurred, and if A had promptly gone to an art store and used the $100,000 to purchase a painting for that amount, and if on leaving the art store, A was mugged and the painting stolen, there is no more reason to treat A as having consumed the painting than A can be said to have consumed the $100,000 cash in the previous hypothetical.127 Similarly, if A took the painting home where it was destroyed that night by a fire, the painting cannot be said to have been lost to society by A's use or consumption of it.

The allowance of a deduction for a casualty or theft loss conforms to the policy justifications for a progressive income tax under both the equal sacrifice theory or the redistributive justification theory. In the case of the former policy justification, the income that A received will be more valuable to him than the same amount of income that B received, and it is appropriate for the tax system to take that into account so as to equalize sacrifice. In the case of the latter policy justification, A has less wealth to redistribute than B has, and so less should be taken from A in the form of a tax.

C. Charitable Contributions

Section 170 provides a tax deduction for gifts to qualified charitable organizations.128 There is a ceiling on the amount of deduction that is allowable, and there are requirements that must be met for a gift to qualify for the deduction. The deduction must be itemized and is subject to the overall limitation on itemized deductions imposed by section 68.129 However, it does not constitute a miscellaneous itemized deduction.130 The charitable deduction under section 170 is listed as a tax expenditure in the Joint Committee on

127. See Turnier, Evaluating Personal Deductions, supra note 40, at 272 n.49 (arguing that the Code's treatment of property as being consumed when it was initially acquired is inconsistent with the Code's treatment of business capital goods, which must be depreciated over a period of years).
129. See supra note 81 for a discussion of the phaseout of the limitation.
130. See I.R.C. § 67(b)(4).

Some commentators have criticized the charitable deduction. The deduction has been called a "matching program" where the government effectively matches a part of the gift given by the taxpayer on account of the deduction. However, commentators have noted that there is no government oversight of how the government's "matching" funds are used.

As many commentators have noted, the key question here is whether a charitable contribution constitutes a personal consumption. The resolution of this issue rests on the previously discussed Haig-Simons definition of income, which equates income with accumulation of wealth plus the market value of personal consumption. If a charitable contribution represents an item that is neither accumulated nor personally consumed, then it is not within the Haig-Simons definition of income. Since the two principal commentaries on this issue were written by Professors Andrews and Kelman, respectively, let us first examine what they said. After considering those commentaries, the author will propose an alternative and independent reason that the deduction does not contravene neutrality.

1. The Andrews Article

Professor Andrews contended that the charitable deduction is not contrary to neutral tax principles. In support of his position, he set forth the example of a taxpayer who donates money to a charitable organization that redistributes such amounts to the poor. Andrews argued that, in this case,

131. See JCT TAX EXPENDITURES, supra note 14, at 21-22 (splitting the deductions into three groups: (1) charitable contributions to educational institutions, (2) charitable contributions to health organizations, and (3) all other charitable contributions).

132. See RICHARD GOODE, THE INDIVIDUAL INCOME TAX 162 (rev. ed. 1976). It is an exaggeration to say that there is no oversight. There is some government oversight since charitable contributions are allowed only when donated to § 501(c)(3) organizations which qualify for the approval of the Internal Revenue Service. However, there is no government oversight as to how the specific funds donated by the taxpayer are used. Section 501(c)(3) merely looks to the stated overall purpose of the organization and to the general uses to which its funds are put.

Commentators also have argued that charitable organizations that receive deductible contributions from taxpayers should be subject to the same federal civil rights laws to which groups that receive direct federal assistance are subject. See, e.g., David A. Brennen, Tax Expenditures, Social Justice, and Civil Rights: Expanding the Scope of Civil Rights Laws to Apply to Tax-Exempt Charities, 2001 BYU L. REV. 167, 170-71.

133. See, e.g., Andrews, supra note 19.

134. See id. at 345.

135. See id. at 347.
“the consumption or accumulation of real goods and services represented by the funds” are shifted from the taxpayer to the poor. Since the taxpayer is not consuming or accumulating the donated money, the taxpayer should not be subject to taxation on it.

Professor Andrews also noted that the charitable deduction equalizes the treatment between taxpayers that donate their income to charitable organizations and taxpayers that donate their services. He used the example of a doctor who chooses to donate her services one day a week to a clinic for low-income patients. The doctor is not taxed on the value of her services. However, a tax lawyer, who is equally as generous as the doctor but without the same useful skills, may donate part of her income to the clinic to pay for services that the clinic requires. Andrews argued that the tax lawyer and the doctor should be treated the same by the tax laws, and granting a charitable deduction to the tax lawyer puts them in equal tax positions. Professor Andrews acknowledged that imputed income is never taxed when the service provider receives nothing in return, and the failure to tax the doctor is merely one application of that general principle. But, Andrews argued that the failure to tax imputed income is a function of not taxing household services because of practical considerations rather than that of a tax principle.

Andrews argued that the restraint against taxing household services does not apply to services performed for charitable organizations, and, as a result,

136. *Id.* The same argument could be said to apply to gifts to family and friends, i.e., the taxpayer is shifting the income to other persons. However, the taxpayer does get some consumption benefit from the vicarious enjoyment derived from the donated use of the gift, and there is the practical consideration that treating family gifts in this manner would facilitate tax evasion via income shifting. Nevertheless, Professor Andrews compared the treatment of the charitable deduction with ordinary family gifts, stating that, “[i]deally, perhaps, the tax should be on the donee rather than the donor,” but he notes the contrary considerations of the simplicity of taxing the donor and the income shifting problem. *Id.* at 348. Professor Andrews also argued “that consumption is largely a household rather than an individual function,” and therefore the household is the appropriate unit for determination of the applicable tax rate. *Id.* at 349.

137. *See Andrews, supra* note 19, at 349.


139. *See id.* at 347.

140. *See id.*


142. *See id.* Professor Andrews noted that the earnings argument may not apply to charitable giving from investment income but noted that the deduction is still justified for equity reasons. *See Andrews, supra* note 19, at 371.

143. *See id.* at 352-53.

144. *See id.* at 352.

145. *See id.* at 353.
allowing a charitable deduction to the taxpayer places the doctor and lawyer in comparable positions.

Regardless of whether one accepts Professor Andrew's rationale for not taxing imputed income, there is a persuasive case for allowing the deduction to the lawyer. Creating an equal opportunity from a tax viewpoint for the lawyer to engage in the same charitable acts as the doctor is a matter of equity. It does not represent a subsidy or support for an activity but rather is an equalization of tax positions. The tax lawyer is in the same position as the doctor in that both wish to donate their time to the clinic that assists the poor. However, the tax lawyer, who, unlike the doctor, does not have skills that are particularly useful to the clinic, donates her time indirectly by performing legal services for third parties and then donating the income generated by those services to the clinic. The two taxpayers each are giving the clinic the value of their services, but the tax lawyer can do so only by giving the clinic the fruits of her labor. Therefore, it does not matter what the justification is for not taxing the doctor on imputed income; placing the lawyer on equal footing with the doctor implements a policy for equal treatment that conforms to the notion of horizontal equity that surely is a basic and neutral principle of tax policy. It also neutralizes the tax bias created by the tax system's failure to tax the imputed income of the doctor and, as discussed in more detail in the qualified residence interest discussion, a provision that attempts to equalize a tax bias should not be considered nonneutral.

Professor Andrews noted that his illustration of transferring money to the poor does not represent many of the types of donations for which a charitable deduction is allowed. Most charitable contributions go to churches, schools, museums, etc., and only a portion of those amounts go to the poor. However, Professor Andrews argued that the deduction is appropriate because the one thing these types of organizations do have in common is that they all produce "something in the nature of common or social goods or services." The donor is never the sole beneficiary of the services or goods provided by the charitable organization.

2. The Kelman Response

Professor Kelman responded that the donor is a meaningful beneficiary of her purported largesse because a donor typically obtains private benefits from making gifts. Kelman argued that the gift may provide the donor privileges with respect to the donee, such as a voice in the selection of the

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146. See id. at 356-57.
147. Id. at 357.
148. See Kelman, supra note 8.
music to be played by a symphony, or the availability of good seats for a performance that otherwise could not be obtained. Even if no benefit of that type is obtained from the donee organization, Kelman noted that unless the gift was anonymous, a charitable gift can enhance the donor’s standing in the community.\footnote{See id. at 849 ("Even if the donor is indifferent whether any particular donee (or charitable conduit or even social peer) responds to his gifts, his private feeling of satisfaction depends on some general reciprocal relationship between his inner self and his society’s traditional recognition of the worthiness of giving.")}. The considerations raised by Kelman illuminate the complex nature of human behavior. They are proper factors to be taken into account by legislators in determining whether, and to what extent, to allow a deduction for charitable gifts. However, they do not demonstrate that the deduction contravenes neutral tax policy. Allowing a deduction because of some of the aspects of a charitable gift is consistent with neutral tax principles. Granted, some other aspects of such gifts are not consistent with those principles. It is for the legislature to determine whether the inconsistent aspects are relatively minor and what influence they should have on the provision for a deduction.

To put this issue in focus, consider the tax law’s treatment of comparable occurrences in the context of business expenses. As previously discussed, many business expenses both provide private benefits to the taxpayer and serve business purposes. In determining whether to allow deductions for such expenses, Congress should weigh a number of factors, such as the relative importance of the expense to the conduct of the business, the potential for abuse, the amount of the expense, and value of the taxpayer’s private benefit. In some cases, such as commuting expenses, Congress has decided to deny any deduction.\footnote{See Treas. Reg. §§ 1.162-2(e), 1.262-1(b)(5) (2001).} In others, such as the transportation costs of travel to attractive locations for a bona fide business reason, Congress has allowed a deduction for the full amount.\footnote{See Treas. Reg. § 1.162-2.} In still other cases, such as the cost of meals partaken when traveling on business, Congress has compromised and allowed a deduction for only part of the cost.\footnote{See I.R.C. § 274(n); see also supra note 105.} The personal and business elements of such items are too interwoven to ignore either, and so their tax treatment cannot properly be settled by taxonomic designations based on ignoring one element and focusing exclusively on the other. If there is a significant business element to an expense, that should be sufficient to remove the taint of nonneutrality from any deduction that Congress enacts. In deciding whether and to what extent a deduction is appropriate, Congress can weigh all of the elements and considerations without the baggage of having the item characterized as lacking neutrality.
3. Neutrality of the Deduction

The same considerations require that the charitable contribution deduction be classified as neutral. If the public benefit of the gift is substantial, that should be sufficient to satisfy any requirement of neutrality that might exist. The extent to which the contribution provides a private benefit to the donor is a factor to be weighed by Congress in determining whether the gift has the requisite charitable purpose to qualify for a charitable deduction and whether there is a sufficient degree of public benefit to justify allowing a deduction.

Therefore, the charitable deduction should not be listed as a tax expenditure. This does not mean that a charitable deduction should be continued. The legislature should weigh the competing considerations and decide, as a matter of public policy, whether, and to what extent, a deduction should be allowed.

As noted above, some commentators have argued against the charitable deduction on account of minimal governmental oversight. A case can be made that the minimization of governmental oversight is actually a positive aspect of the charitable deduction, since it minimizes the censorship power of the government. The question of whether or not the paucity of governmental oversight with respect to the charitable deduction is good or bad does not go to the tax expenditure concept. The charitable deduction fits within the principles of the ideal tax system and should not be listed as a tax expenditure, thereby subjecting it to the negative connotation that attends that classification. The legislature should make its decision concerning the deductibility of charitable gifts on the basis of the considerations discussed above without being prejudiced against allowing the deduction by having it characterized as contrary to neutral tax principles.

4. Implementing the Principles of Progressivity

In addition to the reasons advanced by Professor Andrews, there also is a justification for the charitable deduction that rests on the principle of progressive taxation. As noted previously, the progressive tax structure rests on a premise that the allocation of the cost of government to the public should impose relatively similar degrees of sacrifice on each person. Progressivity

153. See supra note 132 and accompanying text.

154. For example, when the government supports something such as public television, then the government has power to influence the views that are expressed. Many charities take actions that are in opposition to positions held by the government. By making the deduction mechanical, it tends to minimize, but not eliminate, the government's ability to influence the charity.
rests on an assumption that the marginal utility of income declines as the amount of income increases. Utility of income represents the availability of income for personal consumption by the taxpayer. To the extent that a taxpayer donates funds to a broad public use, only an insignificant part of which benefits the taxpayer, those funds are not used to consume goods or services that are thereby lost to society. Consequently, the amount contributed should not be counted in determining the income that is available for the taxpayer’s personal consumption. Only the remaining income is available and, therefore, only the remaining income should be counted in determining the appropriate tax burden on that taxpayer. The charitable deduction accomplishes this. Admittedly, this is a variation of the argument that a charitable contribution should not be considered consumption under the definition of income, but if the tax system does not allow a deduction for the expense, the utility that the taxpayer has with respect to the remaining dollars will be distorted; thus, the principles of progressivity do support the deduction.

Once again, note that the neutrality of the charitable deduction does not constitute a factor supporting its retention. It merely precludes a bias against retention that would exist if it were a nonneutral provision. The determination of retention or repeal of the charitable deduction should rest exclusively on policy considerations.

5. Deduction for Appreciated Property

The aforementioned analysis applies to charitable deductions of both cash and property to the extent that the deductions do not exceed the donor’s bases in the property. In many circumstances, the Code provides a charitable deduction for the fair market value of donated appreciated property. In such cases, the donor is allowed a deduction for the unrealized appreciation of the property. The analysis herein does not support a deduction for the portion of the deduction above the basis of the property. If one accepts the tax expenditure concept, a deduction for the donation of unrealized appreciation fits within that concept. Professor Andrews also admitted that his arguments do not support the deduction for unrealized appreciation:

The argument here is concerned only with adjusting gross income to make it a more accurate measure of private consumption plus accumulation by allowing a deduction to offset the inclusion in gross income of receipts that have been turned over to

155. See Treas. Reg. § 1.170A-1(c) (2001); see also I.R.C. § 170(e)(1). In some cases, only the amount of the taxpayer’s basis in the donated appreciated property is deductible. See I.R.C. § 170(e)(1). The ceiling on the amount that can be deducted is lower for gifts of appreciated property than for other gifts. See I.R.C. § 170(b)(1)(C), (D).
philanthropic use. Since the effect of the fair market value rule is to allow a tax deduction for an amount, the unrealized gain, that will never be included in gross income, it clearly goes beyond that rationale.\(^{156}\)

Therefore, as noted by Professor Andrews, the deduction for unrealized appreciation must be viewed "as a subsidy or artificial inducement, above and beyond mere tax exemption, for philanthropic giving," i.e., a tax expenditure.\(^{157}\)

D. Qualified Residence Interest

In general, no deduction is allowed to an individual for interest payments if the underlying debt is not connected with a trade or business or an investment.\(^{158}\) There are a few exceptions to that general rule, the most important exception being the itemized deduction allowed for qualified residence interest.\(^{159}\) In general, subject to a dollar ceiling, this provision allows an itemized deduction for interest payable on a loan incurred in connection with the acquisition of the taxpayer's principal residence and another residence selected by the taxpayer, which loan is secured by the residence. In addition, subject to a separate ceiling, the interest on certain loans, other than acquisition indebtedness, that are secured by such residences is deductible.\(^{160}\) The Joint Committee on Taxation lists the deduction allowable for interest on such loans as a tax expenditure.\(^{161}\)

The following scenarios illustrate the nature of the issue that the qualified residence interest deduction presents. In studying these examples, assume, contrary to current tax law, that no deduction is allowed for interest payable on loans incurred to acquire a personal residence.

A house is for sale for $100,000. B, who wishes to purchase the house, has $100,000 available which she can use either to invest or to purchase the house. If she purchases the house, she will use it as her residence. Consider the following two alternatives:

1. B chooses to pay $100,000 cash for the house, and B occupies the house as her residence. While living in the house, B enjoys the imputed income from the "rent" that the house provides. That is, B enjoys the use of

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156. Andrews, supra note 19, at 372.
157. Id.
159. See I.R.C. § 163(h)(3). This is not a miscellaneous itemized deduction and thus is not subject to the 2% floor. See I.R.C. § 67(b)(1). It is, however, subject to the overall limitation imposed by I.R.C. § 68. But see supra note 81.
161. See JCT TAX EXPENDITURES, supra note 14, at 18.
the house, which is the "rent" provided by the value of the house, or by the $100,000 that B invested in purchasing the house. The tax law does not tax B on that imputed income. So, B derives the income from her $100,000, consuming it by satisfying her need for shelter, and yet escapes taxation on that income. There are several good reasons why Congress has not sought to tax such imputed income, and the Tax Expenditure Budgets do not include imputed income in their lists.

(2) Before making the decision to invest her $100,000 in the house, B inquires as to the interest rate she would pay if she were to borrow $100,000 from the Friendly Bank, secure the loan by a mortgage on the house, and use the borrowed funds to purchase the house. B discovers that she would pay 7% annual interest for the loan. But, B knows that she can invest her $100,000 in a safe investment and receive 10% interest on the investment. In the absence of tax considerations, B would fare best if she were to borrow the $100,000 from the Friendly Bank, pay interest at 7%, and invest her funds at 10%. She would be able to keep the 3% difference, or $3000, each year. However, B's attorney informs her that the $10,000 interest she will earn on her investment will be taxed at a 40% tax rate. As a result, while B will owe $7000 in annual interest to the Friendly Bank, she will have only $6000 available from the investment after taxes to pay the interest. If the interest payable to the Bank is not deductible, B will have to pay $1000 out of her other resources to the Friendly Bank. In light of the tax situation, B would be better advised to invest her $100,000 in purchasing the house without taking out the loan from the Bank. Even though she can earn more by investing her funds at 10% than she would pay in interest on a loan, the use of the funds to purchase the house turns out better for her because the tax law does not tax the imputed income from the $100,000 that is invested in the home. The failure to tax the imputed rent from the house creates an economic bias that distorts market choices. It favors the buyer who pays with her own money over the buyer who pays with borrowed funds. It also favors buying a residence, with or without borrowed funds, over renting one.

If the interest payable to the Bank were deductible, as it is under current tax law, and if B is not subject to the overall limitation of I.R.C. section 68, B would do better to borrow the money to purchase the house and invest her funds. If she can deduct the 7% interest she pays to the Bank, that will effectively insulate 7% of the income she earns on her $100,000 investment from taxation. The remaining 3%, or $3000, will be taxable at a 40% rate, but B will then have $1800 left after payment of taxes. The allowance of a deduction thus neutralizes the bias that the failure to tax imputed income created, at least as between B's choice whether to use her own funds to purchase the house or to borrow the funds. By neutralizing the tax
consequences, B will make her decision on the basis of market considerations, and that decision will result in the more efficient allocation of resources.

The function of the interest deduction allowed under section 163(h)(3) of the Internal Revenue Code can be viewed as a means of neutralizing the tax bias that otherwise would distort the choice between B’s borrowing funds or using her own funds. It must be noted that the tax laws necessarily create biases that distort many market choices, and it is not possible to eliminate or neutralize them all. The most that can be done is to neutralize the bias that otherwise would influence some specific choices, such as the choice whether to borrow or to invest one’s own funds. There must be some compelling social or economic reason for Congress to wish that certain choices be made free of a tax bias before Congress will eliminate that bias. In doing so, Congress may very well create a new tax bias or aggravate one that already exists. For example, the granting of the qualified residence interest deduction aggravates the tax bias in favor of purchasing a residence rather than renting one.

When the purpose of granting a deduction is to neutralize a tax bias created by the operation of the tax system, should that deduction be classified as a tax expenditure? On the one hand, Congress must have had a programmatic purpose in choosing to eliminate the bias, and the use of a tax deduction to further a programmatic goal seems to fall within the tax expenditure concept. On the other hand, Congress is seeking to eliminate a distortion that the tax law itself created, and that might seem more like a correction of the unintended consequences of the tax system than the subsidization of a program.

Although not the standard for a tax expenditure budget that is applied in this article, Treasury’s definition of a tax expenditure includes a provision designed “to reduce certain tax-induced distortions.” Thus, from the point of view of Treasury, the qualified residence interest deduction should be classified as a tax expenditure, as Treasury has labeled it.

But the definition that Treasury employs is flawed. The thrust of the tax expenditure concept is that Congress is using the tax system as a device to spend money on some programmatic goal in the same manner that Congress makes direct expenditures. While the purpose of such a neutralization deduction is to promote some program, the need for that provision arises because of the operation of the tax system itself. The correction of undesired consequences of the tax system is a very different animal from a direct

162. OMB Budget 2001, supra note 33, at 107; see also OMB Budget 2002, supra note 17. The 2002 budget does not set out the standards used but only states that previous standards were applied. See id.

163. See OMB Budget 2002, supra note 17.
expenditure made to carry out a program. The label of "tax expenditure" is unwarranted in this case.

However, the case for treating qualified residence interest as neutral is weaker than the case for the other deductions discussed in this article. The most likely reason that Congress granted this deduction was to further encourage home ownership without any thought as to the extent that the deduction eliminated a tax bias. This article contends that the fact that the deduction eliminates a tax bias should be controlling, rather than focusing on the subjective intent that Congress had. But the obvious importance in this provision of encouraging home ownership makes the elimination of a tax bias shrink in stature.\footnote{Apart from neutralizing a tax bias, the principles underpinning progressivity lend some support to classifying the qualified residence interest deduction as neutral. The standardized tax rate schedule does not take into account the differences in cost of living in various parts of the country. The cost of living, and therefore housing, in Topeka, Kansas is much less than in San Francisco, California. Dave Anderson, in a conversation with the author, suggested that the qualified residence deduction adjusts for that difference in cost, i.e., the higher the loan, the greater the amount of interest and thus the qualified residence deduction. Interview with David Anderson, Esq., Partner, Loeb & Loeb, LLP, in Los Angeles, Cal. (July 10, 2001). However, this contention that the deduction is supported by progressivity has less strength than in the case of the other deductions described herein. One factor that lessens the efficacy of this suggestion is that there is a dollar ceiling on the amount of a qualified loan. Nevertheless, certainly there are instances in which the deduction will work as suggested by Anderson, and therefore the contention does have merit.}

Note that the qualified residence interest deduction includes interest on both acquisition indebtedness and home equity indebtedness.\footnote{Home equity indebtedness is a post-October 13, 1987 indebtedness, other than acquisition indebtedness, that is secured by a qualified residence to the extent that the aggregate amount of such indebtedness does not exceed the difference between the fair market value of such qualified residence and the amount of the taxpayer's acquisition indebtedness with respect to the residence. \textit{See I.R.C. §} 163(h)(3)(C).} At first blush, the justifications given for allowing a deduction for interest on acquisition indebtedness would seem to be inapplicable to a deduction for interest on home equity indebtedness. However there is a reasonable connection between the two. Obtaining a home equity loan is akin to drawing money out of the residence. Thus, to the extent that the amount of the loan does not exceed the original purchase price of the house, less the outstanding balance of any acquisition indebtedness, the home equity indebtedness can be seen as comparable to a retroactive change of the amount used to purchase the house, i.e., a retroactive increase in the amount invested elsewhere rather than used to purchase the house. This merely indicates that there are reasonable grounds for allowing the deduction, although concededly those grounds are more
tenuous than those supporting the deduction for interest on acquisition indebtedness.

Again, it is important to emphasize that the exclusion of the interest deduction from the list of tax expenditures does not make it sacrosanct. Congress decides whether or not it is a desirable provision. The same considerations that motivate the allowance of a deduction for interest on home mortgages apply to interest on debts incurred for other consumer purchases, but Congress chose to deny a deduction for such interest.\(^{166}\)

1. Itemization and the Standard Deduction

Some might argue that the thesis of this article is flawed based on the assertion that the personal deductions addressed by this article do not promote progressivity, since the deductions are itemized deductions and therefore are not available to the large number of taxpayers who use the standard deduction.\(^{167}\) There are at least three independent reasons why that objection is specious.

First, the standard deduction serves as a substitute for itemized deductions by providing a standardized amount that reflects the total of the itemized deductions that many taxpayers would have if they itemized. By allowing a standardized amount as a deduction, Congress has relieved many taxpayers of the burden of keeping track and retaining proof of those expenses that give rise to itemized deductions. The standard deduction also eases both the administrative burden of the taxpayer in filing a tax return and the burden of the government in auditing it. If fewer expenses qualified as itemized deductions, the dollar amount of the standard deduction likely would be lowered.\(^{168}\) As a result, the personal deductions discussed in this article indirectly impact the tax rates applied to the income of taxpayers who use the standard deduction by providing them with a higher amount of deduction.

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166. See I.R.C. § 163(h)(1).

167. A taxpayer either can deduct her itemized deductions or take a standard deduction of a specified dollar amount; the taxpayer cannot deduct both. See I.R.C. § 63(a), (b), (d) (1994). Nonitemized deductions and the personal exemption can be deducted by a taxpayer regardless of whether the taxpayer used the standard deduction. See I.R.C. §§ 62(a), 63(b) (1994 & Supp. V 1999).

168. See I.R.C. § 63(f). In more recent years, the standard deduction may have been used by Congress to provide a tax reduction that is targeted at lower-bracket taxpayers who typically are the persons who use the standard deduction. For example, the additional standard deduction that is allowed for aged or blind taxpayers will not benefit higher-bracket taxpayers who typically itemize their deductions. This does not detract from the point that the basic standard deduction reflects a kind of average amount of itemized deductions in the same general way that the rate schedule reflects a kind of standardized utility curve.
Second, the personal deductions which the author contends promote the principles that underlie progressivity do not undercut the progressive rates as they apply to those who use the standard deduction. Let us look at medical expenses first, and then briefly examine the others.

Medical expenses that are reimbursed by an insurer and medical premiums paid by an employer are excluded from a taxpayer's income.\(^\text{169}\) That exclusion applies regardless of whether the taxpayer itemizes or uses the standard deduction. So, the issue of the effect of having a standard deduction applies only to the medical expense deduction under section 213. As a consequence of the floor of 7.5% of the taxpayer's adjusted gross income, the medical expense deduction is allowed only for taxpayers who have extraordinarily large expenses. Ordinary medical expenses are accommodated in the rate schedule itself. If a lower bracket taxpayer has unusually large medical expenses that nevertheless, together with her other deductions, are not large enough to warrant itemizing,\(^\text{170}\) those types of expenses are part of the elements that are taken into account in determining the amount of the standard deduction that Congress established, and so can be seen as accommodated in the standard deduction.

The same reasoning applies to the casualty and theft loss deduction. Only an extraordinarily large amount of loss—one that exceeds the 10% of adjusted gross income floor—is deductible. If a lower bracket taxpayer has casualty and theft losses in an amount that is sufficient to warrant itemizing, the taxpayer will not use the standard deduction. If the losses and other deductions are not great enough to warrant itemizing, they will be accommodated in the standard deduction. Note that if a taxpayer who has personal casualty losses also has personal casualty gains, the losses are treated as nonitemized deductions to the extent they do not exceed the personal casualty gains,\(^\text{171}\) and are deductible by taxpayers who use the standard deduction.

The identical considerations apply to the charitable contribution deduction. If the charitable and other itemized deductions are not large enough to justify itemizing, they will be accommodated in the standard deduction, the amount of which is set to approximate such items.

Third, the objection that the personal deductions do not provide relief for taxpayers who use the standard deduction is a complaint against the practice of dividing deductions into itemized and nonitemized categories with limited deductibility for the former. Even if that objection were otherwise viable, it does not address the propriety of allowing a deduction for such items. Rather,

\(^{169}\) See I.R.C. §§ 104(a)(3), 105(b), 106.

\(^{170}\) Of course, if the expenses are large enough to warrant itemizing, the taxpayer will not elect to use the standard deduction.

\(^{171}\) See I.R.C. § 165(h)(4)(A).
it addresses the question of whether the difference in treatment accorded to itemized and nonitemized deductions contravenes the policies that underlie the principle of progressivity.

Take the example of the deduction allowed for employee business expenses that are not reimbursed by the employer. Most unreimbursed business expenses of an employee are treated as miscellaneous itemized deductions. These are not personal deductions; they are part of the cost of the employee's production of income and so properly reduce taxable income to the extent that they are permitted to be deducted. Yet many employees cannot take deductions for these expenses because they use the standard deduction, and because of the 2% of adjusted gross income floor. That discontinuity does not demonstrate that the employee business expenses that are deducted have no positive role in the progressive rate system. What it does suggest is that the limitations on the deductibility of such expenses are unwise.

In the case of personal deductions, there may or may not be adequate grounds to limit their use to those who itemize, but that issue has no bearing on the question of whether the personal deductions that are allowed promote the principles of progressivity.

CONCLUSION

It has been some years since the issue of medical and charitable deductions has been addressed by Professors Andrews and Kelman. This article has tried to respond to some of the criticisms that Kelman raised to the arguments set forth by Andrews and to contend that Kelman's arguments do not reach the question of the tax neutrality of those provisions. In addition, while not disparaging Professor Andrews' arguments, this article has set forth a new and independent justification for the two deductions. Moreover, this article has explored justifications for two other personal deductions: the qualified residence interest deduction and the casualty and theft loss deduction.

The new and independent justification that the author proposes for characterizing personal deductions as tax neutral provisions is grounded on the premise that progressivity is an integral part of the tax system and that the graduated tax rate structure, which is the means used to implement progressivity, is designed to reflect the declining utility that dollars of income have as the amount of taxpayer's income increases. As income increases, the utility of additional dollars of income decreases, and therefore taking a larger

172. See DOUGLAS A. KAHN, FEDERAL INCOME TAX 229-30 (4th ed. 1999); see also I.R.C. § 67(b).
percentage of that additional income as a tax equalizes the sacrifice or burden imposed on taxpayers having disparate amounts of income. The tax rate schedule constitutes a standardized and crude utility curve for the average taxpayer. Certain events, such as illness or theft, alter the utility curve for those taxpayers that experience them, making the standardized tax rate schedule grossly inappropriate when applied to them. If such events involve large enough dollar amounts and occur in the life of a community frequently enough to warrant addressing, the tax rate schedule that is applied to those persons for the year in which the event occurs should be modified to more accurately reflect the utility of their income to them. The medical expense, charitable contribution and casualty and theft loss deductions serve that function. Since those deductions implement the principles on which the progressive income tax system rests, they are not nonneutral and are not tax expenditures. The question of whether such provisions should be retained or repealed turns on value judgments and policy issues and should not be influenced by characterizations of their neutrality or nonneutrality in an ideal income tax system.

The 2002 budget makes it clear that the Bush Administration is skeptical of the tax expenditure concept. While the author has not explicitly taken a position as to whether the tax expenditure concept is valid, there is a subtext to this article suggesting that the concept is unworkable and misleading. A consequence of showing that many personal deductions, which currently are listed as tax expenditures, can be seen as complying with neutral tax principles is that the selection of items to be included in a list of tax expenditures has a considerable degree of arbitrariness. The inclusion or exclusion of items appears to depend more on the political views of the parties making the selection than on objective criteria. As Bruce Bartlett notes: "Were the tax expenditures budget nothing but an analytical tool, it might be unobjectionable, despite its shortcomings. But it is far more than that. It institutionalizes, in a very powerful way, a particular view of tax policy that makes it exceedingly difficult to make positive reforms."

Nevertheless, it is useful to have available estimates of the amount of additional revenue the government would receive if a specific provision were removed from the Code. While the estimates in the tax expenditure budgets are crude in that they fail to account for changes in taxpayer behavior that the repeal of the provision would engender, even such crude estimates are useful. When Congress considers whether to make changes in the tax law, it

173. See OMB BUDGET 2002, supra note 17, at 61; see also supra note 33.
175. See id. at 418 (explaining several deficiencies in how the tax expenditure budget calculates its estimates).
needs to have some idea as to the effect that such changes will have on revenue collection. As the author has noted, decisions to retain or repeal a tax provision should rest solely on policy considerations, and revenue collection is obviously one such consideration. The objection to the tax expenditure budget is not that it makes such estimates or even that the estimates are inaccurate. Rather, those who object to the tax expenditure concept do so because it characterizes certain selected provisions as nonneutral and thereby especially suspect. The bases on which items are included in or excluded from tax expenditure budgets are themselves suspect. A question then remains whether the usefulness of having such revenue estimates is more than offset by the negative characterizations that are improperly accorded to many provisions.