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Halfway to Tax Reform by Joseph A. Ruskay and Richard A. Osserman

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HALFWAY TO TAX REFORM By Joseph A. Ruskay and Richard A. Osserman. Bloomington, Indiana: Indiana University Press. 1970. Pp. x, 307. $8.95.

Halfway to Tax Reform would enable an intelligent layman to learn what was accomplished by the Tax Reform Act of 1969[1] and to become aware of many remaining features of the federal tax law which still need further reform. Although occasionally the authors venture into state and local taxation, such as the exemption of church-owned property from state and local taxes,[2] the federal income tax receives most attention. There is also some discussion of needed reforms of the federal gift and estate tax.[3]

The book contains an extensive list of what is alleged by many tax scholars and economists to be tax preferences. To catalog all these tax

1. Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of INT. REV. CODE of 1954).
2. J. RUSKAY & R. OSSERMAN, HALFWAY TO TAX REFORM 14-16 (1970) [hereinafter cited as RUSKAY & OSSERMAN].
3. *Id.* at 125-26, 134-49.

preferences would result in an unduly long review.[4] Accordingly, this review comments on only a few of the more well-known preferences.

Much of the impetus for the enactment of the Tax Reform Act of 1969 came from widespread publicity given to a Treasury study which showed that 154 persons with adjusted gross incomes over 200,000 dollars in 1966 paid no federal income tax.[5] Actually this came as no surprise to tax scholars. For people with substantial wealth and opportunity to invest in tax shelters, the highly progressive, top rates have been a myth for many years. It is also quite correct, as the authors indicate, that although the Tax Reform Act of 1969, by imposing a minimum tax and through other techniques, reduced the opportunities for tax sheltered income, many opportunities still exist. It would be difficult for any tax scholar to contend that we now have an entirely equitable tax system in which all persons with equivalent incomes, as judged by accountants or economists, are taxed equally.

One of the problems in securing tax reform is that there invariably is some argument that can be made on behalf of a particular tax preference. For instance, high risks in drilling wells and need for known oil reserves justify percentage depletion;[6] financial needs of private colleges justify the deduction for value of appreciated property (not adjusted basis) given to them;[7] and so forth. If ideological grounds can be found to defend most tax preferences, the combined political strength of those benefiting under the existing tax law makes a comprehensive tax reform act such as that proposed by the authors a remote possibility.

One of the discouraging aspects of proposed tax reform is that congressional committees, after listening to the arguments for and against an alleged tax preference, frequently compromise with a partial curb. The compromise almost invariably is more complex than the previous law. An example of this is the attempt to change to a rule that appreciated property given to a charitable organization must be deducted at its present value, rather than allowing deduction at a lower cost basis. When Congress finished with this proposed change under the Tax Reform Act of 1969, the result was a very complex set of rules.[8] When half-way reform is

4. While I differ with the authors on a few alleged tax preferences, on most I am in agreement with their position. In fact, the authors are to be commended for covering as much as they did in a short book.

5. *See, e.g.*, S. REP. No. 91-552, 91st Cong., 1st Sess. 13 (1969).

6. INT. REV. CODE of 1954, § 613.

7. INT. REV. CODE of 1954, §§ 170(b), (e).

8. The provisions include INT. REV. CODE of 1954, §§ 170, 507-09, 642(c), 664, 4940-48.

achieved, how great is the gain if the resulting distinctions and classifications are so numerous and complex that they will be difficult for Internal Revenue to audit and administer effectively? Certainly the gain is minimal if unsophisticated taxpayers pay unanticipated tax deficiencies because they did not understand these complexities.

A true tax reform, which rejected compromises on unjustifiable tax preferences, would also result in tax simplification. That in itself would be an additional tax reform. Perhaps a feasible way to achieve such a reform would be to have some agency outside the Congress, such as a new Internal Revenue Commission, lower tax rates substantially by closing tax preferences, and then have Congress either enact or reject the Commission's recommendations without amendment.

One problem which the authors do not discuss is the relationship of inflation to the federal income tax. This is particularly important in regard to the treatment of capital gains. Does a man who bought common stock in 1950 and sells it in 1971 for twice the price have a gain if the purchasing power of the dollar is only one-half in 1971 what it was in 1950? Similarly, is the depreciation allowance adequate for a building built in the 1940's if the cost of replacing that building now would be much greater than the cost on which the depreciation deduction is computed? Thus, a policy argument for the preferential treatment of long-term capital gains is that it would compensate in a crude manner for taxing illusory gains resulting from inflation. It might also serve as a crude averaging device for a gain realized at one point in time which has resulted from appreciation in value over a long period of time. This argument, however, has little validity when the holding period is only six months and one day.[9] Lengthening the minimum holding period for a long-term gain and, perhaps, putting the deduction for long-term gains on a sliding scale with larger deductions for longer holding periods would strengthen the fairness of capital gains taxation.

Two other tax preferences whose practical appeal can be blunted by inflation are insurance and municipal bonds. In many cases the owner of the municipal bonds[10] will suffer a net loss if comparison is made to what he could have realized if he had invested in growth common stock, paid income tax on the dividends and then sold for a capital gain. The families of many holders of life insurance will also lose more to inflation than is gained from the tax shelter that renders the increase in

9. This is the minimum holding period to qualify for long-term capital gain treatment. *See* INT. REV. CODE of 1954, § 1222(3).

10. Interest paid on municipal bonds is specifically excluded from gross income by INT. REV. CODE of 1954, § 103(a)(1).

cash surrender value-free and excludes death proceeds from income.[11]

To a considerable extent the authors give pros and cons for various alleged tax preferences. However, in the case of the exemption for state and local government bonds,[12] I think there was inadequate presentation of the arguments for continuance of the exclusion. There clearly is a substantial benefit to state and local government from the existing exemption. Because of the tax exclusion from gross income of the interest, these governmental units are able to pay interest rates approximately two per cent lower than that paid on taxable corporate bonds. This saving decreases taxes, particularly on the home owner, who bears a large portion of the tax cost of state and local government. As the various attempts to tax municipal bonds have shown, officials of state and local governments will exert great political pressure to prevent this change. If these bonds are to be taxed, some federal subsidy to state and local government to compensate for the increased interest cost would probably be needed.

If the exclusion from gross income of municipal bond interest is changed, one germane policy issue is whether the change is to be retractive. To make it applicable to bonds outstanding would cause those bonds to decrease substantially in market value, with the decrease being greatest for those with the longest period to maturity. Since this intergovernmental tax immunity is a doctrine almost as old as the nation,[13] a holder of such a bond would have just cause to believe that he had been treated unjustly. In effect, he would have been subjected to a capital levy. However, if Congress concludes that equity requires that a change in regard to tax exempt interest not be retroactive, the primary problem will continue for many years. The major objection to tax-exempt bond interest is the inequity of not taxing this income while an equal amount of income in the accounting sense from another source is taxed to others. One conclusion to be drawn from this is that it is much easier to prevent a tax loophole from being created in the first place. Once a tax loophole exists, the market place adjusts to the existence of the loophole. As a result, elimination of the loophole tends to be more difficult than having prevented the loophole would have been originally. The disruption of both the municipal bond market and of many planned local bond issues

11. INT. REV. CODE of 1954, § 101.

12. RUSKAY & OSSERMAN, *supra* note 2, at 95-105.

13. McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).

during the congressional hearings on the 1969 Act was a vivid example of the dislocation that can come from tax reform.

The authors sometimes, particularly in the area of imputed income, go beyond what even the most responsible members of the Congress would be likely to support. For instance, the services in the home of a non-working wife are argued to be income.[14] The example is given of a couple who both work but have the same combined income as another couple where only the husband works. Strict equity, it is argued, requires that there be imputed income from the non-working wife's services in the home. The administrative difficulties of taxing the value of these services is acknowledged by the authors. For the government to tax the value of services of a wife for her family is a shocking concept. The example given by the authors has some persuasion, but this probably stems from the seeming inequity of splitting income on a joint return, rather than from the appeal of the imputed income concept. Splitting income is a fact when both husband and wife have income; where only the husband has income it is a fictional device to eliminate inequity between community property and common law states. Abandoning the split income concept and not recognizing community property concepts under the federal tax laws has more appeal to me than imputing income from intra-family services.

The 1969 Act introduced a discrimination against couples whose partners both work. Surprisingly, this inequity has received little attention. When rates were lowered for single persons, a situation was created in which a married couple both working and having approximately equal incomes pay more tax than if single and living together. For instance, if each working spouse had an income of 10,000 dollars the extra tax is 280 dollars![15]

While further tax reform is needed, there is doubt that it can be achieved. The authors, however, have rendered a valuable service by their summary of remaining tax preferences. The public should not be led by the "Tax Reform" label on the 1969 Act to believe that nothing remains to be done.

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14. RUSKAY & OSSERMAN, *supra* note 2, at 200-01.

15. Richards, *Single v. Married Income Tax Returns Under the Tax Reform Act of 1969*, 48 TAXES 301, 302 (1970).

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