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SOME INCOME TAX SIMPLIFICATION PROPOSALS

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I. INTRODUCTION

This Article proposes various moves for simplification of the task of computing the tax base under the individual income tax,[1] with a principal view of making the income tax capable of compliance by "ordinary" individuals without the aid of tax preparation software or outside assistance.[2]

Part II offers a brief overview of the pros and cons of simplification as a reform agenda or project. Part III deals with simplification moves that can be carried out independently of conventional tax reform proposals. Part IV considers simplification benefits that are attendant upon plausible tax reform (or revenue-raising) proposals. Part V offers some concluding remarks.

II. SIMPLIFICATION AS AN AGENDA

An obvious aim of simplifying the federal income tax is to save on taxpayer compliance costs, especially time spent on filling out tax returns. It is reported that individual taxpayers spend not insignificant amounts of money and more than twenty-four hours on filing federal tax returns.[3] Such short-form tax returns as currently exist, the Form 1040-EZ and the Form 1040-A, do not appear to simplify matters significantly because taxpayers would still need to consider

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1. Simplification of rate structures (such as moving to a flat rate system) is not a "simplification" issue, since applying a tiered rate structure to the tax base is a simple arithmetic operation easily performed by a computer, including a program found on a website. Complexity in the rate structure should be equated with lack of transparency (disguised changes in marginal rates), such as occur with the deduction phase-out provisions found in I.R.C §§ 68 and 151(d)(3), both of which were revived by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (2013).

2. Previous collections of simplification proposals are found in AM. LAW INST. ET AL., FEDERAL INCOME TAX SIMPLIFICATION (Charles H. Gustafson ed., 1979); STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (Comm. Print 2001).

3. William Gale & Benjamin Harris, *Tax Simplification: How Costly Is Complexity?*, TAX POLICY CTR., http://www.taxpolicycenter.org/briefing-book/improve/simplification/cost.cfm (last updated Dec. 14, 2007) (reporting and extrapolating from other studies).

items omitted from these returns in order to determine eligibility to file them.[4] Computerized tax preparation services save on computation time (at a cost), but still require the entering of all relevant data and (often) the plowing through of checklists relating to numerous obscure deductions and tax credits. Ownership of rental property (or property partly devoted to business use) alone adds significantly to taxpayer burdens.[5] Complex and data-heavy tax returns also place burdens on government enforcement agencies.

A second aim of simplification is to render taxpayers' perception of the federal income tax as being internally coherent, and not as a Christmas tree showering an array of goodies (and baddies) to the highest (and lowest) bidders. Simplification is offered here as a "good government" project that would increase taxpayer morale and compliance rates through improved transparency and comprehensibility.

A third aim would be to reduce dispute-resolution costs. The way to further this aim is to clarify borderlines and reduce (where possible) the necessity for factual inquiries.

The opposite of simplification is complexity, and complexity in turn partly results from the dynamics of political economy, which produces a legislative output wherein it is easier to deliver government programs through the tax system (sometimes referred to as "tax expenditure" provisions) as opposed to the "normal" means of direct federal subsidies or regulation. Politics also dictates that provisions benefitting political constituencies be numerous (perhaps to the point of overlap and duplication) and salient,[6] whereas provisions cutting back on taxpayer benefits be obscure and backhanded.[7] Addi-

4. The Form 1040-EZ is for joint and single filers with no dependents, who have no investment income (other than up to $1500 of interest income), no business, rent, or royalty income, and who do not itemize. *Form 1040EZ: Income Tax Return for Single and Joint Filers with No Dependents*, INTERNAL REVENUE SERVICE (2012), *available at* www.irs.gov/pub/irs-pdf/f1040ez.pdf. The Form 1040-EZ includes a line for the earned income credit (EIC), which requires a worksheet computation. *Id.* The Form 1040-A is a two page form that resembles the Form 1040 but with no schedules (except possibly Schedule B and Schedule 8812) and certain deductions and credits omitted. *Form 1040A: U.S. Individual Income Tax Return*, INTERNAL REVENUE SERVICE (2012), *available at* www.irs.gov/pub/irs-pdf/f1040a.pdf. These forms may lull taxpayers into ignoring relevant items (income, deductions, and credits) that should be reported and which might well reduce net tax liability.

5. Such property entails computation of depreciation, allocation of deductions to rental or business activity, and disallowance (or limitation) under I.R.C. §§ 183, 280A, 280F, 465, 469.

6. For a public choice theory "take" on tax legislation, see Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891 (1987) (book review).

7. For example, instead of repealing the itemized deductions, said deductions are diluted by floors (*see* I.R.C. §§ 67, 165(h), 213(a)), ceilings (*see id.* § 170(b)), phase-outs (*see id.* § 68), and overlays (the Alternative Minimum Tax, *see id.* §§ 55(a), 56(b)(1)). *See also* statutes cited *supra* note 5 for provisions diluting deductions with regard to rental or business use of property.

tionally, certain groups possess a vested interest in tax complexity.[8] This Article, however, does not address the political obstacles to simplification. Nevertheless, certain simplification measures proposed herein might be immune from one or more of the political dynamics just described.

At the technical level, complexity in tax is mostly driven by a faith in "accuracy." Accuracy is in part a function of one's preferred concept of income. Thus, if one thinks that "income" requires adjustment for such items as sales taxes, casualty losses, medical expenses, unrealized gains and losses, imputed income, and off-market benefits, then the computation of the tax base becomes more complex than in the absence of such adjustments. Many of these adjustments are justified under the framework of welfare economics ("welfarism"), which posits that the tax base should be adjusted directly or indirectly (through proxies) for non-market changes in individual utility or well-being. However, a comprehensive welfarist tax system is impossible (apart from political resistance to a welfarist state), because welfarism ultimately refers to individual subjectivity. Determinations of subjective states entail enormous transaction costs and are unreliable. Proxies for subjective states are crude and insufficient. Finally, welfarist adjustments to the tax base are piecemeal.[9] A partial and flawed welfarist tax base must be unfair in terms of taxing "likes" (even in terms of well-being) alike.

Accuracy also entails a belief that even realized changes in wealth can be accurately accounted for, i.e., that capital expenditures can be distinguished from expenses, that depreciation and capital recovery can be accurately measured, that costs of income production can be distinguished from costs of personal consumption, and that accrual accounting is more accurate than cash accounting.[10] The mere list of these issues conjures up complex Code provisions and issues of a factual nature that are frequently disputed and litigated.

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8. *See* Liz Day, *How Maker of TurboTax Fought Free, Simple Tax Filing*, PROPUBLICA (Mar. 26, 2013, 4:00 A.M.), http://www.propublica.org/article/how-the-maker-of-turbotax-fought-free-simple-tax-filing; Evan Halper, *Maker of Tax Software Opposes State Filing Help; The Government's Offer to Fill Out Forms Is a Hit with Poor and Elderly, but Not with Intuit*, L.A. TIMES, May 5, 2006, at A1.

9. The exclusion for physical personal injuries, I.R.C. § 104(a)(2), is a good example of a piecemeal welfarist tax provision, tied to the objective fact of a monetary recovery. Non-compensated injuries do not (and practically could not) give rise to reductions in the tax base.

10. Accounting for changes in wealth could, in theory, be rendered accurate under a mark-to-market ("accretion") income tax, but only if valuation itself is accurate—an unattainable goal. In the case of unique assets, accurate valuation is an illusion: only an actual sale can reveal what a willing buyer would pay to a willing seller. An accretion income tax does not exist anywhere on the globe, and the chance that it would be enacted in the United States appears remote.

At some point, accuracy is not worth the effort.[11] Simplicity requires that the individual income tax base be constituted by objective outcomes (not estimates or conjectures) that can be attributed to individual taxpayers without government intrusions into personal privacy. That is, market transactions (outcomes) should be the data set for figuring the tax base of individuals.

Simplicity also possesses a cognitive aspect, as distinguished from a mechanical aspect. What is desirable is an internally coherent tax base principle that relates to the taxation function of raising revenue. The principle should be graspable by non-sophisticated individual taxpayers. The principle that is most compatible with mechanical and cognitive simplicity—as well as substantive tax fairness—is what I call "objective ability to pay" (as distinguished from a "utility" concept of sacrifice), determinable on an annual basis. This principle translates into an income tax base constituted by net realized increases in wealth (disregarding realized decreases in wealth that are not costs of income production). However, the task of justifying and elaborating upon the concept of an objective ability-to-pay tax base is a separate project in itself, and accordingly this Article will generally attempt to maintain a primary focus of simplification without pushing a particular tax reform agenda.

III. SIMPLIFICATION WITHOUT REFORM

The proposals discussed below do not, in the main, entail significant policy or revenue-driven changes. Familiar "tax reform" options that would advance the simplification agenda are discussed in Part IV. Items that appear to serve no purpose at all are discussed in this Part.

A. Taxpayer Relief from Arithmetic

Since the IRS performs the necessary calculations in reviewing returns, taxpayers should be allowed to forego this task (in whole or in part), if they so desire. A taxpayer would be allowed to attempt the calculations herself for informational purposes.[12]

11. *See generally* Louis Kaplow, *Accuracy, Complexity, and the Income Tax*, 14 J.L. ECON. & ORG. 61 (1998) (assuming that accuracy entails complexity, and providing framework for a trade-off between simplicity and accuracy).

12. A more comprehensive version of this approach is the pro-forma return; the government itself prepares a tax return, reviewable by the taxpayer, in which all known third-party data is entered, with the government performing the tax calculation. *See, e.g.*, Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn*, 107 TAX NOTES 1431 (2005).

B. Checklists for Tax-Benefits Eligibility Requirements

Where possible, the eligibility requirements for a tax benefit should take the form of a checklist allowing a "yes" or "no" answer for each eligibility requirement. These checklists would mostly be located in the instructions to the Form 1040 and other schedules and forms, and would render these instructions more user-friendly.

C. Tax Credits to be "Off Tax"

Tax credits for individuals (other than the foreign tax credit and credits for income taxes already paid by the taxpayer) are government subsidies. As subsidies delivered by the IRS, these credits should be dealt with on a separate page of the return or otherwise clearly separated (or even detached) from the tax calculation itself. Subsidy-type credits should not be labeled as "reductions in tax liability" or "tax credits," but instead they should be called "federal government payments" that happen to be obtainable as an adjunct to filing a federal income tax return.

Additions to tax liability can take the form of other federal taxes, tax-related interest, fines, penalties, and refunds of excessive tax credits,[13] and should be similarly segregated from the computation of the income tax.

D. Rate Schedules

Since the rates and brackets involve political decisions, no opinion is advanced herein as to the rate schedules themselves. Nevertheless, it can be observed that moving to a single rate (or to fewer rate brackets) is not, by and large, a significant simplification move in itself, especially if taxpayers are not required to perform calculations.

E. Subsistence Income

Subsistence income should not be taxed,[14] but exempting subsistence income can be done in a much simpler fashion than under current law. Since subsistence levels appear to vary only with the size of a household, a simple table could be designed to set out the subsistence allowance per size of household.

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13. Additions to tax are labeled "Other Taxes" on page 2 of the Form 1040. *Form 1040A: U.S. Individual Income Tax Return*, *supra* note 4, at 2.

14. Income up to the subsistence level is unable to contribute to the government under liberal political theory. The centerpiece of a super-simplification proposal made in Michael J. Graetz, Essay, *Taxes That Work: A Simple American Plan*, 58 FLA. L. REV. 1043 (2006), is to raise the exemption level of the income tax far above the subsistence level to $100,000 (or more) and to make up the lost revenue through a value-added tax, which is a tax on business activity. This Article assumes that no significant new federal tax would be enacted, so that simplification would be confined to the individual income tax, where the notion of off-the-bottom allowances has been widely accepted.

1. Eliminate the Standard Deduction

The standard deduction (roughly $6000 per individual)[15] serves two purposes that can be better carried out separately. The first function is to constitute, along with the personal exemption (roughly $4000 per individual),[16] a universal low-income allowance; but this function can be better served by increasing the personal exemption itself. The second function is to provide a floor under "itemized deductions" as a group,[17] which (1) eases accounting burdens and (2) avoids duplication with the off-the-bottom allowances. However, this function can be performed better by separate floors under certain deductions.

2. The Personal Exemption Amount

The personal exemption amount should approximate the subsistence level of income for a household consisting of one individual. A starting point for calculating subsistence levels is the official poverty level, but that amount could be rounded up and adjusted to take into account such universal costs as state, local, and gasoline taxes and the cost of medical care. A reasonable figure (for 2014) might be $12,000 for an unmarried individual.

An issue is what the personal exemption amount should be for married couples under the present system, which allows married couples to file joint returns for aggregate taxable income. Statistics indicate that the subsistence level is a function of the number of persons in a common household, and does not depend on the age of household members or whether the "second" member of the household is married to the "first" member.[18] Proceeding on the (optimistic) assumption that the tax law is to be adapted to the household concept, then, if the personal exemption for an individual is set at

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15. The standard deduction for 2013 eliminated tax on the first $12,200 of taxable income for a married couple filing jointly, $6100 for an unmarried individual (or married person filing separately), and $8950 for a "head of household." Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 447-48.

16. In 2013, the personal (and dependency) exemption amount was $3900 per individual. *Id.* at 448. Both the standard deduction amounts and the personal (and dependency) exemption amounts are indexed for inflation, resulting in increased amounts from year to year.

17. An individual takes the greater of (1) the standard deduction, *see* I.R.C. § 63(c), or (2) aggregate allowable itemized deductions, but not both. *Id.* § 63(b). The term "itemized deductions" means deductions other than (1) the standard deduction, (2) deductions listed in § 62 that are taken in arriving at adjusted gross income, and (3) the deductions for personal and dependency exemptions allowed by § 151. *Id.* § 63(d).

18. For 2013, the official (rounded off) poverty level as determined by the U.S. Department of Health and Human Services was $11,490 for an individual, increasing by roughly $4800 for each additional family member. Annual Update of the HHS Poverty Guidelines, 78 Fed. Reg. 5182-83 (Jan. 24, 2013).

$12,000, a reasonable figure for a married couple living together would be $18,000.

The scheme suggested immediately above might be politically "off the table" on the ground that it would be perceived as reintroducing a marriage penalty,[19] but this perception would be inaccurate if unmarried, committed couples occupying the same household were treated as being married.[20] In any event, if it is politically necessary that the personal exemptions for a married couple be twice that of an unmarried individual, plausible exemption amounts for 2013 would be in the neighborhood of $20,000 for a married couple and $10,000 for an unmarried person.

3. Dependency Exemption Amounts

The purpose of the dependency exemption is to allow for the costs of supporting dependents. Accordingly, the dependency exemption should be a lesser amount than the augmented personal exemption for a single-person household, because the dependent is free of having to maintain a household. The current dependency exemption amount (roughly $4000) is almost the same as what the poverty-level statistics suggest is appropriate, but (again) the poverty level amount would only be a starting place for obtaining an appropriate figure.[21]

A person claimed as a dependent by another should have a zero personal exemption. A personal exemption on top of the income exclusion for support received by the dependent entails a double tax benefit for subsistence to the same taxpayer. The dependency exemption, coupled with the exclusion for support received and the loss of the dependent's personal exemption, effectively shifts the dependent's tax existence to that of the support provider, except for the dependent's separate economic activity.

4. The Definition of "Dependent"

The tests for determining "dependent" status that involve "support provided" (by the dependent or the claimant, as the case may be), relative to total support,[22] are unworkable.[23] The relevant distinction

19. Currently, the standard deduction for a married couple is twice that for an unmarried individual. *See supra* note 15.

20. Two unmarried taxpayers maintaining separate households would have aggregate personal exemptions of approximately $18,000, but that would presumably be justified by the fact that separate households are being maintained.

21. Annual Update of the HHS Poverty Guidelines, *supra* note 18, at 5183.

22. I.R.C. § 152(c)(1)(D) ("qualifying child" must not provide more than one-half of own support), (d)(1)(C) ("qualifying relative" must receive more than one-half of support from claimant).

23. Support for this purpose includes economic resources that are not gross income and that often take the form of in-kind room, board, and other items, and exclude items that are not spent on living costs. These facts are intrinsically hard to ascertain, are not

should be between dependents living in the taxpayer's household ("household dependents") and those that are not ("other dependents"). A person living in the taxpayer's household should be deemed to be a household dependent[24] *unless* she (a) is not within a specified degree of relationship (or registered domestic partner),[25] or (b) has "income" above a certain threshold amount.[26] For this purpose, the income threshold amount should be an amount greater than the dependency exemption amount, but certainly not greater than the personal exemption amount.

To be an "other dependent," the person should be required to satisfy a somewhat stringent "relationship" test. Additionally, the claimant must have provided, by cash transfers or payments,[27] an amount that exceeds the greater of the exemption amount or the putative dependent's "income." Finally, the person would be disqualified if (a) she is an owner of her place of abode or (b) her "income" exceeds the personal exemption amount.

An issue is how "income" should be defined for each category of dependent. A possible construct would be "adjusted gross income" (AGI), plus the untaxed portion of Social Security retirement benefits and excluded interest, personal injury recoveries, non-taxable distributions from trusts and estates, and amounts received on account of disability.

5. *Eliminate the Child Tax Credit*

This ($1000 per qualifying child) tax credit,[28] which appears to be simple on its face, is complicated by phase-out rules, the linking of refundability to the taxpayer's earned income over $3000, and its interaction with other tax credits. The purported rationale is to augment the dependency exemptions (but only for children under the age of seventeen living in the taxpayer's household),[29] but circumstantial

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public, and cannot be provided by disinterested third parties.

24. The idea is that the claimant should be deemed to have supplied value at least equal to the dependency exemption amount.

25. The purpose here is to weed out persons who cohabit for convenience or pleasure.

26. The purpose here is to weed out persons who are basically self-supporting.

27. If the taxpayer allows the putative dependent to live in a dwelling owned by the taxpayer (other than the taxpayer's residence), the taxpayer can be deemed to have spent cash on the dependent at the rate of, say, 5% of the dwelling's cost.

28. I.R.C. § 24(c).

29. The legislative history states only:

> The Committee believes that the individual income tax structure does not reduce tax liability by enough to reflect a family's reduced ability to pay taxes as family size increases. In part, this is because over the last 50 years the value of the dependent personal exemption has declined in real terms by over one-third. The Committee believes that a tax credit for families with dependent children will reduce the individual income tax burden of those families, will better recognize the financial responsibilities of raising dependent children, and will

evidence suggests that this credit is a kind of federal "workfare" supplement for the working poor with dependent children.[30] The credit is a wasteful squandering of government revenues to the extent that it does not allow for, or subsidize, incremental costs of child care. The aims of this credit can better be accomplished by (1) aligning the dependency exemption amount with the amount necessary to support a household dependent[31] and (2) providing tax credit(s) for the working poor with children.[32]

F. The Working Poor

1. No Separate Rate Schedules for Unmarried Individuals and Heads of Household

The existing system providing for four categories of filing status can be easily reduced to two, namely, married couples filing jointly and everyone else.

The current rate schedule for an unmarried individual is the same as for a married person filing separately up to a taxable income of about $75,000, but, above that level, two unmarried persons with evenly split incomes (and living together) pay less tax than a married couple filing jointly having the same aggregate income.[33] This disparity could influence marriage decisions of high-income couples. The disparity is presumably based on economies of scale available to married couples. However, marriage status is an extremely crude indicator of economies of scale. Moreover, it is hard to justify implicit (incremental) cost-of-living allowances at high-income levels. Indeed, cost-of-living differentials that result from taxpayer choice, apart from being inscrutable to being measured on a case-by-case basis,

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promote family values.

H.R. REP. NO. 105-148, at 310 (1997). The stated rationale suggests a deduction rather than a credit. The credit has since been liberalized so as to be available for a "qualifying child" (the taxpayer's descendant, sibling, or sibling's descendant) living in the taxpayer's household but under the age of seventeen. *See* I.R.C. § 24(c)(1) (referencing *id.* § 152(c)).

30. The existing federal cash-transfer program for families with dependent children is Temporary Assistance for Needy Families (TANF), which replaced the Aid for Dependent Children (AFDC) program in 1997, the same year that the child tax credit was enacted. *See* Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105. TANF is designed to encourage welfare recipients to enter the workforce, and the child tax credit is refundable only if (and as) earned income (wages) exceeds $3000. *See* 42 U.S.C. § 601 (2006); I.R.C. § 24(d)(1), (d)(4). Since the benefit level of TANF is largely decided by the states, the child tax credit amounts to a federal supplement to TANF.

31. *See supra* pp. 6-7.

32. *See infra* pp. 8-11.

33. *See* I.R.C. § 1(c), (d), (f)(8), and the rate tables for 2013, published in Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 445 (showing a divergence above a taxable income amount of $73,200).

should (arguably) not be taken into account at all.[34] Certainly, any adjustments of this sort would complicate the system. Thus, the rate schedule for unmarried persons—which has already been partially repealed—should be wholly eliminated, so that the same rate schedule would apply both to unmarried individuals and to married individuals filing separately.

A head of household is an unmarried individual with one or more dependents living at home.[35] Both the head-of-household rate schedule[36] and the head-of-household standard deduction[37] are more favorable than that of an unmarried individual (but not as favorable as for a married couple filing jointly). No reason exists for taxing upper-middle-class (and wealthy) individuals at favorable rates just because they have one or more live-at-home dependents, or for why the first dependency exemption should (in effect) be significantly greater for an unmarried person with a live-at-home-dependent relative to other taxpayers with a dependent.[38] The legitimate aim of the special rate schedule to account for incremental work and child-care costs can be better accomplished by some increase in the dependency exemptions and a tax allowance for working taxpayers with live-at-home dependents (see item 3 below).

2. *Replace the Child Tax Credit, the Earned Income Tax Credit, and the Household and Dependent Care Credit with a Single Dependent Care Allowance*

The child tax credit is not linked to any costs of child care over and above the routine support that is already deducted by reason of the dependency exemptions.[39] The earned income credit (EIC)[40] is extremely complex and serves two goals—refunding part of the payroll tax and subsidizing the working poor with dependents—that can better be accomplished separately. The household and dependent care credit[41] has a clear enough purpose, but it (uniquely) requires

34. *See* Calvin H. Johnson, *The Inequities in Cost of Living Adjustments*, 28 A.B.A. SECT. TAX'N NEWS Q. 24 (2009); Michael J. McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977). In welfarist terms, adjustments for higher costs of living are incoherent, because the incremental monetary costs are incurred voluntarily to obtain higher non-monetary benefits.

35. I.R.C. § 2(b).

36. *Id.* § 1(b).

37. The head-of-household standard deduction is $8950 for 2013, compared to $6100 for other individuals. Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 448 (2013).

38. A non-itemizing head of household with one dependent effectively obtains approximately an extra $3000 of allowance off the bottom relative to other taxpayers (for 2013, the precise amount is $2850, the difference between standard deductions of $8950 and $6100). *See id.*

39. Thus, single-earner couples obtain a windfall: a subsidy for non-existent (or wholly discretionary) expenses, such as private schooling.

40. I.R.C. § 32.

41. *Id.* § 21.

accounting for eligible costs, confers an unwarranted subsidy for high-income taxpayers while (as a nonrefundable credit) being useless for low income individuals, and is overly broad in allowing tax benefits for discretionary personal household expenses (e.g., housekeeping costs). All of these credits are keyed to wage income while being subject to phase-out or cut-back rules, indicating that they are aimed at those low-to-moderate income households with a wage-earner and live-at-home dependents. The phase-out rules for the EIC are especially complex and kick in at low amounts of earned income (or AGI), rendering compliance difficult for that portion of the population that is likely to be poorly educated.

First, a refundable credit should be available for wage earners equal to the Social Security tax rate (currently 6.2%) times earned income up to, say, $10,000, for a maximum credit of $620.[42] This credit (the Wage Earner Credit, or WEC) would not be conditioned on having household dependents, but would be subject to the same phase-out rule as the Household Dependent Allowance (HDA), described below.

Since dependency exemptions would already allow for the "normal" cost of supporting dependents, any additional tax benefits should be keyed to the incremental costs of caring for household dependents where the taxpayer is unable to provide the care herself by reason of being disabled or employed.[43] Thus, to be eligible for this allowance (the HDA), the taxpayer must be disabled or a full-time student, or must have worked more than, say, 1200 hours during the year. If the eligible taxpayer is married (broadly defined), the spouse must be disabled, a full-time student, or must also have worked the same minimum total hours. Additionally, the taxpayer must have at least one dependent living at home for more than, say, half the year. The live-at-home dependent should occupy a specified degree of relationship to the taxpayer and be under a certain age, disabled, or over a certain age.

Design issues for the HDA abound. First, should the allowance take the form of a deduction or a tax credit? In internal-to-tax terms, any allowance off the bottom or cost of earning income should take the form of a deduction. The opposing view is that the allowance should be viewed as a government subsidy for part of the costs of in-

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42. *Topic 751 – Social Security and Medicare Withholding Rates*, IRS.GOV, http://www.irs.gov/taxtopics/tc751.html (last updated Oct. 23, 2013). This is similar to the Making Work Pay credit of I.R.C. § 36A, which has expired. Also, the credit should not exceed the Social Security taxes actually paid.

43. THE PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 60 (2005), *available at* http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_5-7.pdf, proposed a Family Credit (without phase-out) for taxpayers with certain amounts or types of income and a separate Work Credit (with phase-out).

cremental dependent care and that a refundable tax credit delivers a uniform subsidy that is not a function of the taxpayer's marginal tax rate. Indeed, a deduction is worthless to a taxpayer having a net income below the "standard" low-income allowances. On the other hand, a refundable tax credit requires the filing of a tax return where one would not otherwise be required.[44] Since the HDA would replace tax credits, the HDA would also presumably take the form of a tax credit.

The eligibility requirements would be a virtual guarantee that eligible costs are incurred. Therefore, it would not be necessary to account for actual costs of incremental dependent care. Accordingly, an eligible taxpayer would be entitled to a refundable tax credit of, say, \$6000 (40% of \$15,000) for the first eligible dependent, with decreasing amounts for a second dependent (say, \$4000), and third dependent (say, \$2000). A credit of \$6000 compares with the sum of: (1) a child tax credit of \$1000, (2) a household and dependent care credit of \$3000,[45] and (3) a \$3250 (in 2013) credit for the first dependent under the EIC.[46]

Both the HDA and the WEC should be phased out at a uniform rate above, say, \$50,000 of AGI.[47]

G. *The Taxable Income Computation*

The task of calculating the taxable income of individual taxpayers is unnecessarily convoluted and can be simplified under the proposals set forth below.

1. *Equal Status Among Deductions*

The distinctions among various categories of deductions (§ 62 deductions, itemized deductions, and miscellaneous itemized deductions)[48] pose unnecessary (and confusing) line-drawing issues, complicate the taxable income computation,[49] and obfuscate the simple notion that taxable income equals gross income less deductions.

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44. An individual income tax return is required only if gross income exceeds the sum of the personal exemption amount and the standard deduction amount. I.R.C. § 6012.

45. *Id.* § 21(c). This credit cannot exceed \$6000 in the aggregate, however.

46. *Id.* § 32(b). In 2013, the maximum incremental credit for a second dependent was \$2122 and for a third dependent was \$672, but no additional amounts were allowed for additional dependents. *See* Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 445 (maximum EIC for a taxpayer with one, two, or three qualified children).

47. Taxpayers with substantial income have the option of providing home care themselves. Stated differently, above a certain income level, paying for dependent care becomes a lifestyle choice. Finally, if the allowance takes the form of a tax credit, then it is wasteful to subsidize taxpayers with substantial incomes.

48. I.R.C. §§ 62(a), 63(d) (itemized deductions), 67(b) (miscellaneous itemized deductions).

49. Aggregate miscellaneous itemized deductions are subject to a 2% floor, *id.* § 67(a),

As noted above, the standard deduction would be removed, eliminating a major reason for having a separate category of itemized deductions. All deductions (including the personal and dependency exemptions) would be allowed in full, without phase-out rules. Floors and ceilings would attach only to certain specified deductions. Such floors and ceilings would be computed with reference to "net income," meaning gross income reduced by the deductions (other than the personal and dependency exemptions) not subject to any floor.

2. Personal Deductions Subject to Floors

The purpose of the floors under the personal deductions is to eliminate duplication with costs already deemed to be covered by the personal and dependency exemptions, so that only extraordinary costs within a certain category are eligible for additional deduction. Floors already exist under the deductions for personal casualty losses[50] and for medical expenses.[51] It is appropriate to consider a floor under each of the remaining personal deductions, but the issues of repeal of and/or floors under the personal deductions are deferred to Part IV.

3. Deduction Phase-Out Rules

Deduction phase-outs create hidden tax rate bubbles that lack transparency and cannot be justified under any theory of progressivity.[52] Deduction phase-outs require the filling out of a worksheet. In contrast, tax credits that are subsidies for the non-wealthy are appropriately circumscribed by phase-outs. It is not inappropriate to require a taxpayer eligible for a government subsidy to expend some effort to obtain it.

4. The Proper Function of the AMT

The Alternative Minimum Tax (AMT) was originally designed to reach high-income taxpayers who paid no or little tax on account of "excess" deductions.[53] The current AMT appears to be a kind of ad hoc revenue raiser that bears no relationship to any normative concept of income, but instead, for most individual taxpayers, operates as a sort of "stealth" partial repeal of certain itemized deductions.[54]

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and itemized deductions are subject to a phase-out rule (up to 80% thereof), *id.* § 68, as well as being effectively disallowed unless the aggregate amount thereof exceeds the standard deduction. *See* Form 1040A: U.S. Individual Income Tax Return, *supra* note 4.

50. I.R.C. § 165(c)(3), (h).

51. *Id.* § 213.

52. The American Taxpayer Relief Act of 2012, Pub. L. No. 112–240, 126 Stat. 2313 (2013), revived phase-out rules for the personal and dependency exemptions, I.R.C. § 151(d)(3), and for aggregate itemized deductions, *id.* § 68.

53. *See* H.R. REP. NO. 91-413, at 4628 (1969).

54. The AMT disallows, *inter alia*, the standard deduction, personal and dependency

On the merits, if a deduction is justified in the first place—particularly as it records a reduction in a taxpayer's ability to pay—no justification exists for reducing or eliminating the deduction explicitly or implicitly. The same end can be attained by other (and more transparent) means, such as the repeal of unwarranted deductions, the imposition of floors, and the foreclosing of avenues of abuse, as is considered in Part IV. Ceilings appear to be appropriate only in the case of wholly "discretionary" personal deductions, but the only such deduction that is truly discretionary appears to be the charitable deduction,[55] which is already subject to a ceiling.[56]

The AMT could be reformed to better accord with its original purpose,[57] but that is not a simplification issue.

H. Social Security Retirement Benefits

The existing rules governing the inclusion in income of Social Security retirement benefits[58] are so complex that a worksheet is required to figure out the taxable amount.[59] Also, the rules appear to be disconnected from any theory of partial exclusion. Yet a taxable amount can be figured by viewing the benefits as entailing a recovery of (all or a portion of)[60] nondeductible contributions (Social Security taxes).[61] A person's contribution history is contained in computerized records of the Social Security Administration (SSA), and this history is periodically mailed to individuals eligible to receive retirement benefits.

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exemptions, state and local taxes, allowable miscellaneous itemized deductions, interest on home equity loans, and a portion of the medical expense deduction. *See* I.R.C. § 56(b). The first two of these are a trade-off for the generous AMT exemption amounts (in 2013, $80,800 for married couples filing jointly and $51,900 for unmarried individuals), I.R.S. News Release IR-2013-4 (Jan. 11, 2013); but perhaps the exemption amounts should be raised somewhat. For a critique of the AMT, see Linda M. Beale, *Congress Fiddles While Middle America Burns: Amending the AMT (and Regular Tax)*, 6 FLA. TAX REV. 811 (2004).

55. I.R.C. § 170. Self-inflicted casualty losses are not deductible at all, *id.* § 165(h)(4), the mortgage interest deduction is limited to two residences (and contains ceilings on principal debt), *id.* §§ 67(b), 163(h)(4), and the medical expense deduction excludes costs of most cosmetic surgery, *id.* § 213(d)(9). Nevertheless, further restrictions on abuse of these deductions are considered *infra* Part IV.

56. *Id.* § 170(b).

57. The current AMT disallows the exclusion for the exercise of "incentive stock options" but leaves out of account the capital gains preference (which currently is neither an exclusion nor a deduction), as well as § 103 (tax-exempt) interest (except with respect to private activity bonds). *Id.* § 56(b)(3).

58. *Id.* § 86.

59. *Form 1040: Social Security Benefits Worksheet—Lines 20a and 20b*, IRS.GOV (2013), http://apps.irs.gov/app/vita/content/globalmedia/social_security_benefits_worksheet_1040i.pdf.

60. An issue is whether such basis should be reduced to account for the share of Social Security taxes used to fund the Social Security disability program.

61. An alternative simplification/reform option would be to allow a deduction for taxes paid, with inclusion of the full amount of benefits. This approach would presumably be off the table on account of current revenue considerations.

The basis recovery system can be modeled on (a) a recovery-of-basis-first system, (b) the annuity rules of I.R.C. § 72, or (c) the tax treatment accorded to mortgage loans.[62] Since the SSA has all the requisite information, it would be able to send a computer-generated tax information return to both the IRS and the taxpayer indicating the taxable portion of benefits.

I. Educational Tax Benefits

The multiple tax benefits for higher educational expenses variously take the form of deduction, exclusion, tax credit, and exempt trust.[63] All these provisions contain overlapping definitions of qualified educational expenses,[64] and most of them contain needs tests and maximum benefit limitations. Those that do not contain needs tests and limitations on benefits (the scholarship exclusion and state tuition programs) essentially amount to exclusions for higher education obtained at a bargain price. Gift-financed education is tax-free by reason of § 102(a).[65]

At a minimum, a universal definition of qualified higher education costs should apply for all purposes. Similarly, a universal needs test (phase-out for high income taxpayers) should apply in all cases in which the tax benefit is contingent on need.

J. Borderline Personal/Business Deductions

Categorical rules for sorting out borderline tax issues are preferable, in administrative-efficiency terms, to fact-intensive case-by-case determinations.

1. Marginal Business and Investment Deductions Generally

Current § 67 disallows "miscellaneous itemized deductions" (MIDs) to the extent of 2% of AGI.[66] An MID is an "itemized deduction" that is not listed in § 67(b).[67] This "anything not on the approved list" rule has deprived taxpayers of rightful deductions in unanticipated circumstances, such as plaintiff transaction costs in ob-

62. Any unused basis of a deceased individual would carry over to persons receiving Social Security survivor benefits. Unused basis would simply expire.

63. *See* I.R.C. §§ 25A (Hope and Lifetime Learning Credits), 117(a) (qualified scholarships), 221 (interest on education loans), 222 (qualified tuition and related expenses), 529 (qualified tuition plans, known as QTPs), and 530 (Coverdale education savings accounts, known as ESAs). Additionally, educational employee fringe benefits are provided for by §§ 117(d) and 127.

64. QTPs can uniquely provide for room and board costs. *Id.* § 529(e)(3)(B). ESAs can uniquely provide for pre-college education. *Id.* § 530(b)(2)(A)(ii). These features are hard to justify on policy grounds.

65. *Id.* § 102(a).

66. *Id.* § 67(b).

67. *Id.*

taining includible damages recoveries and deductions allowed under § 183(b)(2), discussed immediately below.[68] Recall that, under the proposal offered above, the category of "itemized deduction" would be eliminated.

Instead, the floor should apply only to those specified deductions (as a group) for which Congress deems that the connection of the expense to income production is tenuous. Leading candidates are unreimbursed employee deductions and "investment" deductions that are only indirectly connected to income production and that typically involve small amounts. Indeed, to supplement such a percentage-of-AGI disallowance rule, consideration could be given to simply disallowing small-amount (say, under $200) borderline items, such as subscription costs to the Wall Street Journal.[69]

2. *Business Meal Costs*

Costs of consuming food and beverages are inherently personal and should be disallowed in full, except where the consumption is directly related to an active business of the taxpayer (such as being a food critic or a professional food preparer).[70]

In the case of employer-reimbursed business meals, the employer is the real spender, and, since it is not consuming the meals itself, should not be subject to the existing 50% disallowance rule,[71] which is meaningless in the case of employers that are exempt from income tax. Any perceived abuse in this area can be dealt with by deeming reimbursed employee meal costs (perhaps in excess of a specified per diem amount) as additional compensation income of the employee.

3. *Business Lodging Costs*

Section 162(a)(2) currently allows a deduction for business-related "away from home" lodging costs.[72] However, the doctrine relating to the "away from home" requirement is confused and arbitrary.[73] As with food and beverage costs, costs of lodging are inherently personal and should generally be denied unless clearly justified. One such exception would be reimbursement by an employer. (However, compensation that is disguised as a reimbursement should be treated as

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68. *See* Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1 (2005).

69. *Cf.* I.R.C. § 165(h)(1) (allowing casualty losses only to the extent they exceed $100 per casualty).

70. Under current law, 50% of business meal costs are disallowed. *Id.* § 274(n)(1).

71. In an employer-reimbursement situation, the 50% disallowance rule falls on the employer, not the employee. *See id.* § 274(n)(2)(A) (cross-referencing *id.* § 274(e)(3)).

72. *Id.* §162(a)(2).

73. *E.g.*, JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 256-68 (4th ed. 2012) (describing this doctrine).

compensation.) Another would be for core-of-the-business lodging costs (say, of a travel writer).[74]

Apart from the foregoing, a business deduction for lodging costs is justified insofar as (1) a plausible business reason exists for maintaining at least one residence at the base location (such as being near a place of work that is used for, say, at least sixty days a year), and (2) a clear business reason also exists for the away-from-base-location lodging. Spouses should be treated as separate taxpayers for this purpose. The "second" lodging should be "away from home" in an objective sense, such as more than 100 miles from both the taxpayer's residence and her business office. These principles should operate to ensure that only incremental (or duplicative) business-driven lodging costs are deductible.

Using these criteria, the outcomes of certain recurring scenarios would be resolved as follows:

(1) Husband and wife maintain homes in different locations to be close to their respective business locations. No deduction would be allowed for either residence because no business reason exists for one spouse to reside in the other spouse's residence.

(2) Itinerant business (salespersons, pro golfers and tennis players, entertainers). In most of these cases no business reason exists to maintain a "base" home in any particular location, and therefore the deduction for lodging costs would be denied.

(3) Two business locations of the same taxpayer (ongoing). Here a business reason should exist for having separate residential locations. A ski instructor in Lake Placid should not be able to deduct lodging costs in Naples, Florida, with respect to a computer consulting business that could be based anywhere.

(4) Non-recurring extended leaves and reassignments. No deduction should be allowed if the taxpayer's family accompanies the taxpayer to the temporary job location, because in that case the taxpayer can avoid duplicative housing costs by renting out the first home. Otherwise, lodging deductions would be allowed only if (and so long as) (1) the taxpayer has not changed employers (or has not been terminated), (2) has not purchased a home in the temporary location, and (3) could reasonably expect to return to her base home location at the end of the "away" period. However, "away from home" status would expire at the end of the first full calendar year following the year of taking up residence at the second location.

74. Such a business might be a not-for-profit activity under I.R.C. § 183, however.

On no account should depreciation be allowed on a taxpayer's principal residence as defined in § 121,[75] because depreciation (by reducing basis) creates tax-favored gain.[76]

4. Not-for-Profit Activities

Section 183(a) disallows all deductions from "not-for-profit activities," but § 183(b)(2) allows deductions to the extent of the income from any such activity.[77]

(a) Accounting

Under present law, it is necessary to account for the costs giving rise to the deductions that initially are allowed by § 183(b)(2), because at least some § 183(b)(2) deductions are then subject to disallowance as miscellaneous itemized deductions, and depreciation allowed under § 183(b)(2) reduces the basis of taxpayer-owned assets.[78] Accordingly, depreciation must be calculated (and perhaps pro-rated between personal and not-for-profit use), and then it needs to be determined what portion of the depreciation is allowed under § 183(b)(2) after considering other deductions allowable under § 183(b)(2).[79] Accounting for such depreciation and attendant basis reductions is not worth the effort, especially in instances such as hunting, fishing, prospecting, amateur artistic ventures, amateur inventing, and sporadic renting of personal-use property.

Therefore, § 183 should be reconstituted so as to disallow depreciation (and other cost-recovery deductions) completely with respect to any asset used in a not-for-profit activity. It follows that no basis adjustments would be required for such assets on account of depreciation (and cost recovery) deductions. Other income-production costs would be allowed under § 183(b)(2) up to the amount of gross income

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75. I.R.C. § 121(a) generally excludes up to $500,000 of gain on a taxpayer's personal residence, defined as a residence that the taxpayer has used as her primary residence for 730 days ("periods aggregating two years or more") out of the last five years of ownership. However, only gain attributable to principal residence use (after 2008) qualifies for the exclusion. *See id.* § 121(b)(4). This rule renders it difficult to obtain full exclusions for more than one residence of a taxpayer.

76. Under present law, the depreciation is allowed and the gain resulting from such depreciation is included as unrecaptured § 1250 capital gain, subject to a maximum rate of 25% under § 1(h)(1)(D), rather than as excluded gain. *Id.* § 121(d)(6). It would be easier to disallow the depreciation and forego the basis adjustments.

77. Actually, § 183(b)(2) allows deductions that would otherwise require a business or investment nexus to the extent that the gross income from the activity exceeds deductions (such as property taxes, mortgage interest, and casualty losses allocable to the activity) that do not require a business or investment nexus. *Id.* § 183(b)(2). The principal effect of this rule is to remove the personal deductions from the possibility of § 183(a) disallowance. The secondary effect is to (possibly) reduce the deductions allowed by § 183(b)(2).

78. *Id.* § 1016(a)(2).

79. *See* Treas. Reg. § 1.183-1(b).

from the activity (reduced by allowable personal deductions). Loss carryovers should continue to be disallowed. The net effect of these changes would be to simplify accounting greatly under § 183(b). In most cases, § 183 would operate to allow the taxpayer simply to ignore income and deductions with respect to not-for-profit activities.

(b) Definition of "Not-for-Profit Activity"

The category of "not-for-profit activity"—which triggers § 183—has been often narrowly construed by the courts to allow marginal activities to operate as tax shelters.[80] The factual nature of the § 183 inquiry encourages taxpayers to frequently litigate the matter[81] with the knowledge that penalties are unlikely. The multi-factor test contained in the regulations[82] invites unpredictable judging. The worst abuses in this area involve real estate used in farming and ranching activities.[83]

If the multi-factor approach is retained, § 183 should be amended so that the possibility of appreciation in property used in, or which is the location of, an activity shall not be taken into account as indicating a profit motive for the activity being scrutinized. Treating the appreciation potential of an asset used in a marginal activity as indicating that the activity itself is for profit is to let the tail wag the dog.[84]

Additionally, a stronger standard could be imposed for overriding the presumption that an activity generating a series of losses is a not-for-profit activity, such as one of "clear and convincing evidence."

An alternative to the "factor" approach would be, as a default rule, to treat any activity as a not-for-profit activity if (a) the activity is not carried on through a C corporation,[85] (b) the activity involves any meaningful element of what people normally consider to be pleasure or recreation for the taxpayer, or (c) the activity involves use of a taxpayer's residence (a topic separately considered immediately below). Exceptions could be carved out, e.g., for activities that become profitable for a certain period, that exceed a certain gross revenue amount, that generate losses only because of favorable tax account-

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80. *See, e.g.*, Engdahl v. Commissioner, 72 T.C. 659 (1979), *acq.*, 1979-2 C.B. 1; Fields v. Commissioner, 1981 T.C.M. (P-H) 1981-550, at 2114 (1981).

81. Annotations of reported § 183 cases occupy seventy-four pages of Standard Federal Tax Reports. *See* 2013-4 Stand. Fed. Tax Rep. (CCH) ¶ 12,170 at 26,896-969.

82. *See* Treas. Reg. § 1.183-2(b) (listing nine factors).

83. Discussions of I.R.C. § 183 are found in ROBERT W. WOOD, 548-2ND TAX MANAGEMENT PORTFOLIOS: HOBBY LOSSES (2d ed. 2012); PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION 595-609 (6th ed. 2008).

84. Personal use of an appreciation-potential asset has always defeated loss and expense deductions apart from I.R.C. § 183. *See, e.g.*, Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962). Section 183 was not intended to reverse prior law on this point. *See* I.R.C. § 183(c).

85. Losses of a C corporation are confined to the corporation and do not pass through to individual shareholders.

ing rules (such as expensing research costs), or that present other objective indicators of a serious profit-making intention (such as acquiring technical expertise and serious marketing efforts).

5. Rental or Business Use of Personal Residence

Section 280A, dealing with business and rental use of a taxpayer's residence, not only potentially overlaps with § 183,[86] but it also resembles § 183 as to its operation,[87] save for the following variances: (1) instead of a for-profit fact test, the triggering mechanism is the objective one of non-residential (commercial) use of a taxpayer's residence;[88] (2) for uses other than certain specified exclusive business uses or rental use (for more than fourteen days), deductions (other than personal deductions) are wholly disallowed;[89] (3) in the case of the specified exclusive business uses or rental use, the allowed amount is computed in the same way as under § 183 but with further disallowance in an amount equal to activity deductions not attributable to such use, but with carry-forward of disallowed losses;[90] (4) certain rentals of a principal residence escape § 280A;[91] and (5), if the residence is rented for less than fifteen days, the gross rental income is excluded and for-profit deductions disallowed.[92] Apart from the statutory complexity of § 280A and its overlap with § 183, accounting under § 280A is burdensome, and the "exclusive business use" test of § 280A(c)(1) cannot be enforced without governmental intrusions into privacy. Residential property subject to significant personal use is unlikely to depreciate on account of wear and tear, as the owner will be strongly motivated to keep the property in good condition.

(a) Integrate the Rental Aspect of § 280A with § 183

In the case of a rental of a residence, the likelihood is that the rental is a device to pay some of the costs of carrying property that was primarily acquired for personal use, or to extract some cash for what is basically a house-sitting function of the tenant. Under such

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86. Not-for-profit rental or other activity in a personal residence could fall under both provisions. Section 280A(f)(3) appears to say that the operating rules of § 280A take precedence but that non-profit years can count for purposes of the § 183 presumption. *See* I.R.C. § 280A(f)(3). Section 280A also potentially overlaps with § 469 (dealing with losses from passive activities, including rental activities), and here again § 280A takes precedence. *See id.* § 469(j)(10).

87. Personal deductions are not disallowed, *id.* § 280A(b), but they reduce the amount that can be deducted (if at all) with respect to the use, *id.* § 280A(c)(5).

88. *Id.* § 280A(a).

89. *See id.*

90. *See id.* § 280A(c).

91. *Id.*

92. *Id.* § 280A(g).

circumstances, it cannot be assumed that the rental is at arm's length for a market-rate rental.

Accordingly, the rental use of a residence of the taxpayer should be treated as a per se not-for-profit activity, subject to the mechanical rules of § 183(b), including the no-carryover rule and disallowance of depreciation on buildings and furnishings.

The § 183 approach should not apply in cases where the personal use is insignificant or a for-profit motive is likely to exist. Possible scenarios deserving of an exception include: (1) rental for more than, say, 300 days in a year at a fair rental,[93] and (2) personal use for less than fifteen days a year coupled with at least 185 days of rental use under management by a professional rental agent.

The existing rule that ignores both rental income and deductions if rental use is less than fifteen days a year[94] is overly generous, as very high daily rentals can be obtained in desirable locations and for special events (such as the Olympic Games, bowl games, football weekends, and the Santa Fe Indian Market). In the case of de minimis rental use, none of the costs of owning or maintaining the residence are truly related to the obtaining of rents, and therefore the rents should be included with no offsetting deductions. Rents (and deductions) should be ignored only if the rents are less than, say, $500 a year.

(b) Disallowance of Deductions for Costs of a Residence Used in a Business

Non-residential uses of a residence are likely undertaken out of personal convenience, not business necessity, and (in most cases) it could not be shown that the business-use space within the residence would not have been acquired for personal reasons. The "exclusive business use" test is unenforceable, as the typical home office can also serve as a media room, a den, a library, an extra bedroom, and a place for personal computing and bill paying. However, the mechanical rule of § 183(b) does not make sense here because costs allocable to the residence do not generate any income directly. Therefore, the appropriate solution in this scenario is simply to disallow not only depreciation but also general residence-related costs (such as utility costs and general house repairs). Total disallowance is consistent with the general tax approach to dual-purpose costs generally.[95] This

93. Websites such as Zillow.com post estimated rental values of virtually all properties in the United States.

94. I.R.C. § 280A(g).

95. *See, e.g.*, Commissioner v. Flowers, 326 U.S. 465 (1946) (commuting to work); Welch v. Helvering, 290 U.S. 111 (1933) (costs of acquiring human capital); Wrightsman v. United States, 428 F.2d 1316 (Ct. Cl. 1970) (costs relating to personal-use property with high appreciation potential); Smith v. Commissioner, 40 B.T.A. 1038 (B.T.A. 1939) (child

approach would obviate the need for allocations of gross income and deductions to the business use of the home.

Here, the deduction-disallowance rule would be waived for: (1) deductions not related to the residence but related to the business activity, (2) deductions relating to in-residence non-transportable business property and supplies not adaptable for personal use (such as technical equipment and chemicals), and (3) separate structures (or attached structures that are not adaptable to personal use, such as art studios) used exclusively in the taxpayer's trade or business. Of course, the "business" in question could itself be a not-for-profit activity subject to § 183.

(c) Travel Expenses to Maintain a Residence

Independently of the foregoing, the Code should be amended to disallow travel expenses relating to property used as a personal residence by the taxpayer for more than, say, fourteen days a year. Such property's location reflects the taxpayer's desire to visit that location, and travel expenses thereto can be assumed to be personal recreational expenses.

6. Tangible Personal Property Available for Personal Use

The IRS is in no position to monitor the bona fide (non-rental) business use of items such as computers, printers, cell phones, tablets, vehicles, and other (movable) tangible property that (a) is not permanently located on the taxpayer's business premises and (2) is available for personal use. Some of these items are currently treated as "listed property" subject to § 280F, but that section still allows deductions for depreciation and other deductions with respect to certain listed property with more than 50% of personal use.

Given that even employers have difficulty in enforcing a business-use-only rule for employees using employer property of this nature (even property located on the employer's premises), it is wholly unreasonable to expect the IRS to enforce the distinction between business and personal use where the taxpayer receives no rental income from the property. Accordingly, deductions with respect to these items should simply be disallowed, period. The Treasury should be authorized to issue regulations allowing exceptions for situations where the IRS is confident that the property is subject to no more than de minimis personal use.

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care to enable one to work); Rev. Rul. 70-474, 1970-2 C.B. 35 (work clothing adaptable to personal use).

7. *Credit Card Interest*

The IRS cannot reasonably be expected to monitor a taxpayer's allocation of interest on credit card debt among the various categories of interest. Accordingly, such interest should be wholly disallowed unless the card is exclusively devoted to business use.

K. *Cancellation-of-Debt Income*

The courts and IRS appear to be extending the concept of cancellation-of-debt (COD) income to situations where the individual has no real increase in wealth or ability to pay.[96] Reigning in the concept of COD income to an appropriate extent can be viewed as being in the nature of "clarification of doctrine," which would advance the cause of taxpayer comprehension and reduce unexpected (and unpleasant) taxpayer involvement with the system.[97]

For purposes of this discussion, "COD income" refers to a situation where a debt disappears by operation of law (such as the running of the statute of limitations), action of the creditor, or agreement between the debtor and creditor.[98] COD income should exist only where the taxpayer is enriched by the borrowing (or credit) transaction as a whole.[99] The paradigm COD scenario is where the taxpayer borrows cash and is relieved of having to pay it back.

COD income should not arise in cases where a mere liability, unrelated to the taxpayer's obtaining cash or property on credit, is cancelled or forgiven.[100] Examples are fines, penalties, tax liabilities, child support obligations, and charges for money, goods, or services never obtained by the taxpayer. In these cases, the "liability" is a mere prediction of a future expense or loss, and the avoidance of even an anticipated future decrease in wealth is not income.

Second, COD income should not arise on the forgiveness of purchase money debt in cases where the taxpayer still owns the acquired property. Such a rule already exists in § 108(e)(5) for two-party pur-

96. *See* Payne v. Commissioner, 95 T.C.M. (CCH) 1253 (2008), *aff'd*, 357 F. App'x 734 (8th Cir. 2009) (per curiam), *cert. denied*, 131 S. Ct. 151 (2010); Hahn v. Commissioner, 93 T.C.M. (CCH) 1055 (2007) (forgiveness of earned interest).

97. I.R.C. § 108(a) avoids current inclusion of COD income in certain cases, but at the cost of reducing such favorable tax attributes as net operating losses carryovers and basis. *See id.* § 108(b). It is doubtful that an ordinary individual taxpayer would be able to comprehend or comply with this approach.

98. The term does not refer to satisfaction of a taxpayer's debt or liability by the taxpayer or by a third party, debt cancellations that are means of paying for goods or services provided by the debtor to the creditor, or erroneous deduction accruals by accrual method taxpayers (or other scenarios that involve application of the tax benefit rule).

99. For other commentary along similar lines, see generally Richard C.E. Beck, *Cancellation of Debt and Other Incidental Items of Income: Puritan Tax Rules in the U.S.*, 49 N.Y.L. SCH. L. REV. 695 (2004).

100. Older cases support this view. *See, e.g.*, Commissioner v. Rail Joint Co., 61 F.2d 751 (2d Cir. 1932).

chase money debt, and it should be extended to three-party purchase money debt.[101] In this type of case, the taxpayer never received cash to spend freely. Rather, the taxpayer is committing herself to pay the purchase price in future installments. Instead of the taxpayer having COD income, the basis of the property should be reduced with recapture of excessive depreciation deductions. Here, the taxpayer is merely paying a reduced amount for the property. The typical application of this approach would be to a renegotiation downwards of a residential mortgage.

Taking the foregoing a step further, COD income should not arise by reason of avoiding consumer debt, including unpaid interest or rental obligations. The rationale (again) is that the taxpayer is paying a reduced price for consumption and that arm's length bargain purchases of consumption do not give rise to income.[102]

However, third-party credit card debt is distinguishable, because it essentially entails a loan of cash to the cardholder followed by an immediate cash payment to the merchant.[103] Thus, a reduction in bank credit card debt is true COD income because the taxpayer has been enriched in tax terms.

L. *Alimony vs. Child Support*

Current law allows a transactional election between two tax regimes concerning the payment of cash from one divorced spouse to another: (1) if several statutory requirements are complied with to constitute the payments as "tax alimony," the payments are deductible by the payor and includible by the payee, or (2) otherwise, as the default rule, the payments are ignored by both payor and payee. These alternatives are supposed to be independent of state law. However, the requirement for tax alimony that the payments must terminate on the death of the payee spouse has resulted in entanglement with state law,[104] as has the rule that a label of "child support" (possibly imposed by a court regardless of the parties' intentions) also negates characterization as tax alimony. Additionally, unsophisticated divorce lawyers are often ignorant of the tax rules and their implications.

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101. The IRS views this scenario as giving rise to COD income. *See* Rev. Rul. 91-31, 1991-1 C.B. 19.

102. In some cases, COD income is avoided under the disputed-debt doctrine of current law. *See* Preslar v. Commissioner, 167 F.3d 1323 (10th Cir. 1999) (holding there is no COD income where dispute is over value received).

103. Rev. Rul. 78-38, 1978-1 C.B. 68. It would be virtually impossible to allocate any reduction in bank credit card debt to particular purchases.

104. *See, e.g.*, Preston v. Commissioner, 209 F.3d 1281 (11th Cir. 2000); Ribera v. Commissioner, 73 T.C.M. (CCH) 1807 (1997).

The default rule should be that cash payments from one ex-spouse to another pursuant to an instrument of divorce or separation should be deductible by the payor and includible by the payee, regardless of state law, what the payments are called, or whether they can survive the payee spouse's death.[105] A deduction/inclusion scheme would accord with the ability-to-pay principle. The payor spouse is typically in a higher tax bracket than the payee spouse, meaning that larger payments (than otherwise) can be made, leaving both parties better off after tax. Economically, there is virtually no difference between cash transfers labeled as alimony or as child support, as only rarely is the payee spouse held to account for misuse of the funds. The payee spouse would be entitled to any available dependency exemption. The spouses could jointly make an election into a no-deduction/no-inclusion rule, in which case the payor would have superior rights to the dependency exemption.

Exceptions to the deduction/inclusion scheme could lie for front-loaded payments, payments that look like they are in lieu of a property transfer, or payments that have the effect of a property purchase (which are to be disregarded under § 1041).

M. Small Business Tax Accounting

This proposal would allow certain small business taxpayers (however defined) to elect to use cash accounting for inventory and other items, thereby giving them the opportunity to fill out their tax returns without resorting to accountants and tax return preparers.

1. Expand Use of the Cash Method

A business is currently required to use the accrual method if it (a) keeps its books according to financial accounting principles,[106] (b) carries inventories,[107] or (c) is required by statute to do so.[108] Whatever might be said for accrual accounting for purposes of financial statements, it is hard to see how cash accounting can misstate income for tax purposes, as a general matter.[109] The tax base is an an-

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105. If the payee is not the ex-spouse, the same rules should apply unless the payee is an exempt entity or non-U.S. taxpayer, in which case the payor would forego the deduction but be eligible to claim the dependency exemption.

106. I.R.C. § 446(a), (c)(2).

107. Treas. Reg. § 1.446-1(c)(2)(i).

108. *See* I.R.C. §§ 447, 448.

109. The legislative history to § 448 lamely states that the accrual method better conforms to financial accounting principles (especially the "matching principle") than the cash method. No abuses of the cash method are cited. *See* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 474-75 (Comm. Print 1987). On the merits, it might be said that trade receivables received on the sale of goods and services are an "accession to wealth," but the current income tax is a realization income tax, and receivables represent unrealized income. Where the receivables are highly

nual construct, and matching is not a tax norm.[110] The cash method should be allowed, at the taxpayer's option, unless a good reason exists to the contrary.

2. Opting Out of Inventory Accounting

Under present law, the purchase (or production) and sale of inventories is required to follow inventory accounting, which entails treating inventory costs (when accrued) as capital expenditures and following a recognized convention, such as FIFO, for allocating such costs to the taxable year. However, some exceptions already exist to this approach.[111]

Although capitalization is a hard norm of income taxation, reasons to relax it exist in the case of small business generally. The link between any particular cost and any particular sold item is already severed by the existence of inventory-accounting conventions. The gain from inventories is not compensation for the use of money or property, nor is it in the nature of market appreciation. Sellers of inventory have a natural incentive to sell it as promptly as is feasible. Essentially, inventory gains are the product of services (buying in one market and selling in another, plus servicing customers). Noncapitalization is simpler than the approach of current law, and there appears to be little potential for tax avoidance, especially if the taxpayer is on the cash method of accounting.[112] In other words, it is proposed that inventory costs be generally treated as business expenses.

The option to forego capitalization should not be available to small businesses that are required to capitalize inventory costs under regulatory law or Generally Accepted Accounting Principles (GAAP) to assets that are depreciable, to inventories of investments (land and securities), to inventories of unique assets (art and collectibles), to

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liquid, the merchant possesses an incentive to sell the receivables. Many receivables of service providers will never be collected, as the sellers of services have no security.

110. *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931); Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998).

111. *See* Treas. Reg. § 1.162-3T (allowing expensing of materials and supplies), § 1.162-6 (expensing of outlays of professionals), § 1.162-12 (farming costs). Additionally, small resellers of goods, farmers, and artists are not required to capitalize direct and indirect costs relating to inventories. *See* I.R.C. § 263A(b)(2)(B), (d), (h). Similarly, businesses that perform services on a "project" basis (such as architects and plaintiffs' lawyers) do not capitalize costs to such projects. *See* Treas. Reg. § 1.263(a)-4 (2004) (service projects to obtain future fees from clients generally not treated as "intangibles"). Certain costs of extracting natural resources are likewise not capitalized. *See id.* §§ 263(c), 616, 617.

112. In the bad old days, expense deductions could be accrued by an accrual method taxpayer simply by entering into a contract for the purchase of goods to be delivered in the future. Under current § 461(h)(2)(A)(ii), the deduction cannot be accrued any earlier than the goods are provided to the taxpayer. *See* I.R.C. § 461(h)(2)(A)(ii).

taxpayers using long-term contract accounting, or to other businesses or items for which expensing is not appropriate (as listed in regulations).

3. *Simplified Asset Accounting*

Except for capital expenditures currently deducted under "expensing" rules, all capital expenditures of a "small business" incurred during the year (that relate to wasting assets) would be collected into a single vintage account and depreciated on a straight line basis over, say, four years, with all assets being deemed to have been put in service on January 1 of the vintage year. No depreciation deduction would be allowed in the year of the asset's disposal. The asset's basis (for purposes of figuring gain or loss) would be its cost less 25% thereof for any year of depreciation.

N. *Book-Tax Conformity for Public C Corporations*

C corporations, as a general matter, compute taxable income in the same way as do individuals for purposes of the corporate income tax.[113] However, a corporation is a tax entity separate from its shareholders, and the corporate income tax is, at its core, an excise tax that takes the form of an income tax in order to accommodate marginally profitable businesses. C corporation tax accounting would be simplified if it conformed to GAAP rather than the tax accounting rules for individuals, at least if the corporation follows GAAP accounting. It might be thought that individual/corporate tax accounting uniformity (1) eliminates tax incentives as to form of business entity, (2) avoids tax disparities that would exist with respect to similarly-situated GAAP-reporting businesses (because GAAP involves principles rather than a comprehensive set of rules), and (3) avoids the tax-driven race to the bottom within the accounting profession that might occur if GAAP were followed for tax purposes.

I do not find these arguments to be persuasive on their face. A strong tax incentive already exists *not* to incorporate: the double shareholder/corporation tax.[114] Additionally, corporate tax reform may include other features, such as lower rates and rules mandating the form of business organization, that could affect evaluation of how corporate tax accounting should work. For publicly traded C corporations, book-tax conformity would balance client demand for higher

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113. *See id.* § 63(a). The gross income computation is the same for individuals and C corporations; some deductions are only allowed for individuals and some are only allowed for corporations, but most are allowed for both. See §§ 63(b), 151(a), and the captions to I.R.C. Subtitle A, Ch. 1, Subch. B, Parts VI, VII, and VIII (Income Taxes).

114. It should be noted that, if the C corporation tax rate is lower than the individual tax rate, and if capital gains (and dividends) are also subject to lower-than-normal individual rates, then corporate accumulations and delayed distributions can save taxes relative to a pass-through system.

earnings against the client demand for lower taxes. Book-tax conformity should itself create a demand for greater uniformity in the application of accounting standards among businesses. I conclude that this simplification option at least deserves serious study as a component of a broader package of business-entity tax reform.

O. Gratuitous Transfers

Various tax rules relating to the income taxation of gratuitous transfers can be simplified or eliminated.

1. What is a "Gift"

Under current law, the test for the § 102(a) exclusion for "gifts" and "bequests" is whether the donor's motive is one of " 'disinterested generosity.' "[115] A test keyed to motive of a person other than the taxpayer is unworkable. Taxpayers are free to take aggressive positions on this issue without incurring a significant risk of penalties and/or tax fraud prosecution.[116] The existing rule breeds costly fact-bound litigation.

A subjective test is unnecessary and should be replaced by the objective test adopted by the gift tax (as well as the charitable contribution deduction), namely, whether a transfer of wealth has not been made for full and adequate consideration in money or money's worth, or in an ordinary commercial transaction.[117] Additionally, any receipt of money or property from a business entity should not be excludible as a gift for income tax purposes.

2. Repeal § 274(b)

Section 274(b) disallows business deductions for certain items that are excluded solely as gifts. This section is badly drafted insofar as it assumes that certain items are excluded as gifts where really they are not. Additionally, this provision would be rendered moot by the change mentioned immediately above. Third, deductibility as a business deduction should not hinge on the tax treatment of another party. The tests for deductibility under § 162 are independent of the test for exclusion under § 102(a). Accordingly, this section should be repealed.

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115. Commissioner v. Duberstein, 363 U.S. 278, 285-86 (1960) (quoting Commissioner v. LoBue, 351 U.S. 243, 246 (1956)).
116. *See, e.g.*, United States v. Harris, 942 F.2d 1125 (7th Cir. 1991).
117. *See* Treas. Reg. § 25.2512-8.

3. Repeal the Basis-Disallowance Rule for Gifts of Depreciated-Value Property

Section 1015 generally provides a carryover basis rule for inter vivos gifts, but a complex exception lies for gifts of depreciated-value property, under which the basis can "float" until the property is sold by the donee. The only conceivable purpose of this rule is to prevent the assignment of built-in losses from a lower-bracket donor to a higher-bracket donee. This scenario would appear to be uncommon, since lower-bracket donors rarely have unrealized-loss property to give away. Yet § 1015 allows the assignment of built-in gains by higher-bracket donors to lower-bracket donees, which is a much more serious problem as far as income-shifting strategems are concerned. Thus, the exception should be repealed.

4. Repeal the § 691(c) Deduction and the § 1015(d)(6) Basis Adjustment

The § 691(c) deduction is available to a person acquiring a right to "income in respect of a decedent" (IRD) of an amount equal to the estate tax (if any) "on" the IRD right, when the IRD is included in income. (IRD rights, which are rights to earned but unpaid income of a decedent, do not obtain a step-up in basis under § 1014.)[118] The theory of the deduction is that, if the decedent had included the income on her final return, the estate tax base would have been reduced by the income tax paid or owed by the decedent. If the income and estate tax rates are the same, the § 691(c) deduction is equal to the hypothetical estate tax savings that would have resulted from the hypothetical inclusion of the IRD in the decedent's income.

The § 691(c) deduction is not only complex, but it is also so obscure (being unrelated to any cost) as to be susceptible of being overlooked except by the cognoscenti. Moreover, it is based on a false assumption, namely that the IRD was subject to income tax of the decedent. In fact, the IRD is income of the recipient of the IRD right, not the decedent.[119] Equal treatment between estate transfers of IRD rights and ordinary cash is not appropriate, because the situations are not the same. The current rules for IRD have the effect of deferring income and of attributing the income to a person who may well occupy a lower tax bracket than that of the decedent. The income tax paid by the IRD recipient will appropriately reduce the IRD recipient's potential transfer tax base. The § 691 deduction serves no legitimate purpose and should be repealed.

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118. *See* I.R.C. § 1014(c).
119. *See id.* § 691(a).

Section 1015(d)(6) gives a donee of appreciated property an income tax basis increase equal to the gift tax (if any) on the unrealized appreciation in the gift property. Apparently, the adjustment is "for" a hypothetical income tax of the donor that would have hypothetically reduced the gift amount.[120] If so, the rationale for § 1015(d)(6) is at least as flimsy as that for the § 691(c) deduction. Not only is this scenario purely hypothetical, but no donor would realize gain that would otherwise be wiped out by the stepped-up basis rule of § 1014.

5. *Grantor Trusts*

The rules as to what trusts are deemed to be owned by the grantor are forbiddingly complex.[121] Proposals range from treating all inter vivos trusts as grantor trusts to that of treating no such trusts as grantor trusts.[122] Here I'll offer an intermediate proposal: a grantor trust would be a disregarded entity[123] if income or corpus *could* be (or is required to be) distributed to the grantor or the grantor's spouse.[124] The identity and status of the person holding such power would be irrelevant,[125] and limitations (standards) on any such distributive power would be disregarded.

Because of the fact that a grantor trust is a disregarded entity for income attribution purposes, a grantor trust should not be treated as a separate taxpayer for any other income tax purpose.[126] It follows that transactions between a grantor and a grantor trust would be

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120. The gift tax on the unrealized appreciation is not an acquisition cost of the donee, because the donor is liable for the gift tax. *Id.* § 2502(c). Even so, acquisition costs are not added to the § 1015 basis, but subsumed within it. *See* Treas. Reg. § 1.1015-4 (basis to the donee is the greater of the § 1015 basis or any cost of acquiring the gift).

121. *See* I.R.C. §§ 671-677. Section 678, treating certain trusts as owned by a beneficiary, would also be repealed.

122. *See, e.g.*, Mark L. Ascher, *The Grantor Trust Rules Should be Repealed*, 96 IOWA L. REV. 885 (2011). Grantor trusts can be used to avoid the highly compressed rate schedule of § 1(e) applicable to trust and estate net income, but trusts can still be used to shift income from the grantor's higher marginal rates to the lower marginal rates of distributees. It should be noted that the "kiddie tax," *see* I.R.C. § 1(g), curbs the use of trusts to shift income to minors, but this renders § 677(b) (trust income used to discharge grantor's support obligation) largely pointless.

123. The grantor continues to be taxed on the trust's income, because the grantor is deemed to be the owner of the trust property. I.R.C. § 671.

124. Sections 674 and 675 (the most technical of the grantor trust rules) would be repealed, and §§ 673, 676, and 677(a) would be combined. Professor Ascher concedes that § 676 (power to re-vest corpus in grantor or grantor's spouse) should be retained. Ascher, *supra* note 122, at 930. Section 677(a) extends the principle expressed in § 676 to income. Section 673 (retained reversions worth more than 5%) should be retained because non-trust retained-reversion transfers are ineffective to shift income.

125. The concept of "adverse party"—an artificial construct—would cease to play a role in this area.

126. *Cf.* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984) (recognizing an installment sale from a grantor trust to a grantor), *nonacq.*, Rev. Rul. 85-13, 1985-1 C.B. 184.

disregarded. The model for such a rule is § 1041, dealing with property transfers between husband and wife.[127]

6. A "Simple Estate" Income Tax Regime

Under current law, estates are taxed as Subchapter J trusts,[128] but special rules come into play only for estates.[129] The system is complex, and its rules are often skipped over in the basic income tax and estate and gift tax courses, so that estate attorneys may be insufficiently aware of them, with the resulting incurrence of unnecessary taxes.[130] There is no policy reason to tax estate net income at the highest marginal rate (as can easily occur under present law), as estates (which result from a transferor's death) are not illegitimate income shifting devices.

A simpler income tax regime should be available for any estate that (1) possesses a net value under a certain amount (perhaps $2 million), (2) does not provide for a successive interest transfer (in trust or otherwise), and (3) is not a trust in disguise (i.e., is wound up within a reasonable time after the decedent's death).

Specific-bequest property, and the income therefrom, would be deemed to be owned by the legatee (and not the estate) for income attribution purposes starting on the day following the decedent's death. All other estate income and deductions would be aggregated at the entity level and attributed to the residual legatees (and/or heirs) in proportion to their interests. (No estate net income would be allocated to fixed-sum legatees.[131]) The estate would pay a withholding tax at the highest individual marginal rate on all estate net income, including net capital gains. (The withholding tax would be charged pro rata against the estate distributions to residual legatees or heirs.) These estate beneficiaries would, in addition to reporting their ratable share of estate net income, obtain a tax credit for their share of

127. Section 1041 treats a "sale" between marital partners as a non-realization event, and the transferor's basis carries over to the transferee. I.R.C. § 1041(a), (b).

128. *See id.* § 641(a).

129. *See id.* §§ 642(b)(1), 663(a)(1).

130. Under current law, if the estate net income is greater than distributions to residuary legatees (and heirs), the excess is taxed to the trust under the highly compressed rate schedule of I.R.C. § 1(e).

131. A "specific property" bequest is one where the legatee is to receive specifically identified property under the will. A "fixed-sum" (or "pecuniary") bequest is of a fixed-dollar amount under a will. *See* Treas. Reg. § 1.663(a)-1(b). Under the law of estates, fixed-sum legatees (unlike other legatees and heirs) are not entitled to a share of estate income, but they may be entitled to interest payments. *See* RICHARD B. COVEY, MARITAL DEDUCTION AND CREDIT SHELTER DISPOSITIONS AND THE USE OF FORMULA PROVISIONS, App. B (4th ed. 1997) (compilation of state rules on this issue). Any interest payable by the estate on account of a delayed distribution of a fixed-sum bequest would be deductible to the estate in arriving at estate net income for income tax purposes and would be gross income to the fixed-sum legatee.

the withholding tax.[132] The executor would file an information return to the IRS and the estate distributees stating the gross income amounts and the tax credit amounts for each residual beneficiary or heir.

7. *Repeal the rule that the in-kind satisfaction of a fixed-sum bequest is a deemed sale of the property*

Under current law, the satisfaction of a fixed-sum bequest with in-kind property is treated as a sale by the estate (or trust) of the asset to the legatee at its fair market value,[133] but other estate distributions entail a different set of income tax consequences.[134] These rules add unneeded complexity to the system and may be overlooked by fiduciaries. The rule as to fixed-sum bequests is conceptually misguided, because the distributee has not given any consideration in money or money's worth for the right to the bequest. Whatever purpose might be served under probate law for treating the pecuniary obligation as a "debt"[135] has no relevance for income tax purposes.[136]

Accordingly, all in-kind distributions should be treated alike: the distribution would not constitute a realization event, and the estate's basis would carry over to the distributee.[137]

P. *Transactional Accounting Issues*

1. *Basis of In-Kind Income Items*

Under current law, some confusion exists as to whether the "tax cost" basis of in-kind property receipts should be the amount actually included in gross income or, instead, the amount includible (although not in fact included). Often this issue is dealt with by applying the complex "mitigation provisions"[138] or fact-intensive equitable doctrines, such as equitable estoppel, equitable recoupment, or the duty of consistency.[139] Resort to these provisions and doctrines assumes

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132. The suggested system would do away with the distribution deduction and the computation of estate distributable net income. *See* I.R.C. §§ 643(a), 661, 662. Net tax exempt income would also be passed through.

133. *See* Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Rev. Rul. 67-74, 1967-1 C.B. 194; *see also* I.R.C. § 267(a)(1), (b)(13) (allowance of loss to estate in this scenario).

134. *See* I.R.C. § 643(e) (default rule is that distribution is not a realization event).

135. Treating pecuniary bequests as "debts" is what results in the estate's obligation to pay interest if the distribution of the bequest is unreasonably delayed. *See supra* note 131.

136. The proposed change is in line with that for "false" COD income, involving the forgiveness of debts not incurred for value received. *See supra* text accompanying notes 100-01.

137. Section 643(e) would be modified to accord with this proposal. If the distribution deduction/inclusion system of present §§ 661 and 662 continues in force for trusts (and large estates), the distribution would be "at" the trust's basis.

138. I.R.C. §§ 1311-1314.

139. The various doctrinal strands in this area are discussed in JOSEPH M. DODGE ET

that the statute of limitations applies to basis determinations, a position that is contrary to the Supreme Court's decision in *Dobson v. Commissioner*,[140] as well as the position of all courts of appeals in cases involving recoveries of amounts erroneously deducted in prior years.[141] Since basis is not subject to the statute of limitations, linking basis to what the taxpayer actually reported does not involve the re-opening of barred issues. As a policy matter, taxpayers should not obtain collateral tax benefits for their own errors and omissions.

Accordingly, the "tax cost" basis of any in-kind property receipt (or of any claim to a right to recovery of an item previously expended) should depend on the taxpayer's actual prior tax treatment of the item.

2. *Repeal § 1341*

Section 1341 gives a taxpayer that refunds or repays a previously included item the choice between the deduction that would be allowed as a matter of course and a credit equal to the incremental taxes "caused" by the prior income inclusion of the refunded amount. This provision has bred a good deal of litigation concerning its imprecisely worded prerequisites. If applicable, § 1341 involves recalculating the tax for a year possibly closed by the statute of limitations. Section 1341 was enacted in 1954 in the wake of a Supreme Court case where the original inclusion was subject to very high marginal rates in 1944 that had decreased by the year of repayment.[142] The correct tax treatment in theory is to allow a deduction (as a matter of right) in the year of repayment, because the taxpayer has had the use of the money until then. Accordingly, § 1341 should be repealed.

Section 67(b)(9) provides that the deduction "allowed by" § 1341 is not a "miscellaneous itemized deduction."[143] However, § 1341 does not allow any deduction whatsoever.[144] Presumably, the intent here was to list the deduction *referred to* in § 1341, but it appears (on account of the reference to "claim of right") that this reference applies only where the § 1341 requirements for electing into the credit are satisfied. This technical glitch becomes moot if, as suggested above, § 67 is amended to cover only enumerated borderline expense deductions

AL., *supra* note 73, at 654-60.

140. Dobson v. Commissioner, 320 U.S. 489 (1943).

141. Federal appeals courts that have considered the issue have uniformly held that recoveries of erroneously deducted amounts are fully includible. *See, e.g.*, Hughes & Luce, L.L.P. v. Commissioner, 70 F.3d 16 (5th Cir. 1995). In other words, a taxpayer's basis in the right of recovery hinges on the actual prior tax treatment, not the correct prior tax treatment.

142. *See* United States v. Lewis, 340 U.S. 590 (1951); H.R. REP. NO. 83-1337, at A294-95 (2d Sess. 1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4436.

143. I.R.C. § 67(b)(9).

144. *See id.* § 1341. Curiously, the deduction for the refund or repayment is viewed as a deductible "loss" under § 165(c)(2), rather than an "expense."

and the distinction between above-the-line and itemized deductions is eliminated. Otherwise, given that the "claim of right" notion has been abandoned in the doctrinal substratum,[145] § 67(b)(9) should be amended to refer to "the deduction arising from the repayment or refund of a previously included amount."

Q. Portfolio Accounting for Publicly Traded Securities

Even with brokers being required to supply basis information for securities transactions,[146] accounting for basis on an item-by-item basis is onerous.[147] Consideration should be given to allowing taxpayers to use an average basis in a portfolio of publicly traded securities. An average-basis approach is conceptually correct for shares of a given stock, since all such shares are fungible. The proposed system would simply extend this concept to the taxpayer's entire portfolio of publicly traded securities, for which a year-end valuation of the portfolio would be required.

1. Mechanics

The system would operate somewhat like inventory accounting, but without a physical "closing inventory." Thus, "portfolio security gains" for a year would be "receipts from security dispositions" less "cost of securities sold." The cost-of-securities-sold amount would be "cost of opening securities inventory" plus "cost of new securities inventory"[148] (equaling total portfolio basis) multiplied by a fraction, the numerator of which is "gross receipts from securities dispositions" and the denominator of which is the sum of (1) such gross receipts and (2) the sum of the market quotes for all securities on hand at the end of the year.[149] Conceptually, this formula produces a basis offset (against sales receipts) equal to that percentage of the aggregate year-end securities basis that reflects the decrease in value of the portfolio caused by the sales. The "opening inventory" for the next year would be "cost of opening securities inventory" plus "cost of new securities inventory," less "cost of securities sold," all for the prior

145. *See* United States v. James, 366 U.S. 213 (1961) (overruling Commissioner v. Wilcox, 327 U.S. 404 (1946), a case that had held that embezzled cash was not gross income because not obtained under a claim of right).

146. *See* I.R.C. § 6045(g).

147. Under current law, where shares of the same stock are purchased at different times, the taxpayer has to either identify the particular securities sold or else use the first-in, first-out convention. Treas. Reg. § 1.1012-1(c)(1). Since shares of the same stock are fungible, an average-basis approach is conceptually preferable to either of the methods sanctioned by the regulations. An average-basis approach is currently allowed only for certain mutual fund shares. *See id.* § 1.1012-1(e)(1).

148. "Cost of new securities inventory" would include any current-year basis adjustments attributable to tax-free exchanges, gifts, bequests, OID accruals, and so on.

149. Thus, if there is no closing inventory of securities, the basis would be 100% (gross receipts/gross receipts) of the aggregate basis.

year. Securities that have become worthless during the year would not produce transactional losses. Instead, worthlessness would have the effect of increasing aggregate basis relative to aggregate portfolio value.

The existing distinction between long-term gains and losses and short-term gains and losses would, if retained, complicate the system, because separate pools of short-term and long-term publicly traded securities would need to be kept, with securities passing from a short-term pool to a long-term pool. The problem can be managed if securities are deemed to move from a short-term pool to a long-term pool only on January 1 of the taxable year that is the second taxable year following the year of purchase. Thus, securities purchased at any time in 2013 would reside in a short-term pool in 2013 and 2014,[150] and any remaining security cost in this pool would shift to the long-term pool in 2015. It would still be necessary to match sales receipts to the correct vintage pool. This problem would disappear if the distinction between long-term and short-term were to be abolished.

2. *No Disallowance of Portfolio Net Loss*

If the taxpayer elects to use this system, all publicly traded securities would be required to be accounted for within it. In that case, the system would operate in a manner that would preclude the cherry picking of losses, because the proceeds from the sale of any security would trigger the same basis recovery amount, regardless of whether that particular security had appreciated or depreciated. Sales would produce losses only where the portfolio as a whole (inclusive of the year's transactions) is in a loss position.

Since the cherry picking of losses would not be a major concern under the portfolio approach, consideration could be given to allowing any portfolio loss for the year as a current deduction, without any carry forward of losses (except for negative taxable income caused by such losses). If losses were allowed in full, the losses should carry symmetrical tax treatment to any favorable tax treatment conferred upon portfolio gain. Thus, if 30% of portfolio gain were excluded by reason of being long-term capital gain, then 30% of portfolio losses would be disallowed.

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150. Securities purchased in 2013 would reside in a "vintage 2013" pool, and sales of 2013 securities would be offset by the average basis of sold 2013 securities. The 2013 pool would continue for the year 2014, and any remaining basis at the end of 2014 would pass into the long-term pool on January 1, 2015. Another pool, for securities purchased in 2014, would continue through 2015, and pass to the long-term pool in 2016.

3. *Partial Repeal of § 1014*

Transitioning to the next part concerning simplification aspects of certain tax reform measures, it is fair to say that academic tax commentators are unanimous in their condemnation of the rule that death wipes out unrealized asset gains and losses.[151] Repeal of this rule would also generate substantial revenue.

The portfolio-basis system described above could, if mandatory, be used as a vehicle for partial repeal of § 1014 (really, of the rule that death is not a realization event for tax purposes). The usual objection to such a repeal, i.e., that historic basis is too hard to ascertain, would carry no weight, as portfolio basis would have been adjusted annually. The net portfolio gain or loss would be deemed realized in the year of the taxpayer's death. The fair market value of the portfolio assets at the decedent's death would fix both the amount realized by the decedent at death and the basis of the decedent's successors in such assets.

IV. TAX REFORMS CONTRIBUTING TO SIMPLIFICATION

This Part deals with tax reform options that also offer simplification potential. Since this Article is not being used as a vehicle for pushing my personal tax reform agenda, the emphasis herein is on the simplification potential offered by what might be called the "usual suspects" in the vast array of possible tax reform proposals.

A. *Tax Expenditures*

It might be obvious that the place to start is with wholesale elimination of those numerous Code provisions that can be called "tax expenditures," in the narrow sense of having been enacted to serve a programmatic goal, such as investment in a certain type of business, the creation of domestic jobs, or the subsidization of child care. (The broader issue of defining a tax expenditure as any deviation from some tax-base norm—such as Haig-Simons income—would not serve the purposes of the present discussion, which is not focused on norms.[152]) All such programmatic tax expenditures must contain qualification rules that distinguish the favored activity from non-favored activity. These qualification rules are typically detailed and

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151. *See* Joseph M. Dodge, *Why a Deemed-Realization Rule for Gratuitous Transfers Is Superior to Carryover Basis and Avoids Most of the Problems of the Present Estate and Gift Tax*, 54 TAX L. REV. 421 (2001), and authorities cited therein.

152. For example, from a consumption tax perspective, capital expenditures should be expensed; from an accretion income tax perspective, capital expenditures should not be expensed, and depreciation should equal the annual decline in an asset's value; from a realization income tax perspective, it is questionable whether depreciation should be allowed at all.

complex.[153] But, although their wholesale elimination from the tax Code would advance the cause of tax simplicity, the same programs, now “off tax,” would entail non-tax complexity and attendant compliance costs. Abolishing the programs altogether might advance the cause of “government program simplicity,” but simplicity at that level has to be weighed in the larger context of policy, which is beyond the scope of this Article. Of course, where these “programs” are not justified in policy terms, repealing them would advance the cause of simplification.

In the name of transparency, I would only suggest that programmatic tax expenditures take the form of tax credits rather than deductions. Since some of the deduction provisions that are generally thought of as tax expenditures (such as accelerated depreciation[154] and expensing of research and experimentation outlays[155]) occupy a gray zone of accounting uncertainty, these provisions might even be justified in the name of simplification. However, simplification in this context only argues that rules are preferable to case-by-case determinations. Simplification alone does not justify one set of rules over another.

B. Capital Gains

The arguments for and against special rates for capital gains are well rehearsed and will not be repeated here.[156] Without doubt, vast simplification of the income tax can be obtained by eliminating (to the extent possible) the apparatus regarding capital gains. Some of this apparatus, however, might be needed to cope with the problem of cherry picking capital losses, which (although tangentially considered above in connection with investment portfolio accounting) is systematically addressed here.

1. Plan A: Eliminate Special Rates for Net Capital Gain

Section 1(h), providing special (low) rates for various categories of net capital gains, is so complex that its details probably cannot be grasped by even a very intelligent tax expert, so that a lengthy worksheet (or computer program) is required. Additionally, Schedule D of the Individual Income Tax Return (Form 1040) requires the entry of extensive data broken down into numerous categories.

An obvious option is to provide no tax benefit for net capital gains in any form.

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153. *See, e.g.*, I.R.C. 179(d).
154. *Id.* §§ 168(b)(1), (k), 179.
155. *Id.* § 174.
156. *See generally* TAX ANALYSTS, THE CAPITAL GAINS CONTROVERSY (J. Andrew Hoerner ed., 1992).

2. *Plan B: Simplify the Benefits Conferred on Net Capital Gain*

A secondary option is to replace the present "rate" approach by a "partial exclusion" approach for net capital gains. For example, some percentage of net capital gains, say, 30%, would be excluded from gross income. The existing approach essentially eliminates any progressivity in the capital gains system at the upper end of the income scale (where virtually all net capital gains are concentrated) and therefore disproportionately favors taxpayers in the very highest rate bracket.[157] The exclusion approach also better accords with an "inflation adjustment" rationale for favorable treatment. Finally, the exclusion approach is compatible with the structure of the Alternative Minimum Tax (AMT), because the exclusion can (and should) be added back in computing AMT taxable income.

3. *Eliminate the Category of "Collectibles" Gain*

Net collectibles gain is currently subject to a maximum tax rate of 28%.[158] Either net collectibles gain deserves treatment on a par with other investments in the capital gains system or it does not. In my view it does not, since collectibles are usually held for personal use or could be held for personal use without the knowledge of the IRS. Hence, it can be presumed that the acquisition and disposition of collectibles is driven more by personal taste than economic considerations. Indeed, losses on such assets are (usually) subject to disallowance as personal losses, and the activity of collecting is likely to be held to be a not-for-profit activity.[159]

If any collectibles are to obtain a full capital gains benefit, strict "investment" requirements should be imposed. For example, the collectible should have been purchased for a substantial sum (say, $40,000, or perhaps more) and should be required to be stored in a vault or warehouse and barred from any personal use.

4. *Full Depreciation Recapture for Real Estate*

The argument against recapture (as ordinary gain) of gain caused by depreciation of real estate is not convincing.[160] The argument is

157. To illustrate this point, assume that taxpayers X and Y are in the 25% and 40% marginal rate brackets, respectively, without regard to capital gains, and that each has net capital gains of $10,000. Under the rate approach of current law, both X and Y pay incremental tax of $1500 on this $10,000. Under a system in which 40% of net capital gains are excluded, X and Y would have incremental income of $6000. X, taxed at a 25% rate, would have the same $1500 incremental tax as before. However, Y would have an incremental tax of $2400.

158. I.R.C. § 1(h)(4)-(5). Actually, matters are more complicated than that, but the complications are not germane to the discussion.

159. *See, e.g.*, Barcus v. Commissioner, 1973 T.C.M. (P-H) 1973-138, at 643 (1973), *aff'd*, 492 F.2d 1237 (2d Cir. 1974) (per curiam).

160. Existing § 1250 recaptures only the excess of accelerated over straight-line depre-

that real estate can appreciate and depreciate at the same time, so that the gain might result from true unrealized appreciation deserving of capital gain treatment. However, the argument is based on the derivation of depreciation from a mathematical model (changes in present values of future yields that are fixed *ab initio*) that inevitably shows "losses" with the passage of time. The mathematical model is only a proxy for *expected* mark-to-market depreciation.[161] If the asset did not in fact depreciate in value, then the asset was not a wasting asset in the taxpayer's hands over the period it was held, and depreciation should not have been allowed in the first place. Appreciation is an "inconsistent event" relative to the depreciation deductions.[162] Only one asset exists, and any gain should be attributed first to depreciation (a certain tax fact), which, by causing the basis to be reduced, directly produces gain. Gain that is clearly "caused" by ordinary deductions (that reduce basis) should always be ordinary gain. Recapture already exists under § 1245 as to equivalent gain on personal property. The less-favorable capital gains tax rate for "unrecaptured § 1250 gain"[163] already amounts to a partial move in this direction.

Accordingly, § 1250 should be repealed, and § 1245 should be expanded to encompass all gain attributable to depreciation (and expensing). This simplification move can also be made without any other change in the capital gains system.

Elimination of the categories of "collectibles gain" and "unrecaptured § 1250 gain" would greatly facilitate a move back to a partial-exclusion system.

5. *Repeal § 1231*

Section 1231 is a complicated provision, the main feature of which provides that net unrecaptured long-term gain from property used in a trade or business is net capital gain (but that net loss is ordinary loss). Expansion of depreciation recapture to real estate would greatly reduce the impact of this provision, so that it would only affect land and other nondepreciable property used in a business. In general, business-use property should generate ordinary gain (and loss), as is the case with other business income (and loss).

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ciation, but exceptions exist. Accelerated depreciation has not been allowed on real estate since 1986. Thus, virtually all gain on depreciable real property is treated as capital gain or § 1231 gain.

161. This much is evident from what many consider to be the seminal work on depreciation: Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964).

162. In the absence of Congressional preemption of depreciation rules, the inconsistent-events doctrine would probably result in ordinary gain to the extent of depreciation. *See* Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983).

163. I.R.C. § 1(h)(1)(D), (h)(6).

Another aspect of § 1231 is to provide that net unrecaptured involuntary-conversion gains on business and investment property can, when combined with other § 1231 gains and losses, end up as net capital gains despite the absence of a sale or exchange.[164] There is no reason that unrecaptured gains should be treated as capital gains just because the property is disposed of in an involuntary conversion, because the taxpayer in such cases can avoid the recognition of involuntary-conversion gain under § 1033 by reinvesting the proceeds of conversion in similar-use property. Unreinvested gains of an individual are available for consumption. Finally, if the purpose of capital gains benefits is to unlock investments, then involuntary conversions are not an inappropriate occasion to confer capital gains treatment, because the disposition was beyond the taxpayer's control.[165] In general, the appropriate remedy for unexpected income or gains is a tax deferral rule, which already exists in the form of § 1033. Thus, this aspect of § 1231 also merits repeal.

A provision parallel to § 1231 (as far as the "character" of gain or loss is concerned) exists under § 165(h)(2)(B) with regard to involuntary conversions of personal-use assets. The same arguments for repeal as noted above apply here as well. (Other aspects of personal casualty losses and gains will be discussed below.)

What remains of § 1231 after repealing the foregoing is a tax expenditure provision that taxes income from certain extractive and agricultural enterprises at lower rates.[166]

C. *Losses on Sales and Exchanges*

Even if lower rates for net capital gains are eliminated, the problem of capital losses would remain. Under current law, a taxpayer's aggregate capital losses for the year can only be deducted to the extent of the sum of (1) taxpayer aggregate capital gains for the year, or (2) $3000 (in the case of non-corporate taxpayers).[167]

1. *Restrictions on the Current Deductibility of Net Transactional Losses*

The restrictions on the current deductibility of net capital losses are designed to prevent the cherry picking of investment losses while allowing gains to go unrealized. The theoretically proper anti-cherry-picking rule would be to allow realized losses to be allowed to the ex-

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164. *Id.* § 1231(a)(3)(A)(ii), (a)(4)(B), (a)(4)(C).
165. This point was the basis for the decision in *Pounds v. United States*, 372 F.2d 342, 348 (5th Cir. 1967).
166. I.R.C. § 1231(b)(2)-(4).
167. *Id.* § 1211. Capital losses that are disallowed are carried over to future years under § 1212.

tent of realized gains plus an amount equal to the excess (if any) of *net* realized losses over unrealized gains.[168] However, accounting for unrealized gains would entail a valuation of appreciated assets at the end of the year,[169] and the income tax avoids valuations as a general rule.

The "portfolio method" of accounting for securities transactions set forth in Part III.Q above is one way to deal with the problem. A less radical approach would be to allow taxpayers to elect to treat unrealized gains on publicly traded investments as having been realized (at the end of the taxable year) to the extent of such realized net losses, and such gains (although not actually resulting from a sale) would absorb the realized net losses. Realized losses on publicly traded investments in excess of realized and deemed-realized gains would be allowed to the extent that such excess exceeds gains that are neither realized nor deemed realized. Since the assets in the deemed-realized-gain category are still owned by the taxpayer, an amount equal to the deemed-realized gain would be added to basis, bringing the basis of such assets up to their fair market values at the end of the year, effectively reducing future gains (as would occur with carryovers).[170]

2. *Simplifying the Rules Defining Gains and Losses Subject to the Anti-Cherry-Picking Rule*

If lower rates for capital gains are eliminated, the existing terminology and definitions of capital gains and losses could be scrapped and a new system put in place that is designed solely to implement the anti-cherry-picking rules in an appropriate fashion. The anti-cherry-picking rule should be limited, roughly speaking, to "voluntary" realized losses from investments and from those business assets that are *not* routinely disposed of at the end of a normal business cycle (such as land and assets having an indefinite or very long useful

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168. Thus, if realized losses are $10,000, realized gains are $2000, and unrealized gains are $5000, the amount currently deductible should be limited to $5000: $2000 + [($10,000 - $2000) - $5000]. Stated differently, the deduction for net realized losses would be reduced by the amount of unrealized ("unpicked") gains.

169. Since all figures in the formula are determined as of the end of the year, a loss that was not truly "cherry-picked" at the time realized could be disallowed and carried over because of appreciation that occurred later in the year. Of course, the reverse could happen as well.

170. Again, assume that a taxpayer has realized losses of $10,000 during the year, has realized gains of $2000 during the year, and has unrealized gains at the end of the year of $5000, all involving publicly traded investments. The taxpayer would report $2000 of realized gains and could elect to report an additional $5000 of deemed-realized gains (excess of end-of-year fair market value of appreciated assets over their then adjusted basis). In that case, all $10,000 of the realized losses would be allowable, because no cherry picking would exist in this scenario. Additionally, $5000 would be added to the basis of the unrealized gain assets, bringing the basis of each such asset up to the fair market value at the end of the year.

life). Thus, inventory and business equipment would normally be excluded from the loss-limitation system, as would be involuntary-event losses, losses that were realized by reason of another party's action, losses incurred by the lapse of a time period, and losses occasioned by worthlessness. Various "deemed sale or exchange" rules, such as §§ 165(g), 166(d)(1)(B), and 1271(a)(1), could be consolidated into one Code section treating certain losses as falling without the anti-cherry-picking rule. At the same time, all transactional gains (not from inventory, business equipment, receivables, etc.), whether voluntary or not, should be allowed to offset losses subject to the anti-cherry-picking rule.

The existing distinction between short-term and long-term would be meaningless under the anti-cherry-picking rule. If no favorable treatment for net capital gains is available, the holding period concept could be dropped entirely.

D. The Personal Deductions

Proposals abound to eliminate, cut back, or restrict all or some of the personal deductions, sometimes in the name of raising revenue,[171] and sometimes in the name of conforming to a normative tax base.[172] The deductions (in various degrees) have already been seriously eroded by floors, ceilings, phase-out rules, and indirect disallowance or deferral under the Alternative Minimum Tax. These backhanded approaches were critiqued in Part III as contributing to complexity and lack of transparency. Here, the focus is on the deductions themselves.

1. Residential Mortgage Interest

Although defended by politicians as essential to preserving middle class homeownership, this deduction for qualified residence interest[173] is criticized by a broad spectrum of tax academics.[174] Plausible proposals include: (1) eliminating the deduction entirely, (2) eliminating the deduction for interest on home equity debt (as opposed to acquisition or improvement debt),[175] (3) restricting the deduction to in-

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171. *See, e.g.*, Edward D. Kleinbard, *The Role of Tax Reform in Deficit Reduction*, 133 TAX NOTES 1105, 1106-07 (2011).

172. Numerous articles discuss the issue of whether any of the personal deductions conform to the concept of Haig-Simons income. *See, e.g.*, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979); William J. Turnier, *Evaluating Personal Deductions in an Income Tax—The Ideal*, 66 CORNELL L. REV. 262, 270-76 (1981).

173. I.R.C. § 163(h)(3).

174. *See, e.g.*, Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, L. & CONTEMP. PROBS., Winter 2010, at 233.

175. Interest on home equity debt (as opposed to acquisition debt) is allowed on up to

terest on (acquisition) debt for the taxpayer's principal residence only,[176] and (4) reducing the dollar figures for deduction-generating mortgage principal. The invocation of middle-class values is not a plausible defense of the deduction insofar as it relates to home equity debt and mortgages on second (vacation) homes.

This deduction is neither particularly complex nor hard to administer. Nevertheless, if a deduction for home equity indebtedness is retained, the "net equity" limitation found in § 163(h)(c)(1) should be removed, because it entails annual valuations of the property and annual determinations of acquisition-debt principal.[177] Alternatively, this net equity rule could be retained but only applied as of the date of borrowing. A third possibility would be to require that the home equity loan come from an unrelated commercial lender.

Since the personal exemptions already include an allowance for housing costs, consideration should be given to imposing a floor under the residential interest deduction (if it is retained) in order to prevent redundant deduction of the same costs. Since persons tend to spend at least 30% of their income on housing costs,[178] and since mortgage interest would often be the largest such cost for homeowners, a plausible floor would be $6000 (one-third of the low-income allowance for a family of two as suggested earlier).[179] However, such a floor—although perhaps a revenue raiser—would not eliminate much data from the system.

2. *State and Local Taxes*

The deduction for nonfederal taxes (unrelated to business or investment) is also controversial. Plausible proposals include (1) abolishing the deduction entirely, (2) eliminating the deduction for property taxes (or possibly only foreign property taxes), and (3) eliminating the deduction for sales taxes.

Accounting for state and local *sales* taxes is impractical. Additionally, sales taxes are naturally viewed (rightly or wrongly) as a cost of whatever is purchased. The case for eliminating the deduction for

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$100,000 of home equity debt principal. I.R.C. § 163(h)(3)(C)(ii).

176. The deduction is available for interest on the taxpayer's personal residence and one other residence. *Id.* § 163(h)(4)(A)(i).

177. *Id.* § 163(h)(c)(1).

178. *See* Mary Schwartz & Ellen Wilson, *Who Can Afford to Live in a Home?: A Look at Data from the 2006 American Community Survey*, U.S. CENSUS BUREAU, http://www.census.gov/housing/census/publications/who-can-afford.pdf (last visited Jan. 25, 2014).

179. Off-the-bottom allowances are discussed in the text *supra* Part III.E–F. However, a fixed-dollar floor is probably a political non-starter, since it appears to favor high-income taxpayers whose mortgage interest expense would exceed the floor. The conventional approach in response to this problem is to express floors as a percentage of net income. However, that kind of floor appears to be out of synch with fixed-dollar subsistence deductions.

sales taxes on personal-consumption items is compelling from both a theoretical and practical perspective. In sum, sales taxes should be treated as part of the cost of whatever is purchased and not as a separate expense.

Property taxes are viewed as a cost of maintaining property, and costs of maintaining personal-use property should not be deducted. Moreover, property taxes on personal-use property can be avoided by renting rather than owning. Hence, it cannot be persuasively argued that these expenses are involuntary or are forced. Thus, the deduction for taxes on personal-use property is also a good candidate for repeal. Certainly, real property taxes on second homes should be disallowed as being highly discretionary. Since it is sometimes hard to tell whether a tax on tangible personal-use *personal* property is really a tax, and since such taxes typically are small in amount, the deduction for such taxes should also be eliminated.

State and local income taxes cannot be avoided except by the extreme measures of moving or cheating. Hence, a plausible case exists for deducting only these taxes. Moreover, since state and local income taxes are not universal in the United States, a deduction only for this category of nonfederal taxes is not a proper scenario for a floor under the deduction.

Taxes on real property are universal, all but five states impose sales taxes,[180] and all but seven (or nine) states impose income taxes.[181] Aggregate state and local taxes as a percentage of income ranged (in 2010) from about 7.0% to 12.8%,[182] which is a fairly narrow spread. Since the tax base is supposed to be a "difference principle," costs that all persons bear equally (or proportionately to income) can well be ignored. Although a floor under a deduction is usually appropriate to weed out commonly incurred expenses of a certain type, allowing a deduction in excess of a floor is indicated only where extraordinary expenses of the category in question is possible. In the case of state and local taxes, it is hard to see how such extraordinary payments can occur. Therefore, even if it is thought that one or more of the categories of state and local taxes should be deducted under a normative

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180. Alaska, Delaware, Montana, New Hampshire, and Oregon do not have comprehensive state sales taxes, but most have taxes that are partial substitutes for sales taxes. *State Sales Tax Rates*, SALES TAX INST., http://www.salestaxinstitute.com/resources/rates (last updated Nov. 1, 2013).

181. States without income taxes are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. *States Without a State Income Tax*, IRS.GOV, http://www.irs.gov/uac/States-Without-a-State-Income-Tax (last updated Apr. 11, 2013). Nevertheless, New Hampshire and Tennessee tax dividends and interest. *See Taxes by State*, RET. LIVING INFO. CTR., https://www.retirementliving.com/taxes-by-state (last updated Jan. 2013).

182. *State and Local Tax Burdens: All States, One Year, 1977 – 2010*, TAX FOUND. (Oct. 23, 2012), http://taxfoundation.org/article/state-and-local-tax-burdens-all-states-one-year-1977-2010.

theory of income, a case can be made that none of them should be deductible in practice.

Under current law, refunds of deductible taxes must be run through the machinery of § 111 in order to determine the portion of them that is includible by reason of having actually reduced taxable income in a prior year. This calculation is required where: (a) the deduction is subject to a floor, (b) the deduction falls within a class of deductions that is subject to a floor, or (c) the taxpayer's taxable income is reduced to a negative number by the deduction. Refunds occur mainly with respect to income taxes. If taxes (including income taxes) are not deductible at all, then refunds of such taxes would be wholly excludible and would not have to be included subject to the machinery of § 111.

3. Personal Casualty and Theft Losses

The standard rationale for this deduction is that personal casualty and theft losses constitute a decrease in wealth that is not "consumption."[183] However, in fact consumption under an income tax is viewed as occurring when a personal-use asset is purchased, not as and when it is used.[184] Moreover, the tax system does not otherwise take into account deviations of consumption value from cost.

As a matter of broader policy, the deduction operates as taxpayer-subsidized insurance for uninsured losses. The deduction is more valuable to high-bracket taxpayers who can best afford to purchase property-loss insurance.

It is tempting, therefore, to repeal this deduction entirely, and for most taxpayers the deduction has already been repealed by reason of the floor under the deduction equal to 10% of adjusted gross income. Nevertheless, in some cases casualty and theft losses reduce ability to pay, and the system should make appropriate allowance in that event. Any reduction in ability to pay occurs by reason of having to prematurely replace "essential" property. (Such a rationale is the same as the "duplicative cost" rationale for deducting business lodging costs.) Thus, the deduction should be triggered only by the unexpected destruction of certain property. The deduction would be the lesser of the cost of replacement or the cost of the items being replaced, reduced by the sum of net salvage proceeds, insurance proceeds, and government cash benefits, but not to exceed a specified

183. Turnier, *supra* note 172, at 272.

184. Consumption costs, whether expenses or capital expenditures, are taxed by being nondeductible. The nondeductible (and non-depreciable) cost of a personal-use asset represents the present value of its future estimated consumption value. Actual consumption with respect to such assets is not taxed as it occurs.

fixed-dollar figure. "Replacement cost" would include unreimbursed costs of lodging for a maximum period of, say, one year.

If the deduction is not repealed or further cut back, the following simplification reforms are suggested.

First, valuation "after" the casualty should not play any role in cases where the item is not disposed of and is repaired or rehabilitated. The valuation of, say, a wrecked automobile is pointless, because a wrecked automobile has no economic use, except as salvage. In such a case, the repair costs (not to exceed the cost of the property), reduced by recoveries, should be treated conclusively as the tentatively deductible amount. Of course, if the item is abandoned or sold for scrap, the loss amount is the adjusted basis reduced by any monetary recovery.

Second, no deduction should be allowed for losses attributable to unrealized appreciation. Hence, the tentatively deductible amount should be reduced by the excess, if any, of the pre-loss value over the adjusted basis of the item.

Third, it is not clear why casualty and theft losses are allowed to avoid the existing floor by first being netted against recognized casualty and theft gains.[185] Personal consumption losses should not offset recognized gains that are essentially investment gains (other avenues exist for nonrecognition of personal casualty and theft gains, namely, §§ 121 and 1033). This netting rule echoes that of § 1231, but § 1231 would be eliminated under a proposal made above. Also, no good reason exists why recognized personal casualty gains should obtain capital gains treatment, as occurs under § 165(h) when such gains exceed such losses. The issue of loss deductibility should have priority over that of character. The portion of § 165(h) relating to whether the casualty and theft deduction is an itemized deduction or an above-the-line deduction would be rendered moot by the abolition of that distinction. Accordingly, § 165(h) should be mostly repealed, leaving only the floor under the deduction (if retained) in place.

4. *Charitable Contributions*

The charitable deduction has been critiqued (and defended) from many angles, but the only consensus reform proposal is to limit the deduction with respect to donations of appreciated property to the taxpayer's basis across the board. (As to depreciated-value property, presumably the deduction should be limited to value.) Certainly it is

185. The 1982 Act revised § 165 so that the 10% floor applied to all casualty and theft losses. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324. The 1984 Act introduced the complex rules of § 165(h) as a technical correction, apparently designed to cull personal casualty theft and casualty gains and losses out of § 1231. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

hard to justify the various distinctions found in § 170(e), which limits the deduction to basis in some cases but not others.[186] This reform would advance the cause of simplification of the income tax.

Apart from the issue of appreciated-property contributions, the charitable deduction should be subject to a floor, equal to, say, 2% of net income.[187] Viewed instrumentally, the charitable deduction is an incentive to give, but nontax incentives also exist, and it is likely that people would give modest amounts to charity without a tax incentive. A modest floor should actually increase incentives to give at the margin. Moreover, a floor would also eliminate a good deal of trivia (and potential valuation disputes) from the system.

Valuation of utilitarian tangible personal property imposes a considerable administrative burden on the tax system. Such property is virtually certain to have depreciated greatly in value and is likely to be slated for abandonment in any event. The donor is hardly incurring any kind of sacrifice by giving these items to a charity, because such items have already been consumed by the donor. Thus, the rationale for any deduction at all in this scenario is very weak and can only survive by supposing both that it is socially better that these items end up in the hands of charity rather than a waste disposal site and that potential donors would prefer (in the absence of a tax incentive) to destroy rather than give. Consideration should be given to authorizing the IRS to issue a valuation table that confers a small (or zero) per item value on such property.[188] Alternatively, the deduction could simply be disallowed for donations of tangible personal property worth less than, say, $200 per item.[189]

For items of utilitarian tangible personal property that possess significant value and that could either be sold or used by the charity (such as cars, boats, furniture, and computers), a deemed-consignment approach is appropriate: the donor would simply obtain a deduction in the year of sale by the charity in an amount equal to

186. Roughly speaking, the deduction equals basis for (1) property held for less than one year, (2) property given to a private (non-operating) foundation, and (3) tangible personal property not to be used by the donee for its exempt function. The latter category was sufficiently abused that Congress was forced to enact § 170(e)(7) in 2006.

187. That is, only aggregate contributions in excess of 2% would be deductible. Higher (10% of AGI) floors already exist under the medical expense deduction, I.R.C. § 213(a), and the deduction for personal casualty losses, *id.* § 165(h)(2)(A). Additionally, a 2%-of-AGI floor exists under aggregate "miscellaneous itemized deductions." *Id.* § 67(a).

188. Section 170(f)(16), added in 2006, disallows a deduction for clothing and certain household items that are in "good used condition or better." *Id.* § 170(f)(16). However, this standard is imprecise and probably unenforceable. The same section allows the IRS to issue a regulation that treats contributed clothing or certain household items of "minimal monetary value" as being worth zero, but no such regulation has been issued, and, again, the standard is vague. *Id.*

189. *Cf. id.* § 165(h)(1) (throwing out the first $100 of losses per casualty or theft event).

the charity's net sales proceeds.[190] It might be objected that the donee might actually use the property, in which case the sales price might turn out to be much lower than the value at the time of contribution. However, since charities have a long history of accommodating donors at the expense of the IRS, a charity's representations to a donor as to its intentions are unreliable (and unenforceable by the IRS). Hence, the donation rule should induce the charity to sell the donated item in the market and spend the cash on whatever it desires.

Another possible reform proposal (possessing a simplification angle) would be to eliminate any income tax deduction for a contribution that will benefit the charity only at or after the donor's death, generically referred to as a "charitable remainder transfer."[191] The income tax is an annual tax, and there is no reason why a donor should obtain an income tax deduction in the current year for a transfer not reduced to possession or use by the charity during the year in question, especially if the donor (or the natural object of the donor's bounty) is enjoying the property in the meantime. The charity really receives no useable value until the retained interest expires. The income tax is not bound to follow the law of future interests. Charitable remainder interests are hard to value, and techniques exist to overvalue the charitable remainder interest relative to the nondeductible retained interest.

The ceilings on the charitable deduction are complex and overlapping. Additionally, concern exists that the charitable deduction can be combined with other personal deductions (as well as the personal and dependency exemptions) to virtually zero-out the donor's tax liability. This problem can be eliminated by imposing a single ceiling as a percentage of *taxable* income (without regard to the charitable deduction itself). In other words, other deductions would operate to lower the ceiling on the charitable deduction.

5. *Medical Care*

The deduction for medical care, subject to a 10% floor of adjusted gross income, is for uninsured medical costs paid by an individual for herself, her spouse, and her dependents.[192] The floor can effectively

190. A rule of this type already exists in § 170(f)(12), added in 2006, but only for vehicles, boats, and airplanes, and it does not apply to vehicles or airplanes if the donee undertakes "significant intervening use or material improvement." *Id.* § 170(f)(12)(A)(ii). This provision is unnecessarily complex, requires paperwork to be provided to the donee and the IRS, and appears to contemplate the possible amendment of the donor's tax returns. Moreover, it is not clear why it is limited to vehicles, boats, and airplanes.

191. A cognate device is the "direct charitable annuity," in which a contribution is made in return for an annuity payable by the charity. A unique problem with this device is that the "donor" benefits from the charitable tax exemption in the form of increased annuity payments (relative to the commercial norm).

192. *See* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9013, 124

be avoided through medical savings accounts, employer health plans, self-employment health insurance, and (to some extent) self-purchased insurance.[193] The floor renders the deduction useless for most of those taxpayers unable to avoid it.

The Code section allowing the deduction, § 213, has become something of a Christmas tree by reason of being worded in such a way that allows the scope of the deduction to expand endlessly to include borderline items that have more to do with desires than objective health needs.[194] The problem is aggravated by the fact that no political constituency appears to favor the elimination or containment of this deduction. Nevertheless, the deduction (if retained) should be limited to costs for, say, the prevention or cure of disease, the alleviation (other than by over-the-counter drugs) of chronic or abnormal pain, or the correction of a non-self-inflicted work-disabling physical defect or condition.

Current health policy favors near-universal coverage through private insurance. It is surprising that the Patient Protection and Affordable Care Act of 2010 did not enact an above-the-line deduction for self-purchased health insurance, a move that would have further eroded the significance of § 213. Instead, what the Act gave us was a tax subsidy, effective starting in 2014, for persons (above the eligibility level for Medicaid but below an amount that is four times the applicable poverty level) who purchase health insurance through "exchanges" in the form of a refundable tax credit found in § 36B.[195] The credit is extremely complex, and it will undoubtedly require a worksheet.

6. Costs of Tax Planning and Compliance

A good case can be made for eliminating the deduction conferred by § 212(3) for costs relating to taxes. This deduction has already been partially repealed by virtue of having been categorized as a mis-

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Stat. 119, 868 (2010) (amending I.R.C. § 213).

193. All except the last have the effect of allowing a deduction for the insurance premium, I.R.C. §§ 106, 162(l), 223, plus a tax-free reimbursement for health care costs. The last scenario entails a nondeductible premium combined with such tax-free reimbursement. Reimbursements are tax-free under § 104(a)(3) or § 223(f). *Id.* §§ 104(a)(3), 223(f).

194. The deduction is overbroad in defining medical care to entail costs relating not to only diseases, but also to costs "affecting any structure or function of the body." *Id.* § 213(d)(1)(A). The over-broadness is compounded by the tendency of the medical and, especially, the mental health professions to expand the definition of "disease" to encompass virtually any biological or mental condition that inhibits the attainment of an individual's personal goals. *See* O'Donnabhain v. Commissioner, 134 T.C. 34 (2010), *acq.*, 2011-47 I.R.B. 789 (Nov. 21, 2011) (allowing deduction for sex change surgery because "gender identity disorder" is now a "disease" recognized by the mental health profession).

195. Premiums (up to the credit amount) will not also be deductible as medical expenses. I.R.C. § 280C(g).

cellaneous itemized deduction,[196] and it now chiefly operates to subsidize tax litigation (including criminal tax fraud defense) and tax planning for the wealthy. Despite the fact that tax planning costs are not within the language of the existing statute, the IRS has decided otherwise, without satisfactory explanation.[197] Other costs of nonbusiness litigation are not deductible.

As a matter of income tax theory, a cost incurred to reduce a nondeductible cost (such as a federal tax) should not be deducted.[198]

E. Personal Injury Recoveries

Under current law, recoveries for personal physical injuries are excluded under § 104(a)(2).[199] Other tort and tort-like recoveries (including punitive damages and compensatory damages for nonphysical injuries) are included. No persuasive rationale exists for the exclusion.[200] If the exclusion is based upon solicitude for plaintiffs, taxing damages can be overcome by grossing up tort recoveries. The exclusion for plaintiffs can be captured (in whole or in part) by defendants, resulting in failure to internalize fully the social costs of the tort.

The distinction between included and excluded damages in turn determines the deductibility of attorney fees and other costs of obtaining recoveries, because only costs allocable to included recoveries are deductible.[201] Since most tort claims are settled, and since private settlement allocations cannot be trusted (no party desires an allocation to punitive damages), it devolves upon tax trial courts to undertake the onerous and costly task of adjudicating the tort claim in order to make an allocation.

These issues can be solved in a fashion that simplifies the tax law by making all personal injury recoveries includible. In that case, all costs of obtaining such recoveries (which are really capital expenditures)[202] would be deductible.

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196. Also, if the deduction reduces taxable income, it is added back to AMT taxable income.

197. *See* Merians v. Commissioner, 60 T.C. 187 (1973) (noting IRS concession of this issue), *acq.*, 1973-2 C.B. 1 (Dec. 31, 1973).

198. A refund of federal income taxes is excluded from income on account of the fact that the overpaid tax was not deductible. Costs of obtaining excluded income (or non-income) are not deductible. *See* I.R.C. § 265(a)(1). Any deduction here can only offset unrelated income. Planning strategies resulting in a reduction of nondeductible federal taxes have the same effect as a refund of overpaid nondeductible federal taxes.

199. *Id.* § 104(a).

200. *See generally* Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143 (1992).

201. I.R.C. § 265(a)(1) (disallowing expenses of obtaining excluded income).

202. *See* Joseph M. Dodge, *The Netting of Costs Against Income Receipts (Including Damage Recoveries) Produced by Such Costs, Without Barring Congress from Disallowing Such Costs*, 27 VA. TAX REV. 297 (2007).

F. Retirement Savings

Explicit statutory tax favoritism for savings vehicles exists for certain funded qualified retirement vehicles, herein referred to as "qualified plans," but the benefit of tax deferral is also obtainable under certain nonqualified (funded and non-funded) arrangements.

1. Qualified Tax-Deferral Retirement Plans

Except for Roth IRAs,[203] the basic pattern for qualified retirement savings vehicles under current law is to allow tax-free contributions to an account to be excluded (or included and deducted) by the account owner, the earnings on the account to be tax free, and for the payouts to be fully taxed.[204]

(a) Complexity in the Service of an Ineffective Policy Design

At the individual taxpayer level, the "complexity problem" with current law is the proliferation of tax-favored plan types with assorted requirements pertaining to qualification, taxpayer eligibility, maximum contributions, minimum and maximum distributions, and more.[205] Simplification could begin by consolidation of the various existing plan types,[206] especially those used by small business owners and self-employed individuals. But tinkering with the existing system is not ambitious enough and may result in further complications.[207]

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203. Roth IRAs generate tax-exempt income from nondeductible contributions, I.R.C. § 408A, and therefore do not fall within the category of "tax-deferral plans."

204. The tax favoritism consists of a deduction for worker contributions to the plan, contrary to the capitalization principle. Alternatively, an employer's contribution to a funded plan benefitting the employee is excludible by the employee, but exclusion is the equivalent of inclusion (as compensation for services) and full offsetting deductibility.

205. A good introduction to the system, along with reform proposals, is found in Norman P. Stein, *An Alphabet Soup Agenda for Reform of the Internal Revenue Code and ERISA Provisions Applicable to Qualified Deferred Compensation Plans*, 56 SMU L. REV. 627 (2003).

206. Qualified plans can be classified according to method of contribution, calculation of benefits, or unique qualification rules, and various categories often overlap or hybridize. Besides Roth IRAs, the following types of plans can be qualified: regular IRAs, "SIMPLE" IRAs, cash or deferred § 401(k) plans, regular pension plans, cash-balance defined benefit plans, pension equity plans, simplified employee pension plans (SEPs), salary-reduction pension plans, profit-sharing defined contribution plans, target-benefit (defined contribution) plans, age-weighted profit-sharing (defined contribution) plans, money purchase (defined contribution) plans, employee stock ownership plans (ESOPs), non-ESOP stock bonus plans, top-heavy plans, annuity § 403(a) plans, exempt-organization annuity § 403(b) plans, and state and local government § 457 plans. *See* I.R.C. §§ 219, 401(k), 403(b), 408(k), 408(p), 457. The rules pertaining (mostly) to plan qualification occupy 338 pages in the Code alone (the 2012 CCH edition).

207. A retirement income simplification/reform proposal submitted by the American Bar Association Tax Section was released on October 3, 2012. Letter from Rudolph R. Ramelli, Chair of the A.B.A. Section of Taxation, & Charles H. Egerton, Former Chair of the A.B.A. Section of Taxation, to Chairmen and Ranking Members of the S. Comm. on Fin. & H. Comm. on Ways & Means (Oct. 3, 2012), *available at* http://www.americanbar.org/content/

The task of meaningful simplification can be approached by way of focusing on the underlying policy rationale for the existing system, which is explicitly that of retirement security.[208] The existing system, overall, is currently embodied in both the Social Security retirement system and the law that governs privately funded retirement plans (the Employee Retirement Income Security Act of 1974 as amended, known as ERISA).[209] Non-workers, ranging from the chronically unemployed to wealthy investors, lie beyond the scope of retirement income security policy.[210]

A possible approach is to eliminate tax-favored plans entirely and to expand the Social Security retirement system so that it provides an adequate level of wage replacement in retirement for all or most of the workforce.[211] Nevertheless, the discussion herein will proceed on the twin assumptions that the Social Security program will continue and that retirement security in excess of Social Security will be privately funded.[212]

In the context of a privately funded system that supplements Social Security, the concept of retirement income security has two prongs. One is financial security through funding, vesting, nonalienability, plan insurance (for defined benefit plans), and portability,

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dam/aba/administrative/taxation/100312letter.authcheckdam.pdf.

208. An alternative means of simplification would be to allow universal tax-free savings accounts, but that move would not only entail a major shift towards a cash-flow consumption tax, but would also undermine the goal of income security, as described *infra* in the text accompanying notes 250-51.

209. The non-tax provisions of ERISA are located at 29 U.S.C. §§ 1001-1461 (2006). The historical evolution of the pension system in the U.S. is recounted in JOHN H. LANGBEIN ET AL., PENSION AND EMPLOYEE BENEFIT LAW 44-63 (5th ed. 2010).

210. It should be noted here that a federal needs-based program, Supplemental Security Income (SSI), provides benefits to low-income persons over age sixty-five, as well as to the disabled and blind. 42 U.S.C. § 1382(a)(1) (2006). In contrast, Social Security retirement benefits are not conditioned on need. *Id.* § 402(a).

211. It appears that many affluent countries provide a more extensive government-funded pension system than does the United States, where the wage replacement rate provided by Social Security appears to be fairly modest. Specifically, the wage replacement rate has been roughly 45% for lowest-quintile wage earners and about 33% for middle-quintile workers, with further declines in the two highest quintiles. *See* Alan Fox, *Earnings Replacement Rates and Total Income: Results from the Retirement History Study*, 45 SOC. SEC. BULL., Oct. 1982, at 3, 13 (mid-1970s data), *available at* http://www.ssa.gov/policy/docs/ssb/v45n10/v45n10p3.pdf; *see also* LANGBEIN ET AL., *supra* note 209, at 38-39. The Social Security retirement income program (which is not really contingent on retirement as such) is part of the Old Age, Survivors, and Disability Insurance (OASDI) federal program. To be eligible, a person must contribute to the program for a specified period. Contributions are withheld by employers for employees. *See* I.R.C. §§ 3101, 3111. Self-employed persons contribute by way of the self-employment tax. *See id.* §§ 1401-1403. Current contributions fund current benefits, so that the program operates on a pay-as-you go basis, as opposed to an investment basis.

212. Under current demographic assumptions, the Social Security program is, if unchanged, expected to run a large deficit in the future, and, in any event, benefits are estimated to represent a lower rate of return on contributions than would be the case with privately-funded plans. *See* LANGBEIN ET AL., *supra* note 209, at 41-43.

many of which can be (and are) achieved simply by federal government mandates under ERISA, as amended, but which are also incorporated into the tax qualification rules.[213] The second prong of the policy is that of covering virtually the entire workforce. This second aim is merely touched upon by legal mandate.[214] Instead, it is almost exclusively the aim of the tax rules,[215] which is to incentivize employers to offer broad-coverage retirement plans (which, inside the firm, are often mandatory for covered employees), with a secondary purpose to incentivize non-covered workers to save for retirement.[216] Unfortunately, the present system of qualified plans has only brought retirement plan coverage up to about half of the workforce, and this coverage is heavily weighted towards high-income employees.[217] The reasons for the ineffectiveness of the present system are legion, but the root of the problem is that employers are not required to adopt qualified plans, nor are non-covered workers required to create their own plan. Employers willing to adopt a plan can (and do) effectively avoid covering large portions of their workforce by hiring workers as independent contractors or less-than-half-time workers.[218] Additionally, unionized workers can be excluded,[219] and benefits and contributions for employees under qualified plans can be integrated with Social Security, thereby effectively reducing plan coverage for low-paid workers.[220] Also, the qualification rules themselves contain loopholes

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213. *See* I.R.C. § 401(a)(1), (2), (7).

214. Basically, the legal mandate is that an employer adopting a plan can exclude only part-time employees, employees under the age of twenty-one, or employees with less than one year of service. 29 U.S.C. § 1052 (2006). The same rule appears (in substance) as § 410(a) of the tax Code. *See* I.R.C. § 410(a).

215. A "minimum coverage" nondiscrimination rule is located at I.R.C. § 410(b). Additionally, contributions or benefits must not discriminate in favor of highly compensated employees. *Id.* § 401(a)(4). Finally, caps exist on contributions and benefits, *id.* § 415(b)-(c), which operate mainly to the detriment of high-salary employees.

216. *See* Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, *in* PENSION AND EMPLOYEE BENEFIT LAW, *supra* note 209, at 402, 402-05. For an account of the enactment of ERISA that stresses the political motivations, see S. SPEC. COMM. ON AGING, 98TH CONG., THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: THE FIRST DECADE 1-25 (Comm. Print 1984) (Chapter 1, *Overview: Why Was ERISA Enacted?* written by Michael S. Gordon). For a more cynical view, see John H. Langbein, *Social Security and the Private Pension System*, *in* IN SEARCH OF RETIREMENT SECURITY 109 (Teresa Ghilarducci et al. eds., 2004) (describing the effect of the system as being a stealth program to allow high-income earners to accumulate wealth at low tax rates).

217. *See* LANGBEIN ET AL., *supra* note 209, at 25-30.

218. The term "employee" is not actually defined in ERISA, but in *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992), the Supreme Court held that independent contractors are excluded. *See also* Treas. Reg. § 31.3121(c)-(d); Rev. Rul. 87-41, 1987-1 C.B. 296. Employees who work less than twenty hours per week are effectively not considered to be employees. *See* I.R.C. § 410(a)(3). For a comprehensive discussion of excludible employees, see LANGBEIN ET AL., *supra* note 209, at 412-15.

219. I.R.C. § 410(b)(3)(A).

220. *See generally* Keith A. Bender, *Characteristics of Individuals with Integrated Pensions*, 62 SOC. SEC. BULL., no. 3, 1999, at 28 (noting that integration is allowed in part so

that allow non-coverage of (especially) low-compensation employees.[221] Finally, the most widely used plan type for self-employed persons is the § 401(k) type of defined contribution plan, which itself is elective on an annual basis.

Technicalities aside, the tax incentives for employers and non-covered workers are too feeble. The only current tax inducement to the employer is a current deduction for cash transfers to qualified employee trusts,[222] but a current deduction for cash transfers already accords with income tax norms, and such treatment operates as an incentive only because Congress has imposed an artificial tax disincentive for nonqualified funded plans.[223] The more salient employer tax incentive consists of offering the tax benefits attendant upon qualified plans to highly compensated employees (who presumably control company policy) on condition, by way of nondiscrimination rules, that they offer qualified plans to rank-and-file employees. This indirect, trickle-down, approach is wasteful for several reasons. First, employer-maintained retirement plans for employees below the top tier would exist to a fair degree without tax benefits on account of the dynamics of employee recruitment and collective bargaining.[224] Second, the cost—lost tax revenue—attendant on bribing high-level employees is high, whereas the incentive is weak, because highly-paid employees—who already have the capacity to save—can achieve equivalent or better tax results through other forms of deferred compensation, such as nonqualified arrangements, incentive stock options, and carried interests.[225] Third, the net cost of covering lower-income employees may outweigh the net tax benefits for high-salary employees.[226] Fourth, workers at the bottom may oppose coverage solely on the ground of a perception (perhaps accurate) that contributions reduce current cash wages dollar for dollar. Fifth, various actors (non-covered employees, self-employed workers, small business owners, and unprofitable businesses) may under-appreciate the benefits of wage-deferral.[227]

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that the sum of Social Security and qualified plan benefits do not exceed the worker's wages).

221. Qualification for tax benefits is conditioned on compliance with nondiscrimination rules, I.R.C. §§ 401(a)(4), 410(b), the ineffectiveness of which is critiqued in Peter Orszag & Norman Stein, *Cross-Tested Defined Contribution Plans: A Response to Professor Zelinsky*, 49 BUFF. L. REV. 629 (2001).

222. I.R.C. § 404(a)(1)-(4) (providing limits on such current deductions).

223. *See id.* § 404(a)(5) (deferring the employer deduction for nonqualified plans until employee inclusion).

224. Unions that obtain pension plans can justify their existence, while the employer can pass all or a portion of the cost thereof on its workforce and other parties.

225. These devices achieve not only income deferral but also result in capital gains treatment for gain that is essentially compensation for services.

226. *See* Wolk, *supra* note 216, at 402-05.

227. A worker without other income at retirement will benefit from shifting income from higher current rate brackets into lower tax rate brackets after retirement. Additionally, under certain assumptions (including one of constant tax rates over time), deducting the

The foregoing calls into question whether employers should be the focal point of retirement income policy. It is certainly the case that employers are not needed as administrators of funded plans; financial institutions are better positioned to perform this function, as well as that of investment guidance.

(b) Plan A: Mandatory Retirement Contributions

One simple alternative to the present system is that of mandatory contributions[228] by employers and self-employed persons to privately run individual-account annuity plans that satisfy the essential conditions of retirement income security.[229] Some sweeteners might be required to induce Congress to adopt such an approach, such as waivers for employees covered by existing plans, tax credits to employers to cover a portion of incremental administrative costs, government subsidies for low-wage contributors, and opt-out provisions for high-income workers.[230]

The simplification advantage of this approach is obvious: tax-deferral incentives would be unnecessary,[231] although tax deferral could still be conferred as a way of increasing the amount of future retirement distributions.

(c) Plan B: Tax Subsidies at the Margin

The other option is to design more effective tax (or other) mechanisms to achieve the goal of near-universal retirement income securi-

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investment and including distributions in full—the paradigm for qualified plans—produces the same after-tax amount as not deducting the investment but fully exempting the net economic return.

228. The contribution would be a specified percentage of a worker's wages. The percentage could vary with the hourly wage rate, but design issues such as this are beyond the scope of a piece on income tax simplification.

229. *See generally* PRESIDENT'S COMM'N ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY (1981); Tax Analysts, *Clinton Details Universal Savings Accounts, Including 401(k) Matches*, 1999 TAX NOTES TODAY 72-1; Daniel Halperin, *Retirement Income Security After the Fall*, *in* 2009 N.Y.U. REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION ch. 11, § 11.09 (2009) (calling for direct government contributions to accounts for low-income workers, to make up for the fact that mandatory contributions would be likely to result in a reduction in wages).

230. A proposal loosely based on these premises, known as the "Universal, Secure, and Adaptable ("USA") Retirement Funds," is set out in TOM HARKIN, U.S. S. COMM. ON HEALTH, EDUC., LABOR & PENSIONS, THE RETIREMENT CRISIS AND A PLAN TO SOLVE IT (2012), *available at* http://www.harkin.senate.gov/documents/pdf/5011b69191eb4.pdf. A similar proposal was made in the 2013 Obama Administration Budget Proposal, *see* OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2013 BUDGET OF THE U.S. GOVERNMENT 147 (2012), *available at* http://www.gpa.gov/fdsyspkg/BUDGET-2013-BUD/pdf/BUDGET-2013-BUD.pdf. A feature of these proposals is to transfer investment decisions from individual account holders to professional fiduciaries.

231. Social Security contributions (taxes) paid by an employee are not deductible, I.R.C. § 275(a)(1), and distributions are mostly includible under a complex formula, *see id.* § 85, that is critiqued *supra* notes 58-62 and accompanying text.

ty. Simplification could be obtained by positing a single vehicle for providing such security, which would be the worker-owned Qualified Retirement Account (QRA). Any person having compensation income during the year would be eligible to contribute to such an account, managed by an independent administrator. The QRA would automatically possess the attributes of funding, vesting, and portability. The tax treatment of such accounts would generally follow the present model of tax deferral. Aggregate additions to a worker's QRA (by the worker's employers and/or the worker herself) for a given year would be a specified percentage of salary, say, 6%, subject to a fixed-dollar cap.[232] Excess additions would not be deductible or excludible (as the case may be), but would create a tax basis in the account.

However, if the QRA approach were solely dependent on voluntary worker contributions, the broad-coverage aspect of retirement-income-security policy would essentially be blown off. Tax provisions designed to incentivize broad coverage would reintroduce complexities into the system, but it is hoped that these complexities can be minimized. Perhaps the most effective means of broadening coverage within a QRA system would be to induce employers to provide mandatory QRAs for all of its employees, under which employers would directly transfer cash to the worker QRAs.[233] The optimal tax mechanisms for accomplishing this goal are not self-evident, but some suggestions follow. Some tax benefits should be aimed at employers directly. Among possibilities to be considered are: (1) a modest tax credit to "compensate" the employer for its trouble,[234] (2) a current employer deduction, as under current law, along with a deduction-equivalent credit for non-profitable employers. Additionally, a possible "stick" would be to wholly disallow deferred compensation tax deductions for employers failing to adopt a mandatory QRA plan. A possible tax incentive for highly-compensated management to support an employer-sponsored QRA plan would be to provide that adoption of such a plan would result in replacement of the normal fixed-dollar cap on annual QRA contributions by a gradual decrease (above the cap amount) in the specified contribution percentage as compensation increases. Thus, if the basic annual contribution limit is 8% of compensation (up to $400,000) not to exceed $32,000 (8% of $400,000), then top management of a company adopting a mandatory plan would be allowed to make additional contributions to their indi-

232. Under current law, the maximum contribution to an employer-sponsored defined contribution plan is the lesser of 100% of "compensation" or $40,000 (as indexed for inflation). *See* I.R.C. § 415(c) (the limit was $51,000 in 2013).

233. Amounts within the limitation would be excluded by the worker if provided by the employer and deductible if provided by the employee. Presumably employer contributions, if any, would count first in applying the limitation.

234. *Cf.* I.R.C. § 45E (credit for small employer pension start-up costs).

vidual QRAs at a rate of, say, 6% on the next $200,000 of compensation, 4% on the next $200,000, and so on.

The foregoing may be insufficient to bring employees of small businesses, moderate-to-low income business owners, and other self-employed persons into the fold. For non-covered low-income workers, an additional refundable credit might be offered for voluntary worker contributions to a QRA, somewhat along the lines of that provided by § 25B.[235] The credit can be expressed as a percentage of contributions to a QRA, not to exceed a fixed dollar amount.[236]

(d) Defined Benefit Plans

Not to be overlooked are employer-funded defined benefit pension plans,[237] as opposed to the individual account plans discussed above. Defined benefit plans are particularly attractive in terms of retirement-income-security policy insofar as benefits are typically expressed as a percentage of wages, and investment risk is borne by the employer instead of the worker.[238] Such plans essentially constitute in-house non-profit annuity companies that require a large actuarial pool. Qualified defined benefit (pension) plans should continue to exist,[239] but tax simplification does not appear to be a significant concern here for individual taxpayers.

(e) Mandatory Annuity Pay-Outs Under All Tax-Favored Plans

By definition, retirement security entails a funded individual annuity that serves to continue wages (or a portion thereof) after retirement or a specified age until a worker's death, to protect against the risk of longevity. It follows that annuity pay-outs should be mandatory for all subsidized retirement vehicles.

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235. The § 25B credit, however, is nonrefundable, meaning that it has no effect on low-income workers. *Id.* § 25B.

236. A tax credit proposal was provided by a group known as Retirement USA. *See Proposals for a New Retirement System*, RETIREMENT USA (Oct. 21, 2009), http://www.retirement-usa.org/proposals-new-retirement-system. A prominent academic commentator favoring this approach is Halperin, *supra* note 229, § 11.06.

237. Such plans, which require a large pool of participants, provide salary-replacement payments based on a formula relating to salary history and years of participation.

238. However, portability (avoiding the loss of benefits by reason of changing employers), which is also an aspect of retirement security, is hard to achieve in the case of defined benefit plans except by converting an accrued benefit right into a lump-sum amount that can be rolled over into a defined-contribution plan.

239. As under present law, I.R.C. § 415(b)(1), annual annuity distributions should be capped at a specified amount.

Additionally, and contrary to present law,[240] a beneficiary of any qualified plan should not be able to withdraw amounts from a QRA before retirement age, except perhaps for permanent disability.[241]

(f) Other Issues

Numerous other issues would need to be dealt with, including the definition of "employee" for purposes of the ERISA tax rules,[242] possible provision for non-working spouses of working spouses,[243] surviving spouses and dependents of workers both before and after the commencement of annuity pay-outs,[244] and divorced spouses.

(g) Roth IRAs

The Roth IRA, instead of deferral, gives a tax-free return on an after-tax investment.[245] Roth IRAs do not conform to the retirement-income-security paradigm because tax-exemption *after* retirement (as opposed to claiming deductions while working) is preferable to tax deferral only if the owner already has post-retirement taxable income in significant amounts. Additionally, Roth IRAs do not require annuities or even minimal distribution rules, and they allow contributions even after retirement age.[246] In short, Roth IRAs do not advance the policy of retirement income security and function mainly to allow the

240. An annuity is not required for defined contribution plans (including IRAs, § 401(k) plans, and § 403(b) plans), which currently outweigh defined benefit plans in terms of coverage.

241. The current system imposes a 10% penalty on pre-retirement distributions but allows for numerous exceptions. I.R.C. § 72(t). The only exception should lie for permanent disability (premature forced retirement), which can be monitored by the Social Security Administration and can trigger conversion into an individual annuity. Insurance problems (such as a medical emergency) should be dealt with, if at all, by other mechanisms.

242. Currently, "employee" is defined in Treas. Reg. § 31.3121(c)-1(d), which also serves as the definition for income tax withholding and payroll tax purposes. The definition adopts a modified common-law fact-based "control" test. Perhaps the test could itself be simplified. *See* Calvin H. Johnson, *Settle Withholding by the Dollars, Not Control*, 136 TAX NOTES 949 (2012).

243. A large percentage of spouses will be employed on their own and will thereby be eligible to contribute to their own qualified plans. It is appropriate that a non-working spouse of a working spouse should be able to contribute to her own QRA on the ground that she is being implicitly paid for domestic labor.

244. The qualified annuity of a person who is married on the annuity starting date could be required to be a self-and-survivor annuity for the annuitant and the annuitant's spouse, unless the spouse waives the survivorship right. Such a rule exists for certain qualified plans under current law. *See* I.R.C. §§ 401(a)(11), 417. Of course, a longer expected annuity period results in lower periodic payments. Moreover, a surviving spouse should not receive a greater aggregate annuity than the largest of her own annuity or the deceased spouse's annuity. Since the purpose of an annuity is the exact reverse of that of life insurance, a QRA should not provide survivorship benefits (or a refund to the deceased worker's estate) in cases where the QRA owner dies before the annuity starting date. A refund feature would reduce annuity payments.

245. *Id.* § 408A(c)(1), (d)(1).

246. *Id.* § 408A(c)(4), (5).

well-off to augment the amount of their bequests. Accordingly, the Roth IRA should be repealed.[247]

2. Nonqualified Tax-Deferral Arrangements

For non-qualified employer-provided deferred compensation arrangements, tax deferral can be obtained either if the arrangement is unfunded or if the employee's interest in the plan is funded but subject to a substantial risk of forfeiture.[248] On the other hand, if an employer confers upon an employee the right and power to obtain current cash income, the employee would be in constructive receipt of the income (even if the cash is not actually taken) unless a meaningful restriction or penalty would attach to the taking.[249] In other words, the employee is not currently taxed unless she (a) is in constructive receipt of income or (b) receives property (or is a beneficiary of an employer-funded trust that receives cash) that is not subject to a substantial risk of forfeiture. In general, the readily available opportunities for deferral through nonqualified arrangements undermine incentives to create qualified plans[250] and fail to satisfy the policy of retirement income security.[251]

(a) Restricted Property Transfers and Funded Nonqualified Plans

The general rule is that receipts of *cash* income are currently included, notwithstanding a risk of forfeiture, and any actual forfeiture gives rise to a deduction in the year of loss.[252] Current § 83(a), which provides otherwise for compensation-related receipts of *property* interests (including funded deferred compensation),[253] came into existence to accommodate court decisions that failed to treat receipts of property

247. If they are retained, Roth IRAs should be subjected to similar required-distribution rules as are applicable to tax-deferral plans.

248. Section 83(a) states that the transfer of property to a service provider is current income unless the property is "subject to a substantial risk of forfeiture." I.R.C. § 83(a). Section 402(b) states that the transfer of cash by an employer to a nonqualified deferred compensation trust is deemed to be a transfer of property to the employee subject to § 83(a). *Id.* § 402(b). This provision codifies the tax common law rule known as the economic benefit doctrine. John F. Cooper, *The Economic Benefit Doctrine: How an Unconditional Right to a Future Benefit can Cause a Current Tax Detriment*, 71 MARQ. L. REV. 270, 273 (1988).

249. Treas. Reg. § 1.451-2(a).

250. Nonqualified deferral plans are, by reason of not being subject to a nondiscrimination requirement, usually limited to highly compensated service providers. Thus, availability of such plans undermines the goal of retirement security for most of the workforce.

251. An arrangement that is unfunded and/or subject to a substantial risk of forfeiture—and is not annuitized—hardly provides for retirement income security.

252. *See* James v. United States, 366 U.S. 213 (1961); N. Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932).

253. Section 402(b) provides that transfers of cash to a deferred compensation plan shall be treated as transfers of property subject to § 83. I.R.C. § 402(b).

subject to a significant risk of forfeiture the same as receipts of cash.[254] This differing tax treatment of forfeitable cash and forfeitable property is hard to justify as a matter of policy,[255] especially where the "property" is nothing more than a right to future cash.[256] Moreover, restrictions on property given as compensation can be viewed as self-imposed (or at least willingly accepted) by virtue of the benefit of tax deferral, and tax deferral for nonqualified arrangements conflicts with the overriding policy of retirement income security through qualified plans.[257]

The cleanest solution would be to alter § 83 so as to be in accord with the treatment of "restricted" cash. Accordingly, the property should be included at the time of receipt and valued without regard to the restrictions.[258] Such a revised § 83 should provide that the service provider obtains an ordinary loss deduction upon any actual forfeiture.

Property that has no ascertainable fair market value on receipt, such as nontransferable (and not-in-the-money) stock options and pure profits interests, are subject to a different default rule, namely: no inclusion until cash receipt (or until the property can be reasonably valued, such as upon the exercise of the option or the obtaining of liquidation rights).[259] Current rules generally accord with this principle,[260] but the principle should be made into a universal rule, which means eliminating the special tax breaks given to incentive stock options (ISOs)

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254. The doctrinal problem was the notion that the receipt of property as compensation, although normally an income realization event, avoided current inclusion because the forfeiture condition rendered the property incapable of valuation when received (assuming that any transferee would also be subject to the forfeiture condition). *See* Kuchman v. Commissioner, 18 T.C. 154 (1952) (holding forfeitable property not currently included). Not so justifiable in terms of doctrine was *Lehman v. Commissioner*, 17 T.C. 652 (1951), where it was held that no income arose upon the lapse of such a restriction, resulting in deferral (and capital gains treatment) until the property was sold. The IRS acquiesced in these cases in Rev. Rul. 68-86, 1968-1 C.B. 184. Section 83(a), enacted in 1969, deferring compensation until the lapse of the forfeiture restriction, can be described as a compromise between this case law and the tax rules for cash. *See* I.R.C. § 83(a).

255. The difference in tax results channels transactions of this sort into the property mode.

256. The rationale of *Kuchman*, 18 T.C. at 163, was that forfeitable property was not capable of valuation and therefore not currently realized income. *See supra* the doctrine and text accompanying note 254. However, the courts could have treated the restriction as being personal and not an aspect of the property itself. However, the restriction can be made to be on the property by a provision that all transferees are subject to the restriction. In any event, Congress can do what the courts fail to do.

257. The argument in favor of § 83 is that forfeiture conditions (usually, leaving the firm) align the interests of employee and employer, but this is not a concern of *tax* policy. Moreover, the proposed change in tax treatment does not prohibit such forfeiture conditions.

258. Current § 83(a) states that non-forfeiture restrictions are to be ignored in valuing in-kind compensation. I.R.C. § 83(a).

259. *See* Commissioner v. LoBue, 351 U.S. 243, 248 (1956); Treas. Reg. § 1.83-7.

260. *See* I.R.C. § 83(e)(3)-(4).

and employee stock purchase plans.[261] Additionally, any income realized under this type of arrangement should be ordinary income.[262]

(b) Non-Funded Plans

The core principle for non-funded, purely contractual deferred compensation arrangements is that deferral is obtainable in the absence of the constructive receipt of cash income, but, as already noted, constructive receipt is easily avoided by imposing a more-than-de-minimis penalty on demanding current cash.

Section 409A, which was enacted in 2004 to deal with certain problems relating to nonqualified deferred compensation, is framed in these terms: "The [House] Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion."[263] Section 409A requires current inclusion in gross income, with interest and penalties, of nonqualified rights to future compensation (funded or non-funded), unless various anti-abuse rules are complied with.[264] With regard to non-funded arrangements, § 409A has effectively expanded the constructive receipt doctrine by requiring immediate inclusion of rights to future cash unless the arrangement (1) prohibits last-minute deferral decisions and elective accelerations of deferred benefits and (2) requires deferred amounts to be distributed only upon objectively determinable occurrences.[265]

Section 409A is considered to be an excessively complex and open-ended response to the stated abuses.[266] The governing concept here should be that tax deferral of salary is essentially not justified at all for tax reasons unless pursuant to a government mandate or under a funded qualified plan, while acknowledging that certain rights to future cash cannot be currently taxed due to future contingencies. Accordingly, deferral should be "allowed" for non-funded arrangements only if (a) no short-term cash-or-deferral elections are available and (b) the plan prohibits—and does not in fact make—distributions on

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261. *See id.* §§ 83(e)(1), 421-424 (providing for no taxation until the sale of the stock, with any gain being capital gain).

262. Deferred compensation that is tied to changes in stock prices is apparently within the scope of § 409A. *Id.* § 409A. Under Treas. Reg. § 1.409A-1(b)(5)(i)(A), (C), a nonqualified stock option may be exempt if it (a) is not in the money when granted or (b) is "service recipient stock" (common stock of the employer). Section 409A, if it is retained in any form, should not apply to nonqualified stock options, since the exercise of an option is not a distribution, nor does it represent an ability to obtain the employer's cash.

263. *See* H.R. REP. NO. 108-548, pt. 1, at 343 (2d Sess. 2004).

264. *See* I.R.C. § 409A(a)(1)(A)(i).

265. *See id.* § 409A(a)(2)-(4). These rules also apply to funded arrangements, but in that context they would be irrelevant if forfeiture conditions could no longer achieve deferral.

266. The proposed regulations under § 409A take up 103 pages in the 2013 CCH Federal Tax Reporter. Section 409A apparently applies to nonqualified stock options and split-dollar life insurance arrangements.

any occasion other than reaching a certain age or long-term disability. In cases where current inclusion would occur except for future contingencies that render the right to future cash incapable of valuation, a penalty tax, say, 10%, would be imposed on actual pay-outs.

3. Rabbi Trusts

The IRS has held that a Rabbi trust (a funded deferred compensation trust that is reachable by the employer's creditors) is not truly "funded" for tax purposes,[267] and therefore falls into the category of contractual deferred compensation. Section 409A(b) taxes to the employee employer contributions to a Rabbi trust that is offshore and any nonqualified deferred compensation amount subject to an employer's financial-health contingency.[268] These rules partially overlap, and it should suffice to provide that financial contingencies of an employer should not be taken into account in determining that a contribution has been made by an employer to a deferred compensation arrangement (i.e., that the trust is funded).[269] At this point, deferral would be impossible if Congress repeals the rule pertaining to forfeiture conditions.[270] If the risk-of-forfeiture rule is retained, it should be provided that financial and investment risks should themselves not be viewed as substantial risks of forfeiture.

G. Foreign Income of U.S. Nationals

The United States generally taxes U.S. citizens and residents ("U.S. nationals") on worldwide income. If another country happens to tax foreign-source income of a U.S. national, the United States generally allows a tax credit against the U.S. tax on the same income (but not to exceed the average U.S. tax on the same income).[271]

1. Repeal the Exclusion for Foreign-Source Earned Income

Current § 911 allows an exclusion from U.S. tax for foreign-source personal services (i.e., "earned") income up to $80,000, as adjusted for inflation ($97,600 in 2013), of a U.S. national if the U.S. national has

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267. *See* Rev. Proc. 92-64, 1992-2 C.B. 422; I.R.S. Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980).

268. I.R.C. § 409A(b).

269. Since the underlying rule—that funded rights to future cash are current property rights—is indifferent to the relationship between the parties (or the nature of the income), the rule proposed here should be made applicable to trusts benefitting independent contractors as well as employees.

270. However, a funded (defined contribution) nonqualified plan must (generally) fully vest within five years. *See* Employee Retirement Income Security Act, 29 U.S.C. § 1053(a)(2)(A)(ii) (2006). Full vesting removes conditions of forfeiture and would require income inclusion under § 83(a). I.R.C. § 83(a).

271. I.R.C. §§ 901, 904(a).

a "tax" home outside of the U.S. and meets a foreign residency test.[272] The calculation of the exclusion is complicated by a deduction for the "foreign housing cost amount," determined under a formula.[273] The exclusion is hotly contested in tax policy circles and is the only significant exception to U.S. taxation of its own nationals.

Earned income is foreign-source if the taxpayer performs the services abroad.[274] The exclusion allows creative talents, consultants, and any person who can perform technical services from a non-U.S. location to avoid U.S. tax, even if there is no business reason to perform these services abroad (or in the country of residence). The income can be earned in a tax haven country that imposes little or no tax on the income, or perhaps in a non-tax-haven country that exempts certain types of services income by statute or under an income tax treaty with the United States.

The argument for the foreign-income exclusion is no stronger than that for excluding all foreign-source income (or perhaps foreign-source business income) of a U.S. individual taxpayer from U.S. tax.[275] But, if the United States were to move wholesale to a territorial system that applied to individual taxpayers, source rules would come under scrutiny. The source rule for services is mechanical and bears little relationship to U.S. policy interests.[276] In the context of the prevailing U.S. norm of taxing U.S. nationals on world-wide income, it is hard to see what purpose the § 911 exclusion serves. In the current world economic climate, it has little to do with exploiting foreign markets or tapping into foreign labor supplies.[277] Removing the exemption would do no real harm, because the foreign tax credit would be available to avoid double taxation of foreign-source earned income. Also, income tax treaty provisions can be negotiated with a view of curbing host country taxation of temporary visitors.[278]

2. *Expand the Simple Version of the Foreign Tax Credit*

The operation of the foreign tax credit is normally quite complex, as it involves the application of "basket limitations" for foreign pas-

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272. *Id.* § 911 (citizens or residents of the United States living abroad).

273. *See id.* § 911(a)(2), (c).

274. *Id.* § 861(a)(3).

275. The tax systems of some prominent trading partners of the United States have a territorial slant, especially where corporations are involved. *See* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION 446-52, 467-71 (3d ed. 2010).

276. The income is sourced where the services are performed, not, say, where the benefit of the services are obtained. *See* I.R.C. § 861(a)(3).

277. The exclusion is critiqued in CHARLES H. GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS 454-57 (4th ed. 2011).

278. *See* INTERNAL REVENUE SERVICE, UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, arts. 14, 16 (2006), *available at* http://www.irs.gov/pub/irs-trty/model006.pdf.

sive income and for other foreign income.[279] Individual taxpayers paying modest amounts of foreign tax should not be involved with these complications. Under § 904(k), the foreign tax credit limitations do not apply if the taxpayer's foreign income is entirely passive and the creditable foreign taxes do not exceed $300. This provision should be liberalized by eliminating the passive income requirement and increasing the maximum foreign tax amount to, say, $1000.

H. Entity Taxation

The taxation of family business enterprise impacts the taxation of individual taxpayers. The discussion below assumes the implementation of a corporate tax "reform" that includes a reduction in tax rates for C corporations relative to individual tax rates.[280] Interestingly, such a "reform" would create several opportunities for simplification.

1. Mandatory Pass-Through Regime for All Non-Publicly Traded Business Entities

If C corporation tax rates are less than individual tax rates, and if the present system is otherwise unchanged, the accumulation/bailout game would be revived for closely held entities that elect to do business as a C corporation.[281] This opportunity can be foreclosed by requiring all non-public business entities and their equity holders to be subject to pass-through taxation.[282] The liquidity premium incident to public trading is what perhaps justifies a separate business entity tax to begin with. Accordingly, only publicly traded entities would be subject to the (reduced) C corporation tax. No reason exists to condition pass-through treatment of corporations on having no more than a specified number of shareholders, as currently exists with S corporations.[283]

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279. *See* I.R.C. § 904(d).

280. The American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat 2313 (2013), raised the highest individual rate to 39.6%, leaving the highest corporate rate at 35%.

281. The game consists of accumulating corporate earnings at a relatively low tax rate, deferring or abstaining from dividend payments, and realizing on the value of the appreciated stock at low individual capital gains rates (with basis offset). Anti-bailout provisions were salient features of corporate taxation during periods when the game was being played. *See, e.g.*, I.R.C. §§ 531-537 (accumulated earnings tax); *id.* §§ 541-547 (personal holding company tax); *id.* § 341 (repealed) (collapsible corporation provision); *id.* §§ 302, 304, 306, 355, 1248 (current Code).

282. "Pass-through taxation" means that profits and losses are attributed (passed through) to the equity holders, with no tax at the entity level.

283. *See* I.R.C. § 1361(b)(1)(A), (c) (S corporation cannot have more than 100 shareholders). A study by the American Law Institute proposes removal of this feature. *See* GEORGE K. YIN & DAVID J. SHAKOW, AM. LAW INST., TAXATION OF PRIVATE BUSINESS ENTERPRISES 170-72 (1999).

It might be argued that pass-through treatment is not appropriate for non-public *corporations* with complex capital structures, because here the burden of losses is not settled by contract or organizational structure, as it is with a partnership or LLC. The difficulty of profit and loss allocation is perhaps overrated. For example, holders of preferred interests can be taxed like debt-holders,[284] and the profit shares of other equity interests would be spelled out. The issue of loss shares in multi-tier pass-through corporations has been addressed by me elsewhere.[285]

Pass-through treatment of non-public corporations would render pointless the personal holding company tax and the accumulated earnings tax, which could be repealed. The proposed change would also simplify the task of entity classification for tax purposes and reduce the factors entering into choice of tax entity decisions into one, namely, whether equity interests in the entity are to be publicly traded, which is a decision that would normally be made on nontax grounds.

2. *A Simplified Pass-Through Regime*

Under a mandatory pass-through system for non-public entities, it might be desirable to offer separate pass-through regimes, as exists under current law: (a) the relatively simple S corporation regime, elective for a corporation meeting certain eligibility requirements (such as the one-class-of-stock rule), and (b) the complex pass-through regime for tax partnerships.[286] However, an S corporation cannot currently elect into Subchapter K, and a partnership (or other entity, such as an LLC, that is eligible to be taxed as a partnership) cannot elect subchapter S status.

It is proposed that non-public business entities be allowed to choose between a simple and a complex pass-through regime, or, more modestly, that a tax partnership be allowed to elect into Subchapter S (as modified to accommodate partnerships).[287]

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284. That is, holders of preferred interests would be taxed on dividends paid (and possibly dividends accrued), which would be deducted by the entity, thereby reducing pass-through income.

285. *See* Joseph M. Dodge, *A Combined Mark-To-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 319-23 (1995).

286. *See* I.R.C. §§ 1366-1377 (operative rules for S corporations); *id.* §§ 702-761 (operative rules for entities taxed as partnerships). The differences are explained in Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749 (2009).

287. *Compare* YIN & SHAKOW, *supra* note 283, at 131-272 (proposing a simplified version of conduit taxation for eligible private business organizations that so elect), *with* Schwidetzky, *supra* note 286 (essentially proposing elimination of Subchapter S).

3. *Nondeductibility of C Corporation Interest*

Under present law, the distinction between corporate debt and equity is salient, because interest and dividends carry different tax treatment to both the corporate entity[288] and the equity holders,[289] resulting in a distortive incentive to use debt.[290] Additionally, the distinction is often difficult to apply in practice, and, being highly fact-intensive, is costly to administer and uncertain in result.[291] From the policy angle, the interest deduction can combine with business tax preferences to generate a very low, zero, or even negative income tax on business earnings derived from capital, resulting in the misallocation of capital to marginal or bad investments.[292]

These problems can be solved by disallowing interest deductions for C corporations—at least those in which capital is a material income-producing factor. This disallowance would be a fair trade-off for reducing the corporate tax rate. Indeed, it should generate sufficient revenue to enable Congress to enact a truly significant reduction in the corporate tax rate.[293]

4. *Eliminate Capital Gains Treatment of Dividends*

Under current law, most dividends received from corporations are treated as long-term capital gains.[294] This special treatment (along with the capital gains preference) operates, as far as corporate equity is concerned, as a form of "partial" corporate/shareholder integration by significantly reducing the shareholder-level tax. However, it is better (in theory) to tax corporate profits at the level of individuals receiving distributions, not the entity, because, although it is easy to collect tax at the corporate level, the incidence of the corporate tax is unknown and could vary among industries and firms.[295] Moreover, a

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288. Interest is generally deductible, I.R.C. § 163(a), whereas dividends are not.

289. Interest is ordinary income, whereas "qualified dividend income" is currently treated as "net capital gain." *Id.* § 1(h)(11)(A).

290. The tax incentive to use debt financing often overwhelms nontax factors in choosing finance mechanisms. Additionally, interest can be used to shift income away from U.S. debtors to related foreign parties. *See* I.R.C. § 163(j).

291. Section 385 was enacted in 1969 to deal with this issue, but that section is contingent on the issue of regulations, and final regulations have never been issued.

292. Expensing of capital expenditures results in "single" taxation of investment returns, whereas the exclusion of borrowing and deduction of interest yield "double" deduction of interest, viewing both phenomena in present value terms.

293. Limiting the current interest deduction to business or investment income, *see id.* §§ 163(d), 469, would fail to solve the arbitrage problem of combining the current treatment of debt with consumption-tax treatment of investments. It might be contended that certain interest (e.g., on purchase-money loans used to purchase real estate) should be exempt from any disallowance rule, but if borrowed money is truly fungible, then such a contention loses force.

294. *See id.* § 1(h)(11).

295. *See Forum: Incidence of the Corporate Income Tax*, 66 NAT'L TAX J. 149-262 (2013) (introduction and four articles).

significant reduction in the C corporation rate itself operates as a form of partial integration. Many of the leading trading partners of the U.S. have moved to partial integration systems of various types.

Accordingly, a significant reduction in the corporate tax rate should be accompanied by restoration of the status of dividends as ordinary income. Also, insofar as a capital gains preference for stock gains and dividends is justified as a partial integration measure, such preference would become redundant to the low corporate tax rate.[296]

5. *Repeal the Earnings and Profits Apparatus*

Under current law, a non-liquidation distribution from a C corporation is gross income only to the extent it is deemed to come out of the corporation's post-1913 earnings and profits (E & P).[297] E & P is a financial accounting construct, and one has to make numerous adjustments to taxable income to calculate it. Additionally, rules are required to determine what distributions reduce E & P.[298] These rules, which are wholly arbitrary, operate so that a few corporations still are deemed to possess pre-1913 E & P.[299] The entire E & P system is much ado about practically nothing, as the E & P system rarely prevents non-liquidation distributions from being taxable dividends.

From another angle, the taxation of equity investments should be separated from any taxation of the underlying entity. The E & P mechanism operates inappropriately as a capital recovery for corporate equity. Shares of stock are correctly not subject to depreciation, because corporate equity has an indefinite useful life. Additionally, partial loss deductions are not generally allowed under the income tax.[300] Thus, recovery of capital under a realization income tax should not be allowed unless there is a true disposition of all or a physical portion of an asset. Stated in abstract terms, taxation of an investment should depend only on the investment and its economic return,

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296. A 1982 study estimated that corporate stocks and bonds accounted for almost 37% of total assets for all top wealthholders, closely followed by real estate (gains on which are already largely exempt under § 121), with other categories being relatively insignificant. *See* Marvin Schwartz, *Estimates of Personal Wealth, 1982: A Second Look*, SOI BULL., Spring 1988, at 31, 32. Thus, the capital gains (and dividends) tax preference could be wholly eliminated, or at least targeted to individuals investing in family-owned businesses.

297. Corporate distributions in excess of E & P are tax free due to the shareholder's stock basis offsetting the cash received, and distributions in excess of basis are treated as gains from the sale of the stock. *See* I.R.C. §§ 301(c)(1), 316(a).

298. *See id.* § 312.

299. The general rule is that distributions are deemed to come out of the most-recently-acquired E & P. *See id.* § 316(a)(2). This last-in, first-out (LIFO) convention is the opposite of the most commonly used convention for inventory, which is first-in, first-out (FIFO).

300. *See* Citizens Bank of Weston v. Commissioner, 252 F.2d 425 (4th Cir. 1958); Lakewood Assocs. v. Commissioner, 109 T.C. 450 (1997); Pulvers v. Commissioner, 48 T.C. 245 (1967), *aff'd*, 407 F.2d 838 (9th Cir. 1969).

not on the remote source of the return.[301] The fact that dividends are not deductible represents the decision that corporate taxable income is a tax base independent from the tax base of the shareholders. (In contrast, the net income of a trust or estate is viewed as a pool of income that can only be taxed once.) A (pro rata) non-liquidation distribution is not a disposition of an investment or a portion thereof, but only a cash return thereon: the shareholder retains the same right to future distributions and same degree of control as existed before. The fact that the corporate assets have shrunk in size is immaterial. Such shrinking would cause the value of the stock to decrease, but that decrease is simply unrealized depreciation, and unrealized depreciation is not deductible under a realization income tax. The E & P mechanism, in short, is contrary to both the realization principle and the separation of the corporate and individual income taxes.

Accordingly, the E & P apparatus should be jettisoned, and all pro-rata non-liquidation distributions should be treated as gross income.[302]

The notion of a "partial liquidation" distribution, resulting in a basis offset without an actual surrender of stock, could be retained.[303] However, since the same basis offset as is desired in a partial liquidation can be obtained by (1) dropping assets into a newly-created controlled corporation, (2) distributing the stock of that corporation to the shareholders of the distributing corporation, and (3) liquidating the corporation whose stock was distributed,[304] the qualification requirements for obtaining a basis offset in a partial liquidation should be essentially the same as would qualify a distribution of stock in a controlled corporation for tax-free treatment under § 355.[305]

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301. Basis recovery in the case of an annuity or a level-payment debt obligation is based on the notion that each cash receipt marks the disposition of a component of the asset.

302. For other critiques of the current system, see William D. Andrews, *"Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956), and Walter J. Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal*, 53 TAXES 68 (1975).

303. *See* I.R.C. § 302(e) (qualified partial liquidation treated as sale of portion of shareholder's stock).

304. The assets of the terminal business can be placed in a separate corporation tax free, *id.* § 368(a)(1)(D), the stock of which is distributed to the existing shareholders tax free, *id.* § 355, and that corporation can be liquidated in a transaction treated as a sale with basis offset, *id.* § 331(a).

305. The three-step transaction described at the beginning of this text sentence achieves the same result as a partial liquidation under § 302(e) only if step (2) thereof—the distribution of controlled corporation stock—qualifies as a tax-free distribution under § 355. Current § 355, in turn, has various qualification requirements, including (1) the distributed corporation must contain assets of an active business that has been carried on for at least five years, (2) that business must be carried on immediately after the distribution, and (3) the transaction must not be a disguised dividend (which would be indicated by a prior agreement to sell or liquidate the distributed corporation). *See id.* § 355(a)(1)(B), (b). The requirements of current § 302(e) are more lax, requiring either that a business (carried on for five years) be terminated or that the transaction not be essentially the equivalent of

An issue is whether, as a transitional rule, existing corporations would be allowed to declare pre-1913 E & P and apply it against the first post-enactment dividends until pre-1913 E & P is exhausted. However, all current distributions with respect to stock are income to the shareholder when received and cannot be pre-1913 income *of the shareholder*. There is no constitutional requirement that dividends out of pre-1913 E & P must be exempt, especially since the accounting convention that has the effect of preserving pre-1913 E & P is arbitrary.[306] In fact, *Lynch v. Hornby*[307] held precisely that a post-1913 dividend paid out of profits accumulated before 1913 could be constitutionally taxed.[308] Therefore, any such transition rule would be unnecessary and, in my view, unwarranted.

V. CONCLUSION

The emphasis here has been on proposals that fit into a realization income tax, which would simplify compliance and administration for the bulk of individual taxpayers. The proposals made herein (some original, some not) advance only some simplification moves among the many that are possible. Other kinds of proposals can be imagined, such as simplifying depreciation accounting (or eliminating depreciation altogether). International taxation is another area that is only lightly considered herein.

Tax academics are often skeptical of a simplification agenda. Tax law, as well as life itself, is complex, and tax professionals thrive on complexity. Thus, we tax professionals have a vested interest in the fact that we have mastered the intricacies of the tax law, which is a major component of our human capital. But we tend to overlook the fact that tax law is not self-executing. Accordingly, we tend to overestimate the ability of the IRS and the general population to follow what we have wrought. In any event, the simplification agenda is not necessarily bad news for tax professionals. The reader will have undoubtedly noted that many of the proposals made herein are not fully developed and would require further working out. Some may even turn out to be non-viable from the simplification angle itself. Tax professionals should be as good at creating simple, workable solutions to

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a dividend at the corporate level (meaning, in effect, that a meaningful contraction of the corporation's business occurred).

306. *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918), construed the 1909 corporate income tax to exclude pre-enactment appreciation. However, since a tax on gross receipts (without basis offset) is constitutional as an indirect tax, basis recovery cannot be constitutionally required. *See* Joseph M. Dodge, Murphy *and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards*, 8 FLA. TAX REV. 369, 401-07 (2007).

307. Lynch v. Hornby, 247 U.S. 339 (1918).

308. I.R.C. § 316(a)(1), excluding distributions from pre-1913 E & P, is, therefore, not constitutionally required.

existing complexities as they are at mastering existing ones. It is certainly a lot more enjoyable.