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Federal Income Tax Reform-1976 Style

Mortimer M. Caplin

FEDERAL INCOME TAX REFORM
1976 STYLE

by
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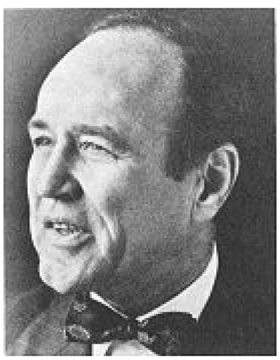

[Introductory note: Mortimer M. Caplin, lawyer and educator and former U.S. Commissioner of Internal Revenue, is a partner in the law firm of Caplin & Drysdale of Washington, D.C. He is a member of the Bars of the District of Columbia, New York and Virginia.

Following graduation from the University of Virginia Law School, Mr. Caplin served as law clerk to Judge Armistead M. Dobie, U.S. Court of Appeals for the 4th Circuit. He first practiced law in New York City from 1941 to 1950 -- with time out for military service in the U.S. Navy. During the Normandy invasion, he served as a Navy beachmaster.

In 1950, Mr. Caplin returned to the University of Virginia to become a professor of law, specializing in tax and corporate law. He also continued in practice as a member of a Virginia law firm.

In 1960, following the election of President John F. Kennedy, Mr. Caplin served on the President's Task Force on Taxation. In January 1961, President Kennedy appointed him U.S. Commissioner of Internal Revenue. He served in that post until July 1964, when he resigned to resume private law practice in Washington with his present firm.

On leaving government, Mr. Caplin received the Alexander Hamilton Award, the highest award conferred by the Secretary of the Treasury "for outstanding and unusual leadership during service as U.S. Commissioner of Internal Revenue".

In his speech, "Federal Income Tax Reform -- 1976 Style," Mr. Caplin will analyze new trends in Federal income tax reform -- contrasting the "every-person-a--taxpayer" approach of the last comprehensive tax statute (1969 Tax Reform Act) with the "tax shelter" emphasis in pending legislation. He will then discuss the potential of tax reform in 1976, including the Treasury's "major simplification" proposal to permit sizable rate reductions for all.]

About 200 years ago, Edmund Burke said: "To tax and to please, no more than to love and be wise, is not given to men." In this same spirit, some view a good tax as one paid by someone else, and tax reform as the easing of their tax burden while adding to that of others. I say this not to be cynical, but to emphasize the varying attitudes among us on what is meant by "loophole closing" and "tax reform."

Scope of Tax Reform Proposals

How would this audience vote if we took a poll on such items as: (1) taxing capital gain as ordinary income; (2) taxing municipal bond interest; (3) using the same graduated rate structure for married and single individuals; (4) ending the $100 exclusion for dividends received by individuals; (5) eliminating the sick-pay exclusion and deductions for child care expenses; (6) ending medical and casualty loss deductions; (7) disallowing current deductions for intangible drilling costs and what remains of percentage depletion from small oil operators; (8) repealing the special tax accounting rules for farmers; (9) taxing as income any appreciation in the value of assets at the time of gift or death; (10) taxing individuals on contributions to qualified employee and self-employed pension plans and individual retirement accounts; (11) denying charitable deductions entirely, or limiting them to the cost rather than appreciated value of donated assets; (12) disallowing accelerated depreciation deductions for real estate investments and equipment lease arrangements; (13) limiting business and investment deductions to amounts "at risk" by disregarding non--recourse borrowings in computing cost; (14) denying deductions for mortgage interest payments and for state and local taxes?

What if by doing these things the government would maintain total income tax collections at present levels, but you would cut your *tax rates* in half, eliminate most record keeping and file a tax return of only two or three pages? What if, under such a comprehensive tax program, your particular tax bill would be about the same? What if it were increased slightly?

Not that I recommend that all these things take place at once, although there are those that do. Rather, I point to them to illustrate the scope and variety of current tax reform proposals, and to raise the practical political implications of trying to get support for all or even some. Whether we are for or against a given item depends so much upon our own circumstances, economic and social -- whether we have inherited wealth; whether we earn income as employees, executives or professionals; whether our income comes from investments; whether we own business and, if so, the kind; whether we are working mothers, aged, sick, disabled, or the beneficiary of one of the many other preferences provided for in the Internal Revenue Code. So much depends, too, upon our philosophy of government, our view of the American free enterprise system, and our overall value structure.

Definition of Tax Reform

To many, tax reform and loophole closing suggest correcting the Internal Revenue Code so as to eliminate errors, ambiguities and omissions which permit wealthy people to avoid paying taxes. Yet, while some provisions of this type do exist, they are comparatively few in number and short-lived. For whether it be by the courts through judicial interpretations, or by the Congress through direct legislative action, this handful of "unintended benefits" is normally corrected over time. This is not the real stuff that tax reform is made of.

What concerns the tax reformer today is not the unintended, but the *intended* preferential Code provisions -- the special tax rates, credits, deductions, exemptions, exclusions from income, deferrals of tax liability -- the special benefits or preferences which deviate from the generally accepted norm for our income tax. Critics describe them in a variety of ways: "benefits," "preferences," "subsidies," "tax expenditures," "back door spending," or simply "loopholes." Their supporters, however, justify them on much higher grounds: "incentive," "stimulant," "relief," "fairness" and "equity." A popular slogan for tax reform today is "capital accumulation."

In the legislative arena, Congress is first faced with deciphering the rhetoric of the various competing viewpoints. It then must weigh the testimony and data before it in light of studies and recommendations of the Treasury Department and the incumbent administration. And, inevitably, it makes a choice -- or, as more frequently happens, a compromise -- in enacting specific tax legislation which it concludes is best suited to the times.

Basic Tax Tenets

Before examining current tax reform proposals I would like to list certain principles that Congress is cautioned to keep in mind as it drafts tax legislation. Some have been eroded by exceptions and refinements; some at times conflict with others. Nevertheless, they are familiar guideposts and do provide a good starting point for further discussion.

Tax neutrality:
Revenue should be raised in such a fashion that the imposition of the tax will not in itself cause the taxpayer to change his economic behavior, that is, to invest in one type of business activity rather than another or to conduct his affairs in a particular form solely because of the tax.

Fairness and equity:
All taxpayers should pay their fair share of taxes. To this end all forms of economic income should be treated alike, without favoring one form of realization of income over another. Equal taxes should be imposed on taxpayers at similar income levels (horizontal equity); and reasonable rate differentials should be imposed on classes of taxpayers at different income levels (vertical equity).

Fiscal goals:
The principal goal of our tax laws should be raising revenue and, in the process, promoting economic growth and stability. We should be highly selective before using our tax system to regulate conduct or to achieve specific social and economic objectives; excessive use for non revenue ends has led to complexity, higher rates, and charges of discrimination and unfairness.

Simplicity:
Tax laws should be drafted so that, to the extent possible, they are understandable to taxpayers and reasonably predictable in application. They should be simple enough to permit both accurate compliance by taxpayers and efficient and evenhanded administration by the Internal Revenue Service.

Self-assessment aspects:
Our "do-it-yourself" or self-assessment tax system is the most efficient in the world, and Congress must make every effort to strengthen taxpayer confidence in its operation. This system of "taxation by confession"- which through compliance alone accounts for some 97 percent of our tax collections -- depends largely on the good will and voluntary cooperation of tax- payers. Unfairness, discrimination and abuse erode this confidence; and they must ever be rooted out and eliminated as new tax legislation is considered.

Almost as an annual rite, at the commencement of each Congressional tax reform hearing, invited tax experts testify on these tenets of taxation. It is like the visiting dignitary's pitch of the first ball on the opening day of the baseball season: after the ceremonies, the players take their positions and the real game begins. There are the usual betting odds on the probable outcome; but, under our democratic political system, the results are far from predictable. They depend in large part upon the efforts and influence of the various protagonists and also upon the recorded reactions of hometown voters.

Tax Reform Act of 1969

Our last wave of tax reform actually dates back to 1968, when Congress reluctantly enacted an extra 10 percent income tax surcharge on American taxpayers and, in the same breath, directed President Johnson to present a reform package by year end. While the Treasury Department embarked on comprehensive studies, Lyndon Johnson was not persuaded that it was proper for the Congress to direct the President to submit tax legislation; consequently, no tax reform bill was sent to Congress. Instead, by letter to the Speaker of the House of Representatives dated December 31, 1968, the President formally advised the Congress of the existence of the Treasury proposals but said that he would make no recommendations as he was leaving office on January 20. In other words, he had decided to give his successor a free hand on tax reform.

Early in January 1969, however, outgoing Secretary of the Treasury Joseph W. Barr roused public opinion by releasing some disturbing statistics and predicting a "taxpayer revolt" unless tax reform was soon forthcoming. He pointed to 155 individual tax returns with adjusted gross incomes of over $200,000 a year and 21 returns with adjusted gross incomes of over $1,000,000 on which not one cent in federal income taxes was paid. Barr's statement seized the newspaper headlines nationwide and Congress found itself besieged with demands for corrective action.

With this public outcry echoing continuously throughout the Capitol, a sweeping law was enacted on December 30, 1969. Affected was almost every individual and industry in the country -- including private foundations, cooperatives and financial institutions. The legislation was unbelievably complex; some 27 groups of tax reform and a multitude of policy decisions were reflected in 255 pages of new tax law and thousands of pages of committee reports and hearings. Nevertheless, two dominant goals are discernible in the legislation: (1) to make sure that everyone pays "some" tax (in order to take care of Barr's 155 high-income non-taxpaying individuals); and (2) to narrow the gap between the tax on capital gains and the tax on ordinary income.

Congress sought to achieve these two goals in a variety of ways. For one thing, it made a partial head-on attack on a number of the highly-publicized tax shelters -- real estate depreciation, percentage depletion, capital gain livestock, farming, citrus groves, unlimited charitable deductions and private foundations. Not that the alleged abuses were eliminated completely, but through a host of precise albeit limited changes it made each a little less attractive, a little less profitable.

Beyond this, Congress took two additional steps:

First, it offered two carrots to discourage shelter- shopping: one, more liberal rules for averaging income (including capital gains) over a five-year period; the other, the imposition of a maximum tax of 50 percent on earned income. It was thought that with only half of the earned income going to the government and half retained by the individual, taxpayers would regard this as a fair trade-off and would find it less attractive to engage in tax avoidance and tax minimization plans.

Second, it wielded two sticks -- to prevent total escape from the other tax-catching sections and to penalize those who made excessive use of the tax preference provisions: one, a 10 percent minimum tax on tax preference items; the other, a limitation on the deductibility of "excess investment interest."

The 10 percent minimum tax was one of the most highly publicized provisions of the 1969 Reform Act. Barr's 155 individuals would now come a cropper. No longer would any American escape the IRS tax net. But, alas, as later history and studies were to prove, it did not work.

Part of the problem was that Barr and the Treasury staff looked at the wrong tax returns in making the analyses and judgments which led to the 1969 reforms. They focused on individual returns with over $100,000 of "adjusted gross income" -- despite the fact that "adjusted gross income" is not an adequate starting point for determining the relative importance of tax preferences. This is so because substantial preference items may have already been employed in the very computation of adjusted gross income; and it is a truism that many taxpayers with extremely modest adjusted gross income have economic income of highly significant amounts. (I had the opportunity to elaborate on this in the *Indiana Legal Forum*, Fall 1970.(1))

To illustrate, the computation of adjusted gross income is made on Form 1040 "above the line" by adding in, among other things, the net income or loss from Schedules C, D, E and F: (1) profit or loss from a trade or profession (Schedule C); (2) gain or loss on the sale or exchange of property (Schedule D); (3) profit or loss from the rental of real or personal property, the leasing of mineral property, and the operations of partnerships or Subchapter S corporations (Schedule E); and (4) profit or loss from farming (Schedule F). Losses which reduce adjusted gross income to little or nothing above the line ran thus be produced by first netting out the tax preference items on the various schedules. For example, deductions for percentage depletion, intangible drilling costs and accelerated depreciation on buildings will be done on Schedules C or E. Similarly, farm losses will be deducted on Schedule F; and one half of long-term capital gains will be deducted on Schedule D. Of course, tax-exempt interest is not reported at all.

Beyond this initial error, only nine tax preference items were finally identified. Brisk lobbying efforts resulted in the elimination of four additional items that had been originally considered: (1) Tax-exempt interest on state and local bonds; (2) Appreciated portion of property contributed to charity; (3) Farm losses resulting from special accounting methods; and (4) Intangible drilling and development costs.

Finally, further softening of the minimum tax impact resulted from the adoption of three limiting factors: a flat 10 percent rate; a $30,000 exemption; and a deduction for regular income taxes shown on the face of tax returns, with a seven-year carryover for taxes not used to shield tax preference income.

1973 Tax Reform Hearings

Certainly by 1973, it was widely recognized that the minimum tax on tax preference items was not achieving its goal. Treasury Secretary Shultz acknowledged in his testimony before the House Ways and Means Committee on April 30, 1973, that "significant" numbers of taxpayers with large incomes were paying little or no tax. Congressman Reuss (Wisconsin) said it was "like a sieve" and only a "love tap" tax. He further characterized it as "a small admission fee" for using tax loopholes, and no more than a "cosmetic solution" to fundamental tax inequity.

More recently, Congressman Vanik (Ohio) and the staff of the Joint Committee on Internal Revenue Taxation published statistics illustrating the ineffectiveness of the 1969 changes. Based on an analysis of 1973 federal income tax returns, the figures demonstrated the following expansion of Barr's original examples of 155 non--taxpaying high-income individuals:

Number of Individuals	Adjusted Gross Income
622	over $100,000
292	between $200,000-500,000
54	between $500,000-$l million
24	over $1 million
7	average $2.5 million

In releasing this information, Congressman Vanik stated: "This is only the tip of the iceberg....The Congress must devise a more equitable tax system to insure that all Americans bear some proper support of their nation's activities." The heart of the problem, according to Secretary Shultz in his 1973 testimony, was "tax shelters":

A common characteristic of a tax shelter investment is that it produces deductions and exclusions -- particularly in the early years -- which may be used against other income of the taxpayer. The result may be an outright reduction in taxes, an indefinite deferral of tax, or a conversion of ordinary income into capital gain.

While he recognized that the tax rules inherent in tax shelters were intended as incentives, he noted that they were having "a dangerously demoralizing effect on the operation of our revenue system." This is so, he said, because "it appears to most taxpayers simply to provide a means by which the wealthy avoid the payment of income taxes."

The Treasury's suggested cure was to (a) limit the items excluded from income, (b) prevent distortions that result from the timing of deductions, and (c) bar the sheltering of other income. To achieve this, the following steps were recommended: (1) repeal the minimum tax for individuals and Subchapter S corporations; and (2) substitute two new provisions: (a) *minimum taxable income* (MTI): to deal with those tax items that are outright exclusions from income and (b) *limitation on artificial accounting losses* (LAL): to deal with those tax rules that provide deferrals.

As these recommendations are the cornerstone of pending proposals now before Congress, let us briefly examine these two new concepts in the form they were recommended by the Treasury Department.

Minimum Taxable Income (MTI)

MTI is a true alternative tax, not a penalty or added tax; for the taxpayer is called upon to pay the higher of two taxes, not both. It will prevent the combination of exclusions and itemized deductions from offsetting more than one-half of a taxpayer's real economic income. In turn, every individual will be required to pay on at least the balance.

This is accomplished in the following manners:

1. Four current income exclusions are added to "adjusted gross income": (a) one-half of long-term capital gains; (b) bargain element of qualified stock options at the time of exercise; (c) percentage deletion in excess of adjusted basis; and (d) income earned abroad which is now excluded under Code section 911. (Two obvious omissions are tax exempt interest on state and local bonds and the appreciated portion of property gifts to charities.)

2. The resulting sum is called "expanded adjusted gross income" (EAGI).

3. To get the " MTI Base," deduct from EAGI the following: (a) $10,000 floor; (b) personal exemptions; (c) casualty loss deductions exceeding 10 percent of EAGI; and (e) investment interest and investment expenses (deductible under Code section 212) to the extent of investment income.

4. Divide the MTI Base by two to get "minimum taxable income" (MTI).

5. Apply the regular income tax rate structure against the greater of (a) normal taxable income, computed as at present; or (b) MTI.

To repeat, the purpose of MTI is to tax at least 50 percent of an individual's real economic income at regular income tax rates. And to achieve this, only 50 percent of his real economic income may be offset by exclusions and itemized deductions.

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In the reform bill passed by the House in December, 1975 (H.R. 10612), MTI was rejected; the 1,969 minimum tax was retained and the Treasury's LAL proposal was adopted, both in strengthened form. Before the Senate Finance Committee, however, Chairman Russell B. Long (Louisiana) indicated strong support for the MTI approach, although it is doubtful that it will survive the Senate's 1976 mark-up of the bill.

Limitation on Artificial Accounting Losses (LAL)

As noted above, the Treasury's LAL principle is contained in H. R. 10612, and is under consideration by the Senate Finance Committee. Its aim is to require a matching of deductions with related income, and thereby prevent the sheltering of other income through earlier "artificial" deductions.

1. LAL achieves its goal by deferring any deduction which is "clearly associated" with income to be received in future years. Among the Treasury's examples of deferment are the following: (a) intangible drilling and development costs for oil and gas wells; (b) prepaid feed in cattle-feeding syndications; (c) Accelerated over straight-line depreciation for buildings; (d) accelerated over straight-line depreciation for personal property under net leases; and (e) pre-opening costs during the construction of realty, including interest, taxes, fees and expenses.

2. None of these LAL deductions will be allowed until the property produces income. In other words, deductions are matched with the same class of income to which they relate; and they are allowed as offsetting deductions only when the income is earned.

3. No offset against other income-no sheltering-is permitted.

4. However, deferred LAL deductions are not abandoned. Rather, they are placed in a "deferred loss account" and held in suspense for use in succeeding taxable years.

5. They later become deductible against the first "net related income" realized from the property; or on the sale or other disposition of the property to which the deferred loss is attributable.

LAL is a complex accounting concept and there are many refinements and details that need to be analyzed to fully understand its operations. The House has elaborated on the concept significantly, and in many instances has toughened its application. Needless to say, if LAL is finally enacted, it will put an abrupt end to the practice of large year-end write offs, currently enhanced by limited partnership syndications and non-recourse leveraging arrangements.

The Tax Reform Act of 1975 (H.R. 10612)

After almost three years of deliberation and hearings, the House on December 4, 1975 passed the Tax Reform Act of 1975 (H. R. 10612). Some 700 pages in length, the legislation vies with the 1969 reform act in its breadth and scope. To tax reformers, the bill's sharp attack on tax shelters is its most important aspect.

The House approach is twofold: (a) to expand upon the Treasury's LAL proposal and (b) to broaden the existing minimum tax.

LAL: In fine detail, the bill applies LAL to six types of operations: (1) real estate; (2) farm operations (including breeding and feeding of livestock); (3) natural resources (oil and gas); (4) movie shelters (including film purchase and production company arrangement); (5) equipment leasing; and (6) sports teams (players' contracts and franchises).

Beyond this, the bill places severe limitations on other types of shelter techniques: deductibility of prepaid interest and nonbusiness interest, nonrecourse financing, recapture rules, and use of syndicated limited partnership arrangements.

As a whole, the LAL and related changes would seriously undermine the attractiveness of most tax shelter investments.

Amendments to Minimum Tax: As a final touch, H.R. 10612 retains the minimum tax on tax preference items but significantly strengthens its impact. This is done by the following changes:

1. Rate: The penalty tax rate is increased to 14 percent (in lieu of 10 percent).

2. Exemption: The exemption is reduced to $20,000 (in lieu of $30,000); and, in addition, the exemption is phased out dollar-for-dollar as the preference income exceeds $20,000 -- so that at $40,000 of tax preference items there is no exemption.

3.Income Tax deduction: The bill eliminates the present deduction for income taxes as well as the tax carryover provisions.

4. Tax preference items: New preference items are added -- (a) intangible drilling costs for development wells; (b) itemized deductions in excess of 70 percent of adjusted gross income; (c) accelerated over straight-line depreciation/amortization on all leased equipment; (d) interest and taxes during construction of realty; and (e) certain depreciation on players' contracts.

These changes alone are estimated to raise additional revenue of almost $1 billion a year. If adopted in conjunction with the LAL provisions, the promises of the 1969 Revenue Act will more likely be fulfilled: i.e., that every citizen with real economic income will pay income taxes; and that the gap between the taxation of earned income and capital gain will be sharply narrowed.

Senate Finance Committee Hearing

The Senate Finance Committee is nearing the end of its hearings on H. R. 10612. The bill's final form is difficult to predict, particularly because of Chairman Long's strong opposition to LAL and expressed interest in MTI. Further complications arise because this is a Presidential election year and because, by June 30, 1976, Congress must act if it is to extend the 1975 tax reduction provisions that expire on that date.

Senator Long was believed to be committed to drafting tax reform legislation by June 30,1976. Recently he stated that this is not now possible; and he added: "I am committed to passing a tax overhaul bill by the end of this Congress . . . I am not wedding myself to a specific date." Before the Senate Budget Committee, he also expressed doubt that the goal of $2 billion from tax reform legislation is attainable.

Almost every affected industry has testified before the Senate Finance Committee on the dire economic consequences that would follow enactment of LAL and the amended minimum tax -- as contained in H.R. 10612. Senator Long has expressed his sympathy for the industry arguments and, in fact, has urged them to mobilize their lobbying efforts in the Senate. As he put it: "When the fur starts flying on the Senate floor, some of your members had better come back to town and talk to some people."

In contrast, Senator Edward M. Kennedy (Massachusetts) takes a much more aggressive view on tax reform: he fully supports LAL and has an overall program which he estimates will raise $7 billion a year. Backed by at least 18 fellow Senators, he promises to make an aggressive fight when H. R. 10612 is discussed in the Senate. As Senators Long and Kennedy each said to the other in a recent interchange: "See you on the floor, Senator."

As the Senate Finance Committee enters its final legislative mark-up period, some outline of the Senate 1976 tax reform legislation is beginning to suggest itself:

1. It is too late for tax reform legislation to be adopted by June 30, 1976; hence, it will be necessary to extend the cutoff date of the 1975 tax reduction provisions so as to leave time for final enactment of the reform bill.

2. Although MTI and LAL have a neat logic to them -- *treating exclusions from income* separately under MTI, and *timing of "artificial" deductions* separately under LAL -- they are unduly complex as a package and raise serious business questions during a particularly uncertain stage in our economy.

3. A revised version of the 1969 minimum tax, blending portions of both MT1 and LAL, seems to be a more acceptable solution. A penalty tax rate of 15 percent and a lower exemption have been suggested. Also, it is probable that more items will be added to the tax preference list, including some that were originally classified under LAL.

4. To cover the more egregious cases of leveraging through nonrecourse financing -- widely publicized

in tax shelter literature -- a new "at risk" principle may be adopted. In brief, a taxpayer's deductions and losses from a venture may be limited to the amount of his actual investment that is "at risk" -- including recourse loans and other adequate security. As nonrecourse loans would not be taken into account for these purposes, loud outcries may be anticipated from the investment community, particularly from real estate syndicators.

We now await final word from the Senate and ultimately from the Conference Committee and the House. But whatever the choice in 1976, it must be recognized that it will be only a compromise solution to a tax reform problem that has long troubled Congress.

STILL ANOTHER ALTERNATIVE

For some years, Congress has been concerned over taxpayers with high economic income who pay federal income taxes at effective rates far below those indicated by the statute -- often lower than the effective rates of others having substantially less income. The Joint Committee Staff reported in 1969 that increasingly "taxpayers with substantial incomes have found ways of gaining tax advantages from the provisions that were placed in the Code primarily to aid limited segments of the economy." In many cases, they have found ways to "pile one advantage on top of another" and, as both the House and Senate agree, this is an "intolerable situation." Secretary Shultz, you will recall, said that it "has a dangerously demoralizing effect on the operation of our revenue system."

One obvious way of correcting this is to repeal all these special provisions and, in their place, to adopt a broadly based income tax with a lower rate structure than at present, coupling it with a liberal averaging rule -- to take account of peaks and valleys of income and losses over a period of years and the bunching of capital gains and other forms of income. This approach has long been championed by many tax reformers. Yet, because of apparent overwhelming political obstacles facing such a proposal, Congress has not given it serious consideration.

Recently, however, Treasury Secretary Simon brought the plan back to life when he proposed a broad based income tax that would permit rates of 10-12 percent at the low end and 35-40 percent at the top. To achieve this, he would "wipe the slate clean of personal tax preferences, special deductions and credits, exclusions from income, and the like, imposing instead a single, progressive tax on all individuals."

Simon has been led in this direction because of the increasing complexity in the law, widespread feeling that the system favors the rich, and a drop in the rate of taxpayers compliance. Repeating the warnings of former Treasury Secretary Barr, he again cautions: "We are faced . . . with an incipient taxpayer revolt." "What has caused more bewilderment and distrust among taxpayers," he says, "than the myriad of so-called loopholes which now litter our tax code?" This would be corrected, he believes, by the new plan's "simple elegance and its basic equity toward all tax-payers." It would give us "a tax system that rests upon the twin pillars of fairness and simplicity."

In 1963 and 1964, Senator Russell Long offered a comparable proposal of an optional simplified income tax system -- permitting taxpayers to elect to pay a lower tax rate upon agreeing to forego the benefit of many of the special exclusions, benefits and deductions of the present law. In a *Reader's Digest* article in 1969, I supported a Simon-type plan, not on an optional basis, but as a fixed requirement for all taxpayers. Liberal averaging rules and a lower rate structure would have to be essential parts of such a comprehensive tax base approach.

But is the Simon-type reform politically feasible at this stage of our national development? Consider all the hard choices that we would have to make -- in removing tax incentives which individuals, business, charities, and state and local governments have relied upon for decades. Consider the investments already made and the enterprises already begun on the basis of existing tax assumptions. Consider the line-drawing that would have to be made between business deductions -- between deductions from gross receipts and gross income and deductions from adjusted gross income. Consider the need for liberal transitional rules over a period of years to provide fairness and equity and to relieve hardship cases. Could all of these considerations be provided for in a single tax reform bill? Or would the goal be more attainable in a series of bills, adopted over a given period of time, following a comprehensive study by a prestigious commission?

The doubters among us have noted: "Our taxes reflect a continuing struggle among contending interests for the privilege of paying the least." True though that may be, it is essential to the welfare of this nation that we continue our quest -- with the backing of political leaders, scholars, tax experts, and the public at large -- for a sound and strengthened tax system. For, as President Kennedy noted in his first tax message to Congress, such a system is necessary if we are to maintain our national defense and "render the public services for enriching the lives of our people and furthering the growth of our economy."

(1) Caplin, "Minimum Tax for Tax Preferences and Related Reforms Affecting High Income Individuals", 4 *Indiana Legal Forum* 71 (1970).

SELECTED QUESTIONS AND ANSWERS

Question:
As a former Revenue Agent, I can attest to the fact that there was a lot of confusion and loss of morale in the service when T. Coleman Andrews, after his resignation, announced his recommendation that we eliminate the graduated income tax. How can you explain a former Commissioner taking such a position, and what is your reaction, as a former Commissioner, to the income tax?

Answer:
I know Mr. Andrews. He is a very interesting man. He came out for elimination of the income tax after he left the government. He ran for President of the United States and its always popular to say "let's eliminate the income tax" if one is running as a candidate for President.

At the same time he never proposed a substitute, and I don't know how you can run a government without adequate financing. How do you pay for the army and navy? How do you pay for a police force? How do you pay for social services? You can point to other ways to raise revenue but in the final analysis you must deal with a tax.

Now you have a sales tax, a manufacturers tax, a turnover tax but such taxes are opposed to the basic philosophy of this country that a tax should be imposed on the basis of the ability to pay. In terms of what type of tax we should have, it may be that we are going to need something other than an income tax as a supplement. Despite all the pock marks, in our income tax laws, I come up personally with the feeling that we should have a tax based on income. I would emphasize economic income. Thus I tend to favor a much broader based tax than we have today. I think that if we eliminated the bulk of the preferences, exclusions, and special rates, that the tax form would become much simpler. I think it would eliminate a lot of the mystery, and it would eliminate a good part of the fear of not having complied.

When we get to the administration of the law, well that is another problem. I do think we're involved in a very sad chapter today. I don't know how you feel about the Internal Revenue Service, but from my own experience, although in effect I'm doing combat every day representing taxpayers now, I have a great respect for that organization. There are some very fine people trying to do a tough job. But I do think that a number of unfortunate things have happened. I think there has been an attempt to tamper with the Service, and we saw that during this recent Watergate experience. A couple of Commissioners left because they didn't want the pressure. I think it affected morale within the organization.

A new commissioner came in, Mr. Alexander, and he abruptly tried to change rules; perhaps too abruptly. He called off investigations that were going on for years, like Operation Haven down in the

Bahamas, and he sort of interfered with procedures that the intelligence division engaged in, and he tried to make changes over night. I think a lot of the things he did were in the right direction but I think it was the manner he was moving that hurt.

I think it is terribly important that there be a kind of revival of faith in the Internal Revenue Service, since the service affects every individual in this country. There is a major job to be done in restoring taxpayer confidence, and in trying to emphasize to people that tax audits are not intended to put people in jail. Many of them are routine. I'd say the bulk of them are routine. Today they are using the computer more and more to identify returns by looking for idiosyncrasies. This is a major subject. Essentially I come up with the fact that I'm not prepared to scrap the income tax today.

Question:
There has been some criticism that our estate tax is catastrophic. President Ford has indicated that there should be a change in that area. There has also been some thought in combining the estate gift and income taxes. I would like to know what your feelings are on this.

Answer:
Well you know that for a great number of years, going back to 1968 there have been a number of major proposals revising the estate and gift tax. I think Pro. Surrey, who is assistant secretary, came out with one report, and then the American Law Institute, a body of lawyers who have been studying this, come up with a similar basic program. It isn't really a program to integrate all three taxes, but only the estate and gift taxes.

The only place you might talk about any sort of integration so far as the income tax is concerned is the taxation of appreciated property at death or by gift. You might view that as really part of the estate taxes, if you imposed a tax at death on the difference between the original cost and the fair market value at death but that really isn't viewed as a estate tax provision. What the proposals recommend is having a "transfer" tax, making no distinction between a gift and estate tax by having one set of graduated taxes. Every transfer you make goes up into another bracket, whether it is in life time or by death. This would eliminate a lot of the life-time estate planning that we hear of. The proposals also aim to avoid generation skipping i.e. To have a tax at each generation instead of permitting setting up a long term trust, an intervivos or testamentary trust, where the tax will be paid one time, and then maybe within the rule against perpetuities it goes on for many generations, and no further estate or gift tax is paid. Another proposal is to enlarge the marital deduction; in affect a 100 percent marital deduction to permit you to have inter-spousal transfers free of tax, with the idea that on the death of that generation, the death of the surviving spouse, you will then impose that one tax. Essentially what they are talking about is a modification of the exemptions and a modification of the rate structure. There are hearings going on now in the House Ways and Means committee on these provisions. I think Congress will try to come out with some new law this year. I doubt if they are going to have an estate and gift tax reform bill this year, and I also think it is very shaky whether you will have an income tax reform bill of any meaning this year but probably one rather than the other. Now what do I think of it? Well essentially I think those proposals are essentially sound. Where I have my only difficulty is on the rate structure. How high will it be? Today the estate tax goes as high as 77 percent, and I have some concern about that. There are those who would say "well, let's encourage lifetime accumulation, consumption, earning; let's cut back on the income tax but with a death, let them have it." In other words you shouldn't be able to pass on anything to the next generation. In effect, let each person start more or less from scratch with some minimal base. I just can't quite buy that. I think that we have to have some incentives; it sort is part of the whole democratic process of ours and our enterprise system. I think we ought to have a significant program of aiding people who are in need, of making sure that we have full employment in this country, and of giving everybody an opportunity for a job on a unbiased basis, and to do all we can to push people along and give them an education. But I am not in favor of confiscation of property at death. I can buy a 50 percent rate; somehow that hits me as a good level.

Question:

As the earnings go up due to inflation the tax bite gets harder and bigger. Is there any tax reform that would make the bite more equitable?

Answer:
Well this is very disturbing factor. A lot of people say that if you buy property at 100, and you sell it at 300 you ought to pay a tax on that capital gain, the 200 points. And indeed maybe you ought to be taxed as ordinary income. Some people on the other side of the fence would say when you bought that property at 100, that was a particular level of earning capacity or purchasing power. Now that we have had inflation, that 300 doesn't buy anymore than the 100 bought. There really hasn't been a true accretion of wealth or income. This is a concern of Congress. There are some who want to have a price level adjustment in your basis so that if you paid 100 you can adjust that 100 to take into account inflation. Another plan which has been seriously considered is to permit instead of only a 50 percent exclusion of long term capital gain (and the present bill requires a holding period of one year for a long term capital gain rather than six months), an additional exclusion for every five years. That, if you held the property over 5 years, another 1 percent exclusion per year with a maximum exclusion of a total of 70 percent. Thus you might pay a tax of only 30 percent rather than 50 percent to take into account the factor of inflation. Some of the opponents of this theory say that if you do it to property, why don't you do it to earnings. The person who is making 300 a week today, can't buy more than the person who made 100 years ago, and you ought to have a compensating factor for the inflation rate there too. It's hard to turn your back on that argument. It seems to me we may have to face broadening the bands of the bracket. Many people are pushed up into a higher tax bracket by an increase in salary which is intended to put them on the same level of purchasing power they had a year or two ago. They are paying higher taxes today at higher rates, because they are pushed into a higher graduated bracket. None of these issues are easy, but I do think that this problem should be taken into account.

Question:
I gather from what you said that you are opposed to the gross receipts tax, in lieu of an income tax. This is a thought that Milton Friedman expressed for many years -- the use of a Gross Receipts tax. I was wondering what specific objections you have for this tax.

Answer:
Well let me just say this first, I think Milton Friedman restated his plan the other day in Newsweek. Friedman, as I remember, says there is very little revenue to be gained over 25 percent, and he therefore proposed putting a ceiling of 25 percent. I mean the last time in Newsweek he probably said that. People he alleged thus won't go into tax shelters, I don't know if I can buy that. The trouble with a gross receipts tax is the inequities. What if you got a little business man who has inventory, are you going to tax him literally on gross receipts? He may have net profit or he may have a net loss, I have a lot of problems with gross receipts as a base. If you start talking about a gross income tax or an adjusted gross income tax, or one like the expanded adjusted gross tax, I could start buying that. I think, based upon talking to a lot of taxpayers around the country, and traveling to different parts of the country and having the opportunity to meet with a lot of taxpayer groups, that there are an awful lot of people who would even be willing to pay a little more, (not a heck of a lot) if they could have the tax based on a simplified adjusted gross income. This would eliminate the deductions and the tax would assume a broadened base to eliminate some of the shelter provisions as well, because everybody would be on a parity. I think there is a lot to be said for that. I think as a matter of fact secretary Bill Simon's idea, if he really means it, has an awful lot of merit to it. The question is what are you going to do about the fellow who is in real estate and tells you "I will not invest in this deal unless I get so much depreciation, otherwise it doesn't make any sense." Why should he take the risk? And what if the real estate developers took the position unless we get this outside capital we are not going to build the needed buildings. I don't know maybe we should let the law of economics reach it's own level; and give them this stimulus. Many people suggest we should. Give them a direct subsidy instead of a tax deduction. That's a good theory to give a direct subsidy, but we must also talk about balanced budgets. Everyone wants to achieve a balanced budget by 1980, the balanced budget year -- this is the language of both party platform. I will say it will be very difficult to get direct subsidies enacted. You will have to stand

on a long line for that.

Question:
If you adopt a simplified tax structure, as you seem to suggest, wouldn't the charities suffer thereby, and wouldn't they certainly oppose such a move on humanitarian grounds.

Answer:
Well this is the big argument that is being made. It so happens we represent the Council on Foundations and I assure you the charities have been up there on Capital Hill. At one time they were going to treat as a tax preference the appreciated portion of property given to charity. If you paid $100 for property and donated the property to a charity when it was worth $300, you got a 300 dollar deduction. The $200 spread was proposed as a tax preference. It was eliminated by Congress because the charities were heard; they represent a very large constituency. There are churches, there are schools, there are colleges, there are all different types of foundations and they all get up there and make themselves heard. The foundations of course were injured tremendously in 1969 when the whole tax reform provisions went in favor of private foundations. You must ask yourself whether you are willing to pay the price for reform. Are you going to make an exception for the charities? The treasury had some simplification provisions which they proposed in 1973 which would sort of eliminate a lot of the deductions but even then they carved out the charities as a special group. You have a pretty strong constituency in the charities, but in the main you're going to have to be awfully effective in bucking them if Secretary Simon's proposal is to go through. Maybe he is going to back off in his proposal and say you got the churches, synagogues, the schools and we can't fight all of them. And this legislature may have to carve that out as one exception, but this is the dilemma that a legislator must face.

Question:
I can see your attack against the deductions or shelters to arrive at Adjusted Gross Income, and you seem to favor the non-elimination of the contributions deduction. But how about the other itemized deductions for instance interest and taxes. Many people in the middle class category have gone out and purchased homes knowing the additional amount that they are paying and counting on those deductions, particularly since the standard deduction has been increased to or take care of the apartment dweller. At this point there seems to be an attack (I don't know how successful it would be if it went politically) against those who own a home and have to incur interest and real estate taxes. The elimination of these deductions now to that homeowner after he bought the home relying on the tax savings, could be devastating. And what are your thoughts on allowing a credit against the tax for local taxes if a deduction is denied?

Answer:
You get into a question of transition rules, whether or not you ought to allow people who own their houses at present to continue to take the interest and tax deduction. Otherwise you are adversely affecting the marketability of their home. Now another guy comes along and says this homeowner is getting all of these deductions -- "I want him to discount that house by 331/3 percent to take into account those various rights." Again this is what has been the road block. Gov. Carter got himself into difficulty a few weeks ago when he answered a question about mortgage interest as being allowed as a tax deduction. He seemed to have some difficulty on that and never finished his statement. I don't want to knock him because he is a good man, but he was talking about this so called comprehensive tax base with a limitations on deductions as a trade off for lower rates. The most feasible time for putting this type of scheme or plan into operation, is when you propose a tax cut. If Congress can lower the rates it can state: "We are going to take away all these itemized deductions and we will lower your rates, and you are going to get a little reduction overall in your tax but you're not going to get a deduction for your taxes and interest." You might go along with that, because your overall taxes are let us say, $5000. You are going to pay only $4500 under the new plan, so you saved $500. They take away your interest and taxes and they take away a few other deductions, like union dues and things like that, but you are going to pay $500 less, so you go along -- maybe. But the next year they raise taxes, and that's what everybody is worried about if we agree to a comprehensive tax base. They may just turn around and

raise the rate once its adopted. As a matter of fact there are those who have proposed a constitutional amendment; that if you go into a comprehensive tax base you may never, without a constitutional amendment, increase taxes over 25 percent. We are back to Milton Friedman's plan. As to your question as to allowing local taxes as a credit, I might say that I do have a thought that I have espoused and written on. I'm against Federal-State tax sharing the way it is. I'm in favor of a tax credit system whereby on your Federal return you take a tax credit, for maybe not 100 percent but for 50 percent of all the taxes you pay, and are given the option of taking a deduction or credit, whichever is better. I think that taxpayers in states and localities imposing these taxes ought to be given a credit. The money shouldn't be poured back into a community as general revenue sharing, where there was no responsibility in that community for the raising of the taxes. Many communities have cut back on their taxes and just take the general revenue share. I think that a high tax state or high tax city ought to get consideration so far as the citizens are concerned for that pattern. So I would meet you half way on that, maybe, not all the way.

Question:
In the last year or so, there have been considerable talks about revising the taxation of multi-national corporations particularly their foreign subsidiaries. I wonder if you would comment as to your views on that.

Answer:
We have a lot of fun talking about what happened in 1961 and 1962, when one of the most dramatic things was the tax bill we then espoused. It had two very significant provisions. One dealt with something called T & E (travel and entertainment expenses) and that probably was as revolutionary as anything else. I still don't know how that was ever enacted, but that was one big area. The other major provision was in the foreign field, The program we recommended at hat time was to continue the foreign tax credit but to eliminate the deferral of income. In effect we wanted current taxation of income earned by let's say a 100 percent subsidiary abroad. We settled for a compromise something called "Subpart F" which is probably the hugest monstrosity in the Code. We did provide for a current tax to a U.S. company of the earnings of a tax haven corporation. In trying to define a tax haven corporation we really had a time of it. I again lead towards current taxation of foreign earnings but also to continue the foreign tax credit. Thus I sort of start off where I began some fourteen or fifteen years ago.