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The Fair Tax: The Personal Realization Income Tax

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THE FAIR TAX: THE PERSONAL REALIZATION INCOME TAX

by

Joseph M. Dodge[*]

ABSTRACT

This article argues that the properly conceived fairness norm for taxation leads to a personal realization income tax. Fairness in taxation refers to "allocative tax fairness," that is, the ethical/political standard according to which taxes are to be apportioned among the relevant population. In concrete terms, the standard constitutes the tax base for individual taxpayers. Allocative fairness is but one norm bearing on taxation, but it is one that (in academia, at least) has unjustifiably taken a back seat to economics and welfarist norms, largely due to the perception that allocative tax fairness lacks any specific content apart from the speaker's political and personal tastes and, therefore, by implication, is without independent normative grounding. The short riposte is that exclusive adherence to economic and/or welfarist norms is itself a matter of personal taste. The more elaborate response entails showing that (1) fairness is an independent norm category apart from economics and welfarism; (2) allocative fairness matters in the construction of tax systems; and (3) allocative tax fairness has a discernable content. That content is conceptualized in the notion of "objective ability-to-pay," which refers to an individual's realized net increase in material wealth over the taxable period (reduced by off-the-bottom allowances), and does not refer to utility, satisfactions, or well-being as such. The tax base that conforms to the objective ability-to-pay principle is that of a personal realization income tax, as opposed to (say) a personal wealth, accretion, or consumption tax.

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I. INTRODUCTION

This article argues that the properly conceived fairness norm for taxation leads to a personal realization income tax. Fairness in taxation refers to "allocative tax fairness," that is, the ethical/political standard according to which taxes are to be apportioned among the relevant population. In concrete terms, the standard constitutes the tax base for individual taxpayers. Allocative fairness is but one norm bearing on taxation, but it is one that (in academia, at least) has unjustifiably taken a back seat to economics[1] and welfarist[2] norms, largely due to the perception that allocative tax fairness lacks any specific content apart from the speaker's political and personal tastes and, therefore, by implication, is without independent normative grounding. The short riposte is that exclusive adherence to economic and/or welfarist norms is itself a matter of personal taste. The more elaborate response entails showing that (1) fairness is an independent norm category apart from economics and welfarism; (2) allocative fairness matters in the construction of tax systems; and (3) allocative tax fairness has a discernable content. That content is conceptualized in the notion of "objective ability-to-pay," which refers to an individual's realized net increase in material wealth over the taxable period (reduced by off-the-bottom allowances), and does not refer to utility, satisfactions, or well-being as such. The tax base that conforms to the objective ability-to-pay principle is that of a personal realization income tax, as opposed to (say) a personal wealth, accretion, or consumption tax.

The article proceeds as follows. Part II is an analytic exercise that reveals the four principal norm categories that bear on taxation. The category of internal-to-tax (i.e., allocative) fairness is here identified as an institutional (i.e., mid-level) norm distinct from a conception of a good or just society.

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1. *See*, *e.g.,* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1627–28 (1999) (stating that issues in the income tax should be resolved by the standard of economic efficiency).

2. *See, e.g.,* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 1–2 (2002).

Part III plays off the seminal work of Henry Simons, who developed the notion of allocative fairness in taxation and then argued for its embodiment in a *personal* income tax (as opposed to a tax on national income). Unfortunately, the definition of personal "income" set out by Simons on page 50 of his seminal work—namely, the sum of an individual's consumption and net increases in wealth for the taxable year[3]—although long cited as a gold standard of income tax theory,[4] has (1) confused Simons's followers, (2) was not followed by Simons himself in the remainder of his commentary, and (3) has not been adopted as the income tax base by the United States or any other political entity. A correct reading of Simons's work as a whole reveals that the page 50 definition of personal income requires three "adjustments" in order to produce an income tax concept that is both theoretically complete and operationally practical. First, "consumption" should not be viewed as an independent category of income apart from "net increases in wealth" but instead should be seen as a nondeductible use of income. Second, the definition of personal income needs to account for two (nondeductible) uses of income that Simons's commentary ignored, namely, transfers of wealth and (non-pleasurable) economic waste. Third, the core notion of personal income (changes in net

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3. HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938). The concept is commonly referred to as the Haig-Simons concept of income, but the contribution of Robert M. Haig (1887–1953), discussed *infra* notes 25–26 and accompanying text, might be called "preliminary."

4. The Simons income concept was advanced as the normative concept of income in STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 12–22 (1973). *See also* U.S. TREAS. DEPT., BLUEPRINTS FOR BASIC TAX REFORM 1–3 (1977) [hereinafter BLUEPRINTS]; 3 REPORT OF THE ROYAL COMMISSION ON TAXATION: TAXATION OF INCOME 22–23 (1966) (Can.) (restating the concept in terms of the command of resources for personal use); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 49–51 (1985); Richard Goode, *The Economic Definition of Income*, *in* COMPREHENSIVE INCOME TAXATION 1, 7–10 (Joseph A. Pechman ed., 1977). For scholarly works in which Simons's income definition is the starting point for analysis, see William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 313 (1972) [hereinafter Andrews, *Personal Deductions*]; J. Clifton Fleming, Jr., & Robert J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement*, 30 VA. TAX REV. 135, 146, 154–65 (2010); Michael J. McIntyre, *An Inquiry into the Special Status of Interest Payments*, 1981 DUKE L. J. 765, 769 (1981); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 46–53 (1990); William J. Turnier, *Evaluating Personal Deductions in an Income Tax–The Ideal*, 66 CORNELL L. REV. 262, 270–76 (1981).

wealth), rather than being measured by annual changes in asset values (as under an "accretion" income tax), should instead be reckoned, under the "realization principle," upon disposition of assets for cash or its deemed equivalent.[5] In combination, these (fully-justified) corrections to the Simons definition yield a revised definition of "personal income" for tax purposes as "net *realized* increases in *material* wealth (over the taxable period) *without regard to source or use*," which (after subsistence allowances) embodies a core tax-base principle of "objective ability-to-pay."

Having arrived as the objective ability-to-pay principle on internal-to-tax grounds, it is next necessary to construct it on external-to-tax grounds. Part IV begins this task by explaining how political theory and practice, general social norms, and human psychology constrain the concept of the tax base so as to reinforce the conclusions reached in Part III, as well as to justify allowances off the bottom.

Part V, the heart of the article, argues that mid-level allocative fairness norms are widely accepted, powerful, and useful, especially in institutional settings. Moreover, the allocatively fair tax principle of objective ability-to-pay finesses deep conflicts of values and political commitments. Part V then "derives" the objective ability-to-pay principle both from the top down (i.e., from external-to-tax norms) and from the bottom up (from internal-to-tax norms), and, in doing so, sorts out the relation between horizontal and vertical equity.

Part VI argues that the objective ability-to-pay principle is best embodied in a personal realization *income* tax, as opposed to an annual wealth tax or a personal consumption tax. Part VII follows with a description of an objective ability-to-pay personal income tax, which closely follows the existing realization income tax but with certain exceptions relating to, e.g., personal casualty losses, accrual accounting, depreciation, cash borrowing, and debt-financed property acquisitions.

The Conclusion, Part VIII, offers a concise summary and concluding remarks on tax theory and its applications.

II. THE STRUCTURE OF NORMS BEARING ON TAXATION

Norms relevant to tax theory and policy can be categorized in terms of their interface between society and the institution of taxation. The norms

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5. Suppose X purchases shares of stock for $100,000 in March of Year 1, the stock is worth $120,000 at the end of Year 1, and is sold for $117,000 in Year 2. Under the Simons definition, X has gain of $20,000 in Year 1 and a loss of $3,000 in Year 2. Under realization, X has no gain in Year 1 but has a Year 2 gain of $17,000. *See* I.R.C. § 1001(a), (b).

relating to taxation can be "internal to tax," i.e., derived from the function of taxation to raise revenue for government use, or "external to tax," i.e., relating to the larger society. At the same time, norms can either be "means" (instrumental in nature) or "ends" (values, or goods in themselves). Crosscutting these two dyads yields four categories of norms pertaining to taxation, all of which are familiar to tax theorists.

	Means	Ends
Internal	Administrative efficiency	Allocative tax fairness
External	Economic efficiency	Notion of just or good society

Tie-ins exist among these norms. For example, the norm of administrative efficiency dictates that the tax base be measured by objective standards, and allocating the tax base by nonobjective standards (say, according to the discretion of government officials) would be viewed as allocatively unfair. Similarly, it is hard to conceive of a just society in which its major institutions operated unfairly (in an allocative sense). Economic efficiency is a means for maximizing social wealth, but the latter only makes sense as an attribute (if an insufficient one) for a good society. Both administrative efficiency and economic efficiency are concerned with maximizing outputs from given inputs. Finally, both of the "ends" categories are founded on ethical, political, and social values.

This article attempts to restore, and give content to, the notion of allocative tax fairness and not to disregard or trivialize the other norm categories. Although moves are made in academia to promote the hegemony of a single meta-norm,[6] it is hard to discern any real consensus as to the content and ranking of norms, which is understandable on account of the heterogeneity of scholars' academic (law versus other disciplines), political, and value commitments. The acknowledgement of norm pluralism also

6. The currently dominant reductionist theory is optimal taxation theory, which is an offshoot of welfarism. However, problems abound in defining "welfare" or "well-being." *See*, *e.g.*, Matthew D. Adler & Eric A. Posner, *Happiness Research and Cost-Benefit Analysis*, 37 J. LEGAL STUD. S253 *passim* (2008). Additionally, welfarism (a descendant of utilitarianism) is itself a controversial view of what constitutes a good society. For starters, it suggests an active and interventionist government that would favor those with abnormally strong psychic needs or desires. *See generally* N. Gregory Mankiw et al., *Optimal Taxation in Theory and Practice*, 23 J. ECON. PERSP. 147 *passim* (2009). The most salient prescriptions of optimal taxation theory (low rates for the highest earners, heavy taxation of necessities, and lower rates for secondary workers) have no chance of enactment.

compels the conclusion that the most allocatively fair tax (a personal realization income tax) is not the only normatively justifiable tax.

III. SIMONS INCOME, ALLOCATIVE FAIRNESS, AND OBJECTIVE ABILITY-TO-PAY

Although the Simons income definition (net increases in wealth plus consumption) has been central to much academic discourse about tax, it has had its detractors, who mainly complain about its supposed lack of normative grounding, at least in economic efficiency and welfarist notions. Subpart A of this Part shows that Simons income is indeed founded on norms, especially those of allocative tax fairness and opposition to extreme material inequality in society. In Subpart B, it is shown that, content-wise, the income tax, as Simons ultimately constructed it, is the prototype of the objective ability-to-pay personal income tax. Subpart C explains why Simons shied away from using ability-to-pay terminology.

A. The Normative Basis of Simons's Income

In evaluating the import of Henry Simons's seminal 1938 work for the modern income tax, it is useful to examine Simons's agenda. In the context of the mid-1930s, Simons (a staunch defender of free-market capitalism)[7] was fighting a war on three fronts in defense of the income tax. First, Simons advanced the notion of a *personal* income tax against other notions of an income tax (especially that of a tax on national income).[8] Second, Simons defended the income concept against the notion of a consumed-income tax (cash flow consumption tax) as then advanced by Irving Fisher.[9] Third, Simons wanted to "translate" the notion of "income,"

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7. Simons rails against tariffs, unions, and restraints on free trade, and yet states that taxes are the best means of mitigating inequality, at least in the short term. *See* SIMONS, *supra* note 3, at v–ix.

8. Other early writings advancing income concepts include WILLIAM WALLACE HEWETT, THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION (1925); EDWIN R. A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD (1911); Carl C. Plehn, *The Concept of Income as Recurrent, Consumable Receipts*, 14 AM. ECON. REV. 1 (1924).

9. *See*, *e.g.*, IRVING FISHER, THE NATURE OF CAPITAL AND INCOME (1912). Later (but pre-contemporary) advocates of a personal cash-flow consumption tax include Nicholas Kaldor and William Vickrey. *See* NICHOLAS KALDOR, AN EXPENDITURE TAX (1955); WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION (1947).

as understood by economists, into a practical and objective accounting system.

It is significant that the title of Simons's 1938 book is *The Personal Income Tax* (emphasis added). Simons stated that the problem of (internal-to-tax) fairness is how to apportion the tax burden (a political given) among the relevant population.[10] Only a *personal* tax can be *allocatively* fair because a personal tax is one where the tax base is constituted by one or more relevant economic attributes, objectively determined, "of" individual taxpayers. Additionally, the tax must be seen as being borne by the individuals who pay the taxes allocated to them.[11]

Simons's external-to-tax agenda is manifest in his favoring a personal income tax over Fisher's personal consumption tax. Here, Simons was pushing an explicit redistributive agenda because a personal tax base constituted by inflows of material wealth, *regardless of source and regardless of use as consumption or investment*, describes pre-tax inflow available for governmental appropriation. A personal *income* tax (but not a personal consumption tax or personal wealth tax) is aligned with the notion of objective ability-to-pay because the tax is imposed on all inflow of net wealth, regardless of its use or disposition.[12]

Simons took the position that top-down redistribution through a progressive personal income tax was worth attaining at the sacrifice of some degree of economic efficiency, another highly-valued norm.[13] Such a statement implicitly concedes that an income tax is not the most efficient tax, although it is efficient enough (in theory), in not thwarting profitable economic activity or being unduly distortive.[14]

A third Simons aim, namely, constructing a tax base that could be practically accounted for, like the first, lay within the internal-to-tax realm. Posthumously, Simons's page 50 definition of income (as opposed to Simons's final conclusions about realization and other issues) has been co-opted by commentators seeking to advance a "pure" accretion income tax system (i.e., one that reckons annual changes in asset values) in the name of

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10. SIMONS, *supra* note 3, at 3, 41.

11. *Id.* at 44–49 (rejecting tax base keyed to national income). Taxes on personal wealth, income, or consumption are widely assumed in the economics literature to be borne by the individual taxpayers on whom they are imposed.

12. This statement is expanded upon in Part VI.

13. *See* SIMONS, *supra* note 3, at 19–25 (discussing tradeoff between progressive taxation and economic growth).

14. The deduction of costs of producing income is necessary to avoid double taxation of the same dollars as both inputs and outputs. Such double taxation would operate as a bias against income-producing activity.

economic efficiency above all else.[15] Although it is useful to be able to use the rhetoric of economic efficiency in advocating desirable reform of the income tax, the purveyors of an accretion income tax are vulnerable to claims that a cash-flow consumption tax, a wage tax, or endowment tax better serve the economic-efficiency agenda.[16] Accordingly, economic efficiency cannot be the true normative foundation for favoring an accretion income tax. Instead, the motive must be distributional, as was the case with Simons. Additionally, since a comprehensive accretion tax base is politically impossible, moves to advance accretionism can only result in aggravating the existing hodgepodge of conflicting accretion and realization features. These conflicts in turn distort economic activity, undermining accretionism's aim.

B. From the Tentative Simons Income Definition to Objective Ability-to-Pay Income

Simons is best known for his definition of an individual's personal income as being "the algebraic sum of (1) the market value of rights exercised in [personal] consumption, and (2) the change in the value of the store of property rights between the beginning and the end of the period in question."[17] This definition is problematic on its face because the possible uses of income extend beyond that of (net) increases in wealth (savings and investment) and consumption (destruction of wealth for personal ends), and include transfers and non-personal economic waste. The definition likewise poses problems for Simons's goals of allocative tax fairness, a tax base suitable for material redistribution, and administrative efficiency. Simons's book wrestles with problems inherent in his preliminary definition—

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15. This phenomenon, which gained traction in the 1960s and 1970s under the banner of "the comprehensive tax base," is noted in Nancy C. Staudt, *The Political Economy of Taxation: A Critical Review of a Classic*, 30 LAW & SOC'Y REV. 651 (1996). Favoring the accretion income tax in the name of economic efficiency are Calvin H. Johnson, *Soft Money Investing under the Income Tax*, 1989 U. ILL. L. REV. 1019, 1020 (1989); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113–14 (1986); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 246 (1992).

16. A cash-flow consumption tax is alleged to be neutral between savings relative to current consumption. *See*, *e.g.*, Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax,* 58 STAN. L. REV. 1413, 1414 (2006); David F. Bradford, *The Case for a Personal Consumption Tax*, *in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 75 *passim* (Joseph A. Pechman ed., 1980).

17. *See* SIMONS, *supra* note 3.

somewhat in the manner of a person "thinking out loud to himself"—but many of Simons's followers have taken the preliminary definition as Gospel and have ignored Simons's equivocations and final conclusions. This Subpart reconfigures Simons's income concept by objectifying the tax base and conforming it to an ability-to-pay principle.

1. *Consumption*

This section argues, on the basis of Simons's text and aims, against equating consumption with personal utility or well-being and for the proposition that consumption is not a component of income but is instead a deduction-disallowance principle. By positing that allowed and disallowed deductions are based on cost (incurred in market transactions), i.e., a use of personal wealth, the notion of consumption is not only objectified but brought into line with the ability-to-pay notion.

a. *The "Consumption" Ambiguity in the Simons Definition*

As a matter of algebra, the Simons formulation of income as "net increases in wealth plus personal consumption" can be restated as a deduction-disallowance principle, on account of the fact that personal consumption itself is one form of a decrease in personal wealth,[18] at least if "consumption," as Simons himself defines it, refers to the using up (destruction) of economic goods by the taxpayer during the taxable year.[19] (Consumption is "personal" if the destruction is an end use rather than a means of generating gross receipts for the taxpayer.[20]) Accordingly,

Personal income = net increases in wealth + personal consumption

= gross wealth increases – gross wealth decreases + personal consumption

= gross wealth increases – (gross wealth decreases – personal consumption)

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18. As Simons states the matter, "[c]onsumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods) . . . ." SIMONS, *supra* note 3, at 49-50.

19. *Id.*

20. Costs of producing income are deductible under a normative income tax, and are in fact deductible (with certain exceptions) under positive tax law. *See* I.R.C. §§ 162(a), 165(a), (c), 167(a), 212(1)–(2).

Thus, "consumption" reduces the "decrease in wealth" amount that is deductible in arriving at a taxpayer's net personal income for the year.

Why would Simons's equation imply that consumption is a separate category of income? Haig's formulation of income (net increase in a person's "economic power"[21]) was designed to yield an income tax, as opposed to a tax on current consumption only. Simons viewed his own formulation of income as improving on (or clarifying) that of Haig on account of the fact that the "changes in wealth" component of income is determined at the end of the period by subtracting current consumption along with other decreases in wealth. Therefore, Simons deemed it necessary to add back rights exercised in consumption during the year. Nevertheless, any such "adding back" serves only to cancel out an improper subtraction. Suppose X during the current year earns wages of $50,000, of which $45,000 is consumed and $5,000 is saved. The income of X for the year is $50,000 ($50,000 - $45,000 + $45,000 = $50,000). Because both iterations of the $45,000 spent on consumption represent the same dollars, there is no need to actually account for them as item-by-item expenditures. On the other hand, if "consumption" in Simons's equation referred to something other than a certain category of expenditures, then both iterations of it would have to be valued and accounted for separately, an impossible task for tax administration.

Simons was attempting to appeal to the accounting profession by invoking the convention of equating sources ($50,000 wages) with uses ($45,000 consumption + $5,000 savings). It is correct to say that what indeed distinguishes an *income* tax from a consumption tax is that both consumption and new accessions to wealth are taxed, but otherwise the attempted accounting exercise does not prove that the essence of income lies in adding together "consumption," "net increases in wealth," and perhaps other categories. The Simons accounting equation is still an *equation*, meaning that "uses" must not only encompass all possible uses but must also be denominated in the same way as sources, i.e., as dollars received and expended, set aside, or transferred. In terms of income tax doctrine, this point is well-recognized: decreases in wealth (deductible or not) derive from increases in wealth (includible income).[22]

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21. *See* Robert M. Haig, *The Concept of Income–Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 7 (Robert M. Haig ed., 1921), *reprinted in* AM. ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION 59 (R. Musgrave & C. Shoup eds., 1959).

22. Depreciation and loss deductions can only be taken to the extent of the asset's basis (prior after-tax dollars). *See* I.R.C. §§ 165(b), 167(d).

b. Consumption as a Use of Material Wealth

Since consumption spending or use cannot be income, the only remaining scenario where consumption might be income is that of the in-kind receipt of a consumption item. But in-kind consumption can be income only when the received consumption item is itself an asset or the equivalent of cash immediately spent on a consumption item. Nevertheless, although certain commentators agree (or appear to agree) with this position,[23] many others take the position that income includes assorted benefits that cannot be characterized as the receipt of an asset or cash.[24]

Both Haig and Simons, neither being tax specialists, sought to "translate" the economics concept of personal income as a flow of psychic satisfactions[25] into a practical, objective, and enforceable tax base, and both defined consumption in the tax sense in terms of material wealth. Haig defined personal income as "the increase or accretion in one's [economic] power to satisfy his wants in a given period,"[26] a notion that implies contract or property rights, which entail control over persons and things (as opposed to subjective satisfactions). Simons stated the matter with greater clarity by defining consumption in terms of the *rights* exercised in consumption,[27] a right being an asset capable of being sold or traded in commerce. Of course, many consumption rights are short-lived, and the tax accounting convention is to treat the cost of acquiring a short-lived consumption right as a nondeductible expense. This convention has the effect of ignoring the asset.

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23. *See* RICHARD GOODE, THE INDIVIDUAL INCOME TAX 11–12, 17–19 (1976); Alfred G. Buehler, *Ability To Pay*, 1 TAX L. REV. 243, 250–51 (1946); Thomas Chancellor, *Imputed Income and the Ideal Income Tax*, 67 OR. L. REV. 561, 561–562, 569–575 (1988); Daniel I. Halperin, *Valuing Personal Consumption: Cost Versus Value and the Impact of Insurance*, 1 FLA. TAX REV. 1, 43–44 (1992); 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, 834 (1979).

24. *See* JOSEPH T. SNEED, THE CONFIGURATIONS OF GROSS INCOME 88–97 (1967) (purporting to follow Simons); William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1114–15 (1974) (stating that leisure and imputed income constitute true accretions) [hereinafter Andrews, *Consumption Tax*].

25. *See* Haig, *supra* note 21, at 1–7.

26. *Id.* at 7. The passage continues with "in so far as that power consists of (a) money itself, or, (b) anything susceptible of valuation in terms of money." *Id.* Unfortunately, the notion of "anything susceptible of value" has no boundaries, especially if it refers to anything one *might* buy with any medium under any imagined set of conditions.

27. SIMONS, *supra* note 3, at 50.

Longer-lived consumption rights are similarly treated, but by a different route: the cost is initially treated as a nondeductible capital expenditure, creating basis in the asset, but the basis cannot produce any deductions.[28] Thus, the consumption value of both short- and long-lived consumption rights is measured by monetary cost, an objective datum,[29] a point that Simons ultimately conceded.[30]

To illustrate the significance of the foregoing, suppose that X receives economic benefits from Y without cost, e.g., by receiving free beverages and entertainment in a social or business context, or by benefitting from the government provision of infrastructure. Under the Simons definition of consumption, these benefits—although having subjective "value" for X—are not income of X because they do not entail the exercise of a consumption right of X. A person cannot have a consumption *right* without owning it (or having the functional equivalent of ownership, such as possession and control). X in these examples has no entitlement to anything and is not exercising consumption power previously held or acquired.[31] Of course,

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28. *See* I.R.C. §§ 165(c), 167(a)(1)–(2) (personal-asset losses and depreciation not allowed). The basis of a personal asset, which equals cost (I.R.C. § 1012), can only reduce or wipe out gain (*see* I.R.C. § 1001(a)), but this result only prevents double taxation of the same dollars to the same taxpayer.

29. The "value exercised in consumption" phrase used by Simons poses the issue of a consumption asset that changes value prior to being consumed. Suppose that K purchases a bottle of wine for $20 and five years later it appreciates in value to $50 and is then consumed. Simons suggests that K might be taxed not only on the $20 nondeductible cost but also on the $30 of enhanced consumption value. *See* SIMONS, *supra* note 3, at 119–20. However, the $30 represents unrealized appreciation in an investment. In an ideal accretion income tax, the $30 appreciation would be taxed, and the $50 investment amount realized would then be seen as spent on nondeductible consumption. Next, consider the scenario where the bottle decreases in value from $20 to $13 prior to its consumption. If the accretion-income-tax adherent were to be consistent, then X should obtain a *deductible* investment loss deduction of $7 to go along with the nondeductible consumption loss of $13. However, no commentator has proposed such a result. The reckoning of investment gain and loss in this context would be impossible (as opposed to being difficult) given that the conversion from investment to consumption occurs in private.

30. *Id.* at 100, 162 (concluding that consumption with respect to consumer assets must be measured by its cost, not value, with such cost being reckoned by disallowing any deduction for it).

31. Simons, in his discussion of an officer in the prince's retinue receiving various perks, such as fancy uniforms, food, and entertainment, focuses on the imponderable degree of psychic enjoyment of the officer, implying (to the casual reader) that the income resides in the enjoyment itself. *See* SIMONS, *supra* note 3, at 52–54. To the contrary, the officer should be charged with income only if the

personal enjoyment of something suggests an inquiry into whether the benefit obtained is income (or the cost thereof is deductible), but this observation only points to the fact that lines between income tax categories can be difficult to apply.[32]

The foregoing is not to be construed to mean that all in-kind consumption is non-income. In-kind consumption rights obtained in market transactions would be gross income (or amount realized). Since cash is the norm in commerce, such a transaction should be viewed as the receipt of cash income followed by a (nondeductible) purchase of the consumption right. Employee fringe benefits are the paradigm of in-kind consumption income.

c. Other Uses: The Transfer and Waste of Material Wealth

Simons seemed to assume that savings/investment and consumption are the only uses of wealth net inflow. However, since consumption is defined as destruction of wealth for personal use, that leaves two other "use" categories that are unanalyzed by Simons: (1) personal-use non-destruction (i.e., transfers of cash or wealth) and (2) non-personal-use destruction (economic waste). Nothing said or implied by Simons suggests any reason why these items should be deducted in a personal income tax. Neither category describes a cost of producing income for the person effecting the transfer or incurring the waste. Wealth inflow (net of costs of obtaining it) represents ability-to-pay in the year acquired, and its transfer or loss in the

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transaction entailed a transfer of the social resources (rights to the facilities and services) provided by the prince in return for the officer's services. It seems clear that the officer received no entitlements. The spending is at the will, and under the control, of the prince for the prince's benefit. That the officer might have subjectively enjoyed the benefits is only an invitation to look beneath the surface of the transaction to see if the perks were a form of disguised compensation.

32. Consumption rights are not always easily discerned. Thus, a barter exchange of services can be unpacked as two arm's-length transactions in which cash wages are paid for rights to services, but no cash actually changes hands due to the fact that the cash prices are identical in amount. In contrast, a gratuitous service (such as childcare or repairing an earring) entails no rights, and cannot be reconstituted as a cash transaction. *See* Douglas A. Kahn, *Exclusion from Income of Compensation for Services and Pooling of Labor Occurring in a Noncommercial Setting*, 11 FLA. TAX REV. 683, 683–85 (2011) (also viewing such arrangements as cost-cutting devices).

current or later year does not, prima facie, reduce ability-to-pay any more than does consumption in the current or later year.[33]

In sum, personal "income" is not properly defined as the sum of various use categories, like consumption and savings. Instead, *personal income is an individual's net increase in (material) wealth (for the taxable period), from any and all sources, and regardless of use*.

2. *Realization*

The Simons tentative income definition describes an accretion income tax under which assets would have to be valued annually. However, nothing that Simons says prior to that point bears on the issue as to when gains and losses should be reckoned, except for the immediately preceding paragraph where Simons states that income pertains to specified time periods and that, ideally, all the data for calculating the tax base should exist within the specified time period (that is, without regard to what happened in prior time periods). An accretion income tax satisfies this wholly pragmatic criterion, whereas a realization income tax (in which, to oversimplify, gains and losses are computed per transaction by comparing historic cost of an asset with its selling price) requires information about events in prior periods.

Simons noted his accretion income definition was to be only a starting point[34] to be refined by the ordeal of having to cope with various problems.[35] Simons's self-contained-period notion is not tied to any deep norm or policy other than that of accounting pragmatism; Simons ultimately concludes that accretion taxation is itself impracticable because of valuation difficulties[36] and accepts the realization principle.[37]

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33. Specific tax-base issues involving transfers and economic waste are dealt with *infra* Part VII.B.3.

34. *See* SIMONS, *supra* note 3, at 42–44 ("What is requisite to satisfactory definition of income will appear clearly only as we come to grips with various problems"); *id.* at 50 ("[I]ncome *may* be defined as . . . .") (emphasis added).

35. "Let us now note some of the more obvious limitations and ambiguities of this conception of income." *Id.* at 51. Simons goes on to discuss imputed income from services, compensation in kind, the measurement of consumption, valuation, and gratuitous receipts. *Id.* at 52–60.

36. *Id.* at 56. Additionally, the accretion idea lies uneasily with Simons's statement that personal income refers to "the *exercise* of control over the use of society's scarce resources" since "exercise" would appear to encompass realization. *Id.* at 49 (emphasis added).

37. *Id.* at 100 (referring to realization principle as "practical expedient"); *id.* at 162 (stating that realization is "not only indispensable to a feasible income-tax

C. Simons and Ability-to-Pay

Both the realization principle and the notion that consumption is a nondeductible use of income align an income tax with the ability-to-pay principle. The alignment is obvious because of the fact that taxes are payable only in cash, implying that income for tax purposes refers to the receipt of cash or in-kind rights that can be deemed the equivalent of cash, as opposed to ephemeral changes in market values and subjective satisfactions. The notion of "ability-to-pay" also implies off-the-bottom exemptions for subsistence, but Simons did not address this issue explicitly.[38] Perhaps Simons took the exemption idea for granted, as exemptions were a standard feature of income taxes from their inception.[39] Additionally, the notion of off-the-bottom exemptions accords with Simons's redistributive agenda and support of progression.[40] If Simons objected to exemptions, he surely would have discussed the topic.

It is fair, then, to say that Simons's agenda and prescriptions produce what we can now call an objective ability-to-pay income tax base principle in substance. Such a principle posits that *taxpayers should contribute to the government a portion of their net material (cash or deemed-cash asset) realized inflow for the taxable period in excess of subsistence needs*. Deductions (apart from realized costs of producing income) are not justified by how such inflow is used. The realization principle refines the "inflow" (and "cost") notions to align the income tax with a taxpayer's ability *to pay the tax in cash*, the only medium acceptable to the government. Such a tax base is fair in the allocative sense by being defined in terms of the subject of taxation itself, and (for the same reason) it is tailored to government's redistributive role (whether one embraces that role or not). An objective

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system but relatively unobjectionable in principle . . . ."); *id.* at 168–69 (stating that deferral of realization of gains is relatively harmless, and that realization avoids extreme fluctuations of income); *id.* at 207 ("Outright abandonment of the realization criterion would be utter folly"). Simons's chief acolyte, Stanley Surrey, also embraced realization. *See* SURREY, *supra* note 4, at 16–18.

38. Simons's discussion of family taxation and gifts does not really address this issue. *See* SIMONS, *supra* note 3, at 137–42.

39. In the 1930s, the exemption was $2,500 for a married couple, $1,000 for a single individual, and $400 per dependent. *See Historical Federal Income Tax Information*, MILEFOOT, http://www.milefoot.com/math/businessmath/taxes/fit.htm (last visited Nov. 30, 2016). In 1938, the average income was $1,731. Henry Blodget, *For a Reminder of What Inflation Does to Your Money, Check Out the "Cost of Living" in 1938*, BUS. INSIDER (Oct. 3, 2014, 7:02 AM), www.businessinsider.com/the-cost-of-living-2014-10.

40. *See* SIMONS, *supra* note 3, at 17–18.

ability-to-pay tax base, being measured by market transactions and avoiding valuations and subjectivity, is objective and highly practical.

Simons, however, avoided using ability-to-pay terminology because in his day such notions as "ability" and "faculty" were deployed in utilitarian "sacrifice theory," which Simons critiqued at length in the introduction to his seminal book. Indeed, Simons was not a fan of utilitarianism generally, citing its hedonistic foundation, inability to articulate the aim of maximizing total social utility, and unconvincing arguments for redistribution.[41] Simons also states that utility-flavored "ability" and "faculty" are so vague as to mean whatever one prefers,[42] a charge that could also be leveled at the present-day welfarist notion of "well-being." Nevertheless, Simons cites Adolph Wagner with approval as holding that taxation had to be viewed as a means to correct distributions of wealth and income, objectively determined, and that "ability-to-pay" makes sense (only) in such a context.[43]

In sum, Simons's work on taxation, far from disparaging the objective ability-to-pay principle, essentially supports it.

IV. WHAT CAN GOVERNMENT LEGITIMATELY TAX?

Simons is now put aside, and the focus hereafter is on the creation of an independent normative foundation for the notion of allocative tax fairness and its specification in the objective ability-to-pay principle, embodied in a realization income tax. In this Part IV, norms pertaining to political institutions are developed and applied to reach the same conclusions as were reached in Part III immediately above pertaining to the issues of consumption and realization. (Looking forward, Part V seeks to justify the notion of allocative tax fairness and why it is best served by the objective ability-to-pay principle; Part VI explains why said principle "translates" to a realization *income* tax; Part VII lays out the features of an objective ability-to-pay realization income tax.)

A. *Liberalism American-Style*

Writers in tax of an economics or welfarist persuasion tend to overlook the grounding of taxation and classical (free-market) economics in political theory and values, especially as these have become social norms

41. *Id.* at 5–15.
42. *Id.* at 17.
43. *Id.* at 15.

that govern action.[44] In the United States, the foundation of the dominant political theory (liberalism), which presents many faces across the political spectrum and is embodied in the Constitution and political practice, is the notion of individual autonomy. Even active-government welfarism (descended from utilitarianism)—which is more of an academic coterie than a broad political movement—has its roots in liberal theory insofar as individual preferences are the desideratum and welfare is equated with (or derivative of) wealth, which is best generated by a market economy.

A principal tenet of liberal political practice is that government power should be constrained in order for individual autonomy to flourish. In turn, the norm of limited government posits a normative distinction between the public and private spheres. Application of this distinction results in the same conclusions as were reached earlier (in the discussion of Simons) considering the issues of consumption and realization.

B. Nonmarket Activity

Simons defined consumption as the destruction of "economic goods," i.e., scarce social resources. However, economic theory is not constrained by the public/private distinction, as exemplified by the fact that Simons (and numerous others) view such private goods as leisure, self-provided consumables, and self-provided services as economic goods because they *could* be purchased and sold in a market.[45] However, this attitude ignores the "social" part of the definition of economic goods. Definitions aside, *that a resource is a social (public) one is what confers upon the government any interest in (or claim to) it under liberal theory and practice*.[46] A resource of a taxpayer is "public" if it entails legal entitlements exchangeable in legitimate markets. Taxing nonmarket activity would violate social-political norms that constrain the commodification of private goods.[47]

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44. *See* Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295, 299, 342–44 (2011) (arguing, in effect, that the broad Simons-derived accessions-to-wealth concept of income is justifiably "bent" by the Internal Revenue Service to avoid conflicts with political values). My thesis, in contrast, is that the ability-to-pay concept (and tax legislation) is itself determined with reference to such values. This point is recognized in principle by Stanley Surrey, and by Joseph Sneed. *See* SNEED, *supra* note 24, at 5 (stating that taxes should be compatible with the "political order"); SURREY, *supra* note 4, at 6–22.

45. *See* SIMONS, *supra* note 3, at 51–52.

46. A similar point is made by Kelman, *supra* note 23, at 842.

47. It has been argued that housework should be taxed so that homemakers would be eligible to receive public benefits that are attendant upon wages. *See* Nancy C. Staudt, *Taxing Housework*, 84 GEO. L.J. 1571 (1996). The

This point was grasped as far back as 1896 by Kleinwächter, who pointed out that the concept of income collapses when it is construed to include private and household goods.[48]

1. *Psychic Benefits*

Psychic enjoyment, even that derived from one's own material goods (such as an art collection), is clearly "private" and out-of-bounds to the tax authority. If psychic enjoyment were income, the tax base would be indeterminate and incapable of enforcement, unless government were to employ means that fail to respect autonomy and privacy,[49] in which case enforcement would be random (resulting in allocative unfairness).

If positive psychic benefits were gross income, then negative psychic states (pain, sadness) would generate deductions. Indeed, the performance of services for wages would entail deductions for wage-earners. Likewise, investment return would be offset by the psychic cost of deferred enjoyment and taking risks. Psychic plusses and minuses derive from individual preferences, tastes, and circumstances, which vary in intensity and range among the population.[50] Finally, after the tax-base plusses and minuses have been tallied, one's psychic aversion to taxes would justify their avoidance and evasion. Market transactions are what convert subjective preferences into objective monetary value, and only monetary values can be the basis of an allocatively fair tax system.

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issues of measurement, privacy, illiquidity, regressivity, the identification of the proper taxpayer, and the linkage of taxation to government benefits are rather casually treated in this piece.

48. *See* FRIEDRICH LUDWIG VON KLEINWÄCHTER, INCOME AND ITS DISTRIBUTION 19 (Hannelore T. McDowell trans.) (translating Introduction (*Einleitung*) to DAS EINKOMMEN UND SEINE VERTEILUNG 16 (1896), https://archive.org/details/daseinkommenund00kleigoog).

49. Simons distanced himself from the notion of psychic income by equating taxable "consumption" with a decrease in *social* wealth: an asset or a *right* (as distinct from pure psychic benefit) is "used up." *See* SIMONS, *supra* note 3, at 96. In another passage, Simons says, "[Personal income] has to do not with sensations . . . but rather with rights which command prices (or to which prices may be imputed)." *Id.* at 49; *see also* Andrews, *Personal Deductions*, *supra* note 4, at 314–15 (defining consumption as preclusive use of social resources for personal benefit).

50. Simons rejects the notions of a good society based on aggregate utility (pleasure). SIMONS, *supra* note 3, at 12–15.

2. *Avoided Costs*

If gross income is predicated on acquisitions of wealth (including consumption rights), it follows that the avoidance of costs is not income. Thus, if a father has a legal obligation to support a child, and such obligation is cut short by reason of the child's death, the relief from a future cost is non-income to the father. Expenditures pose deduction issues, and the avoidance of any given expenditure simply reduces the possibility of obtaining a deduction for it.[51]

3. *Avoided Wage Income (Leisure)*

Economists are wont to claim that leisure is a form of consumption, and therefore should be taxed in principle. Presumably, "leisure" must refer to something other than what one spends in markets on recreational activities, entertainment, and the like, in which case leisure is merely a sub-category of psychic benefit. The economics case for taxing leisure is to remove existing tax disincentives for maximizing material economic return, a program that can be carried out by taxing foregone wages. But the same logic of taxing leisure as foregone wages would impute income to capital that is not put to its highest and best use (such as a farm that could be converted to a housing development), or to underutilized human capital (such as a law professor who would otherwise earn more in the private practice of law). A tax on economic potential (endowment) is not an "income" tax, which is a tax on material economic outcomes.[52]

Foregone income cannot be appropriated by the government and then redistributed. As Simons recognized,[53] leisure (even if it were material) is not a suitable subject of top-down redistribution, as it is likely to be randomly distributed across the population, or even skewed toward the bottom. At the level of social values, the practice of taxing only market outcomes respects autonomous decisions to avoid entering markets for labor and capital. Since a tax on leisure would be payable in cash, the taxpayer at

51. The notion of "avoiding costs" is distinguishable from the situation where the taxpayer *incurs* a cost that is then avoided in a way that results in the obtaining by the taxpayer of a net material benefit. *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) (third-party satisfaction of taxpayer's debt).

52. For critiques of the endowment tax concept, see Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 TAX L. REV. 229, 239 (2011); Ilan Benshalom & Kendra Stead, *Values and (Market) Valuations: A Critique of the Endowment Tax Consensus*, 104 NW. U. L. REV. 1511, 1515 (2010).

53. *See* SIMONS, *supra* note 3, at 52.

the margin would be compelled to enter the market to raise the cash to pay the tax. A truly neutral "tax" on leisure would need to be of the "same kind" as leisure itself (such as compulsory service for the state), which would conflict with core liberal values.[54] The paradox inherent in the notion that leisure (or endowment) should be taxed is that markets, the arena in which free choice is the paradigm, would be forced upon people by a paternalistic government policy that would impose a penalty on choosing *not* to enter markets.[55]

4. *Off-Market Services*

a. *Self-Provided Services*

Benefits obtained from self-provided services (such as, for example, self-provided lawn care) are untaxed, whereas the same services purchased in the market are taxed due to the cost being nondeductible. Economic efficiency considerations by themselves might favor taxing the value of self-provided services, but (again) it would not be acceptable to tax such value in a liberal society. The value of self-provided services may be variously described as (1) psychic income (referring to the satisfaction obtained), (2) an avoidance of monetary costs (not having to pay someone else to do the job), or (3) avoidance of earning wages (with which to pay another party to do the job). Each of these characterizations has already been shown to be an unacceptable basis for taxation. The self-mower acquires no material good that can be transferred to the government. Additionally, the good is in no way "social" because it has not entered commerce or even social relations.[56] The self-mower has merely expended private time in one particular fashion as opposed to possible alternatives.

Taxing the self-mower would be impractical and perhaps self-defeating. The activity would need to be brought into the open and valued by a coercive government, and the cost of equipment, parts, repairs, and gasoline would also have to be accounted for, a burden of the taxpayer. The end result of the accounting would yield very little (or perhaps negative) net income, rendering the whole matter worse than pointless.

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54. *See* Kelman, *supra* note 23, at 842 (noting that nontaxation of leisure has support across the political spectrum).

55. *See* Sugin, *supra* note 52, at, 248–51.

56. Simons states that the value of shaving oneself should not be taxed. SIMONS, *supra* note 3, at 52. Personal grooming is private and unobservable by the government but so are other self-provided services. *Id.*

b. Services Received from Others

If, as noted earlier,57 the spending of money by X for Y's benefit is not income to Y (because Y has not acquired a consumption right), then a fortiori the receipt by Y of X's services (such as childcare or hosting a dinner party) cannot be income,[58] unless X's services are received in a bargained-for exchange for services or goods rendered.[59]

c. Self-Created Assets

Although current law treats self-created assets as non-income even if (and when) consumed by the taxpayer,[60] a self-created asset, upon its completion, appears to be an increase in personal taxable wealth. However, a rule that required current inclusion of self-created assets would entail government intrusion into private matters and could only be enforced sporadically and inequitably. And, if the item is included, the monetary costs (raw materials, seeds, tools, equipment, and supplies)[61] would be deductible (sooner or later), leaving only the value added to the item by the taxpayer's labor. Given that self-provided services are non-income where the services are enjoyed currently, the same result should occur when the services are deployed toward the creation of personal-use property (yielding deferred enjoyment).[62]

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57. *See supra* text following note 30.

58. Nonmarket services received are correctly viewed as non-income, rather than as excluded income. *See* I.R.C. § 102(a). The Regulations make it clear that the gift exclusion only applies to property and money. *See* Reg. § 1.102–1(a).

59. *See* Reg. § 1.61–2(d)(1); Rev. Rul. 79–24, 1979–1 C.B. 60.

60. *See* Comm'r v. Glenshaw Glass, 348 U.S. 426, 431 (1955) (holding that "accession to wealth" is at the core of the income concept). However, the self-creation of an asset is not an "accession," which implies "obtained from outside oneself." *See* MERRIAM-WEBSTER, *www.merriam-webster.com/dictionary/accession* (defining accession to mean "adding to" property holdings and as being synonymous with "acquisition") (last visited Dec. 1, 2016). An example of an accession would be the legal appropriation of a valuable object found in the ground. *See* Reg. § 1.61–14(a). One does not "accede" to one's own labor or the fruits thereof. In any event, the *Glenshaw Glass* formulation of income requires "realization," and realization would not occur until the sale, etc., of the self-constructed asset.

61. Materials might be obtained from nature without cost, but this is relatively uncommon, as most endeavors to obtain the bounty of nature (agriculture, husbandry, fishing, mining) entail significant material costs.

62. *See* Morris v. Comm'r, 9 B.T.A. 1273, 1278 (1928), *acq*. VII–2 C.B. 28 (1928).

The issue discussed here can also be viewed in terms of realization, with the value added by self-supplied labor being a kind of unrealized appreciation.[63] (In the case of consumer assets, taxing such appreciation would seem to require allowing deductions for subsequent depreciation.) However, under current law income from services is generally not taxed until reduced to cash (or a right to future cash). Even advocates of an accretion income tax might hesitate, on neutrality grounds, to tax services income that causes business/investment asset appreciation more heavily than conventional services income. This point extends beyond self-created tangible assets to that of self-created intangibles, such as business goodwill and intellectual property.

C. The Rootedness of Realization

The realization principle is often thought of being a "mere" concession to administrative efficiency, not founded upon any grand theory because, by obviating any need for annual valuations, it saves costs and effort, and avoids guesses and estimates. This attitude overlooks the fact that practicality is itself a strong norm pertaining to government action.

From an economics angle, it is commonly assumed that the realization principle systematically favors taxpayers (versus the government), relative to an accretion income tax. As a matter of logic, the argument is circular by asserting the premise that unrealized gain is "income." But even if one grants the premise, the conclusion (a factual result) does not follow. It is granted that the deferral of a *fixed dollar* amount of income is beneficial in the sense that the present value of the future tax (assumed to be at the current tax rate) is less than what the current tax would be. However, unrealized gain is not a liquidated amount but is indeterminate by being able to grow, shrink, or disappear with the passage of time. Thus, if the "deferred income" grows at the same rate as the discount rate, the present value of the future tax is not reduced by reason of deferral.[64]

A different version of the same argument is the realization principle favors investment in appreciating assets as opposed to investments throwing off periodic cash yield (such as interest). However, such investments are not inherently the same because unrealized gains produce no current cash income (or its equivalent), and the gain may disappear. (Accumulating

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63. For a discussion of this topic, see Noël B. Cunningham & Deborah H. Schenk, *How to Tax the House that Jack Built*, 43 TAX L. REV. 447 (1988).

64. A related argument, i.e., that unrealized appreciation is "reinvested income" that obtains favorable consumption tax treatment, is considered (and rejected) *infra* in the text accompanying note 108.

interest that is disguised as appreciation can be treated as interest for tax purposes, as currently occurs with original issue discount.[65])

The truly salient tax incentives for appreciating investments are the capital gains tax preference[66] and the forgiveness of unrealized gains at death.[67] Both of the features are alien to an allocatively fair income tax.[68]

In any event, economic neutrality with respect to investments is unattainable. An annual tax on net unrealized appreciation would distort economic activity by requiring, for at least some taxpayers, a sale or borrowing. Transaction costs would be especially severe with illiquid assets like pension accounts, unimproved land, closely-held business interests, unproven mineral interests, intellectual property, and collectibles, such that investment in these kinds of assets would be discouraged.

Accretion taxation for only liquid assets is appealing in the abstract, and would entail the practical advantage of eliminating the need to keep basis records for such assets. Also, it would virtually eliminate the lock-in effect.[69] However, a move to such a system would require a politically unpalatable one-time mark to market of existing liquid assets.[70] Also, such a move would (1) entail some forced sales, (2) raise line-drawing issues, (3) encourage investment in illiquid assets, and (4) incentivize the destruction of wealth.[71] In sum, any tax rule having to do with realization will create

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65. *See* I.R.C. § 1272.

66. *See* I.R.C § 1(h) (lower tax rates for net capital gains).

67. *See* § 1014(a) (unrealized gains and losses wiped out at investor's death).

68. Simons opposed both features, although he was sympathetic to income averaging for large irregular gains. SIMONS, *supra* note 3, at 150–67. Simons favored realization of gains and losses at death. However, a better approach in theory and practice is to assign a zero basis to gratuitous transferees. *See infra* text accompanying note 143.

69. The lock-in effect is itself irrational if one views the realization principle as deferring tax on income attributable to pre-realization years. Issues that lie beyond the scope of this article are (1) the strength of the effect and (2) its net harm to the economy, the latter being simply assumed or hypothesized.

70. Since the existing system incentivizes the realization of losses but not gains, a one-time mark-to-market of liquid assets would be heavily weighted on the gain side, resulting in a government windfall. Unless the tax rate on the net gain were extremely low, it is hard to see how such a move could gain political acceptance.

71. The gift/estate tax, which requires valuations, operates to encourage self-imposed illiquidity and other value-reducing action in order to obtain valuation discounts.

economic distortions, and it is not obvious that one set of distortions is worse than another.[72]

Running deeper than inconclusive financial and economic contentions are the roots of realization (even for liquid assets) not only in liberal practice but also in human psychology. To the extent that an accretion income tax would "force" sales, it would be perceived as a problem of government intrusion into private decisions. (The reverse effect of a realization income tax to discourage sales is not seen as coercive.)[73] Accretion taxation of assets that are closely linked to livelihood and lifestyle (e.g., closely-held business and agricultural interests, collectibles, homes, and retirement accounts) would be especially resisted because these assets are not really "available" to the market, and, indeed, may not be visible to the tax collector, at least until a third-party-mediated sale occurs.[74]

It is reasonable for a rational individual to consider unrealized gains (even in the case of liquid investments) to be insufficiently "real" or "final" to justify a current tax thereon payable in cash. Prior to realization, nothing has been appropriated for the taxpayer's personal use (even if such use is only to try another investment). The appreciation is, as far as the taxpayer is concerned, "out there," and not really available for current consumption.[75] Likewise, no cash has been obtained to share with the government and, as noted above, many assets are not readily reducible to cash in a short time frame. In the case of tangibles, the use of the property is likely unchanged. In the case of financial investments, the appreciation would be caused by changes in discount rates, estimates of net future yields, or general economic conditions—phenomena that likewise confer no present economic benefit on the investor. Even with marketable securities, any "paper" gain represented

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72. For example, the tendency of the realization principle to reduce or postpone sales avoids pointless transaction costs, and it is not clear that a churning strategy gives better investment results than a buy-and-hold strategy.

73. The behavioral effects of an accretion or realization income tax operate mainly on the gain side. Indeed, since a realization income tax encourages the realization of losses (but not gains), a mechanism (*see* I.R.C. § 1211) is needed to neutralize such a "cherry-picking" strategy.

74. Such resistance is manifested under the current income tax by the fact that the gain (and use value) of personal residences largely avoids tax, *see* I.R.C. § 121, and state property taxes often cap values at the purchase price (or purchase price plus an interest-type adjustment).

75. A related psychological phenomenon is that of "house money," in which early winnings in a gambling session are unlikely to be cashed in (despite the high liquidity of gambling chips) but instead are likely to be put at risk in new gambles, at least until the initial winnings are lost. *See* RICHARD H. THALER, MISBEHAVING: THE MAKING OF BEHAVIORAL ECONOMICS 80–84 (2015).

by unrealized appreciation may disappear by the time the value of the property is converted to beneficial enjoyment. For a person who bought property for $50,000, which first increased in value to $1 million and then decreased in value to $100,000 (at which point the property was sold), the huge appreciation bubble above the $100,000 sales price was only a missed opportunity.

On the government side, accretion income taxation would be a volatile revenue generator, weakening the connection between taxing and spending in annual budget cycles. No income tax system in the world follows the accretion model even for liquid securities.[76] The weight of these points appears to be causing the realization principle to be gaining respectability, or at least tolerance, in academic circles.[77]

D. Allowances off the Bottom

Allowances off the bottom (deductions or exemptions for subsistence consumption) are founded on liberal political theory, according to which a citizen's basic needs are "prior" to government, or, more fully, that a person's subsistence needs precede any tax claims of the government.[78]

V. CONSTRUCTING THE ABILITY-TO-PAY NORM OF SUBSTANTIVE ALLOCATIVE TAX FAIRNESS

After 100 years of the US income tax, it is no longer necessary, or desirable, to begin (like Haig, Simons, and other early writers) with concepts

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76. The two mark-to-market provisions in the Code are narrow. *See* I.R.C. §§ 475, 1256.

77. *See* Marjorie E. Kornhauser, *The Story of* Macomber*: The Continuing Legacy of Realization*, *in* TAX STORIES 93, 93–98 (Paul L. Caron ed., 2009); Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 355–60 (2004); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 24–36 (1992) (observing economic efficiency aspects of existing realization rules); Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 862 (1998).

78. Noted libertarians agree with allowances off the bottom, despite the redistributive consequences. *See* MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE: A PERSONAL STATEMENT 306–07 (1980); F.A. HAYEK, 2 LAW, LEGISLATION AND LIBERTY: A NEW STATEMENT OF THE LIBERAL PRINCIPLES OF JUSTICE AND POLITICAL ECONOMY 87 (1976); Richard A. Epstein, *Taxation in a Lockean World*, *in* PHILOSOPHY AND LAW 49 (Jules Coleman & Ellen Frankel Paul eds., 1987).

of income developed elsewhere and then to adapt them to tax. A concept of income for tax purposes can be independently constructed from norms relating to the functions of taxation in society.[79] This Part constructs the concept of "objective ability-to-pay personal income" as the content of the substantive tax fairness norm, a content which is not only (as noted above) compatible with liberal values in general but also with government policy relating to redistribution and the institutional function of taxes to raise revenue.

A. Reasons to Take Allocative Tax Fairness Seriously

In the pantheon of values, "fairness"—generally meaning "evenhandedness," "lack of bias," and so on—has a "formal" (as opposed to "substantive") flavor because it refers to the process of distributing (allocating) benefits or harms. The threshold question is, "Why should one care about (tax) fairness, even in the formal sense of equal treatment?"

1. Allocative Fairness as a Universally Recognized Ethical/Institutional Norm

The core fairness maxim of equal treatment of equals is so basic to human intuition and argumentation as to be deployed by folks at all levels of native intelligence and education.[80] The notion of fairness lies at the core of interpersonal ethics because it binds individuals in a web of reciprocity. The reciprocity extends to, and imposes an ethical obligation on, government institutions. This obligation opposes favoritism, arbitrariness, and using government office for private gain, all of which effects help confer legitimacy on government. Fairness is particularly salient where individuals are asked (or required) by government to bear burdens.[81] It is a commonplace

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79. Andrews stakes out a similar approach in stating that the issue is whether the "purposes underlying a [tax-base] provision are indeed extraneous to the purposes of the tax." *See* Andrews, *Personal Deductions*, *supra* note 4, at 311–12.

80. *See* Claudia Civai et al., *Equality Versus Self-Interest in the Brain: Differential Roles for Anterior Insula and Medial Prefrontal Cortex*, 62 NEUROIMAGE 102 (2012), http://www.econ.umn.edu/~rusti001/Research/Neuroeconomics/Neuroimage12.pdf (claiming a biological basis for equal treatment being the default social norm).

81. *See* Paul H. Robinson & John M. Darley, *Intuitions of Justice: Implications for Criminal Law and Justice Policy*, 81 S. CAL. L. REV. 1, 3–4 (2007) (finding that persons evaluate criminal law on basis of widely-shared justice intuitions rather than practical reasoning); *see also* THALER, *supra* note 75, at 127–39 (noting the influence of fairness concerns on individual's economic choices). The

observation that people are far more willing to accept burdens where commensurate burdens are imposed on similarly-situated others.[82] Thus, horizontal equity is a necessary condition to the acceptance of taxation by the citizenry.

In the past 40 years or so, influence over the creation of tax law by "experts" in the United States has diminished relative to input from politics.[83] Fairness, and other values and norms, are routinely invoked (often crudely) in political rhetoric. Scholarship that ignores fairness and other socio-political norms cannot seriously hope to shape tax law.[84]

2. *The Inevitability of an Institutional Fairness Perspective*

Fairness is conceived as a desirable attribute of discrete institutions, such as the tax system, rather than of government in the aggregate. For non-theorists, it is inevitable that fairness issues are framed in institutional terms. How else could fairness issues be framed for non-omniscient beings? How could government as a whole be seen as fair? Fairness must relate to a particular good or burden. And, if all benefits and burdens are fairly apportioned, then the system as a whole would (at the least) be fair.

3. *The Social Utility of an Institutional Fairness Perspective*

The focus on a particular benefit or burden is a cognitive heuristic, referred to (disparagingly) as "myopia" or (neutrally) as "disaggregation bias," but, whatever it is called, it is a useful filter to cope with the

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prevailing norm of descent and distribution is equal shares for children, regardless of affection, mutual benefit, or need. A good deal of academic literature exists on the related issue of self-interest versus political altruism. *See, e.g.*, Justin Esarey et al., *What Motivates Political Preferences? Self-Interest, Ideology, and Fairness in a Laboratory Democracy*, 50 ECON. INQUIRY 604 (2012), http://myweb.fsu.edu/tsalmon/bes.pdf (concerning voting preferences for redistribution).

82. This point is embodied in the low constitutional threshold for taxation (universally imposed) compared to the high threshold for property takings (imposed on select individuals). *See* Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967).

83. Serious engagement by the Treasury, policy-makers, and tax experts perhaps reached a high point in the 1986 Tax Reform Act, which has since largely unraveled.

84. Examples of proposals based on pure theory that have no chance of enactment are mentioned *supra* note 6 and *infra* note 97.

complexities of society and government. It enables the framing of manageable problems to be dealt with according to specialized technical and institutional competence. In the case of taxation, tax systems and rules can be evaluated apart from the big-picture issues of what is a just society and the proper roles of government, about which no political (or academic) consensus exists.[85] An institutional focus allows for a "tax insider" culture to develop, relatively free of disparate personal ideological attachments.[86] This culture, which interacts with explicitly political currents, has an interest in the integrity of the tax system and therefore has a commitment to the concept of tax fairness from a system perspective.

4. Allocative Fairness in Tax Theory

Returning to tax theory, the dominant camp (in terms of institutional affiliation) is welfarism, which debunks the institutional allocative fairness perspective principally on the ground that one should not care about tax fairness because after-tax outcomes can be altered by government programs.[87] (A second, if related, argument, to be dealt with later, is that horizontal equity is subservient to vertical equity.[88]) On the merits, the welfarist argument can be stood on its head: because post-tax outcomes are subject to alteration by government programs, allocative tax fairness is harmless from a welfarist perspective and therefore can be tolerated to satisfy or indulge those for whom it is important. Indeed, if institutional fairness is a government output that satisfies widespread psychic needs,[89] then it is welfare enhancing. This point turns on its head a third type of anti-fairness argument, namely, that fairness (and other values and norms) lack independent value but are simply items in an array of "tastes" or "preferences" of self-interested individuals.

Not all legal academics are welfarists. In areas of legal theorizing outside of tax, internal-to-law allocative norms (sometimes referred to as

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85. *See* Ira Lindsay, *Tax Fairness by Convention: A Defense of Horizontal Equity*, 19 FLA. TAX REV. 79, 82–83 (2016).

86. *See* Patrick B. Crawford, *Analyzing Fairness Principles in Tax Policy: A Pragmatic Approach*, 76 DENV. U. L. REV. 155, 157–59 (1998) (arguing that a pragmatic approach liberates the analyst from truth claims and commitments to philosophical positions and allows fairness principles to be taken seriously).

87. *See* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 25 (2002) (debunking tax norms specifically).

88. See *infra* note 99 and accompanying text.

89. But internalized norms of social reciprocity and ethics hardly qualify as "economic" as that word is generally understood. In any event, this move is benign as it opens up economic research to a wider range of variables.

"mid-level norms") are taken quite seriously. (Examples of nontax legal theories based on such norms include "retribution," "restorative justice," "bindingness of promises," and "rights" of various kinds.) In tax, a non-welfarist theorist can be identified by some allegiance to the notion of resisting the use of the tax system to carry out government programs through "tax expenditures,"[90] whereas a welfarist would presumably embrace tax expenditures. Incidentally, this conflict between welfarists and non-welfarists only exists for tax expenditures that take the form of exclusions or deductions from the tax base. Programs carried out through tax credits do not alter an allocatively fair tax base, and therefore are not really "tax" provisions, but rather government subsidies assigned to the Internal Revenue Service for administration purposes, which in turn raises issues of transparency and administrative competency. In any case, even a welfarist should be wary of tax-base tax expenditures. For example, the casualty loss deduction, as an obviously welfarist tax-base provision, is inferior (even from a welfarist perspective) to government insurance because it disincentivizes private casualty insurance and disproportionately benefits high-marginal-rate taxpayers.

In light of the foregoing, it is puzzling that critics of the notion of an internal-to-tax allocative fairness norm complain that such a norm might not, by itself, further their notion of a just society. (The usual manner of stating this complaint is that allocative tax fairness is disaggregated from the issue of comprehensive social "equity.") This critique asks far too much of the tax system insofar as it suggests that the tax system itself should be riddled with tax expenditures, despite the possibility that such tax expenditures may be ineffective, and despite the risk that they may collide with government nontax programs. This last point is a political-theory version of the economics theory of the "second best," wherein a move (say, in the tax system) towards economic efficiency may run afoul of other government programs (or unremedial conditions), resulting in no net efficiency gain.[91] So might it be the case with a tax system riddled with welfarist features that aim for welfarist policy objectives. Since government programs (including those implemented through tax credits) have the final say relative to tax-base provisions, it would be prudent for a welfarist to leave an allocatively fair tax base alone.

Additionally, allocative tax fairness is actually supported by welfarist considerations, i.e., that allocative fairness (1) is harmless, (2) enhances aggregate psychic welfare, and (3) is better than no fairness at any

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90. *See* SURREY, *supra* note 4.

91. *See Theory of the Second Best: Implications*, WIKIPEDIA, https://en.wikipedia.org/wiki/Theory_of_the_second_best (last visited Dec. 1, 2016).

institutional level.[92] The strongest such argument is that an allocative tax fairness principle constructed along objective, market-outcome lines is perhaps overall the best proxy for measuring the "well-being" of individuals, given the problems of subjectivity inherent in the welfarist program.[93] The proxy notion makes sense, as both the desire for acquiring wealth and choices for disposing of it express a person's exercise of tastes and priorities in the public sphere. The "best proxy" notion is huge because it sets up an objective market-based tax base principle to be the "default" tax base index even for a committed welfarist.

The four-fold classification of norms set forth in Part II suggests that norms perform different functions in differing contexts. On the ground (including academia), the various norm categories may be seen as converging or diverging with respect to any tax issue. Certainly, political actors do not perceive economic efficiency, allocative fairness, welfare maximization, and pragmatism to be the "same" or easily harmonized. A basic value conflict persists between instrumental (aggregate welfare) and deontological (rights-based) approaches to social and legal issues, and within each camp numerous variations exist. In this connection, the "rights" flavor of the equal-treatment notion is duly noted. In conclusion, it is worth repeating that the project herein of identifying a tax base that embodies allocative tax fairness, a norm of significance, does not claim to be hegemonic.[94]

B. Objective Ability-to-Pay as "the" Substantive Principle of Allocative Tax Fairness

If tax fairness is worth pursuing, it is next necessary to settle on its content. Applying the institutional meta-norm of equal treatment of like-situated individuals to taxation only yields the familiar tax maxim of "horizontal equity," which, however, is empty, or even trivial if one is referring simply to the "rule of law" (where equal taxable incomes will mechanically produce equal taxes). It is not surprising that those who downgrade tax fairness claim either that it has no substantive meaning or that

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92. In terms of meta-theory, institutional fairness is still viewed as a good in itself, even though it does not assure the ultimate social good. To pose an analogy, biology and chemistry are still useful disciplines even if particle physics underlies both.

93. *See* KAPLOW & SHAVELL, *supra* note 2, at 23–24 (2002).

94. Simons was a norm pluralist in advancing allocative tax fairness and using the tax system to redistribute material wealth, at some cost to another norm he valued, namely, economic efficiency. *See* SIMONS, *supra* note 3, at 89–97.

the meaning is whatever one wants it to be, so that there is no point or purpose in taking it seriously.

Instead of a casual dismissal of tax fairness, one can indeed construct a substantive content for it by adapting the equal-treatment notion to the institutional function of taxation, namely, to exact cash from a person's material wealth in order to finance government. In light of that function, the substantive question is, "What should be the index, standard, or criterion of likeness and difference in tax, i.e., what principle should define the tax base?" And the answer (in general terms) is derivative of both the question and the context: the tax base must refer to the relative material resources (wealth) of individuals available for government appropriation, a notion that is captured by the notion of "ability-to-pay," which not only has a venerable pedigree[95] but is even enshrined in the constitutions of numerous nations.[96] This notion (as just noted) is also compatible with a welfarist agenda and other redistributive theories.

It is true that, as a pure verbal expression, the term "ability-to-pay" does not fully reveal its full content. Nevertheless, it possesses a core meaning of material wealth (convertible to cash) of an individual over and above subsistence requirements, [97] and it is clear that tax systems that fail to comply with this minimal ability-to-pay notion (such as a head tax, an endowment tax, a tax on imputed returns, and even an accretion income tax) have no chance of becoming law due to a recognition of their allocative unfairness (as well as other issues relating to individual autonomy and privacy). The full content of the ability-to-pay principle is explicated *infra* in

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95. See Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399 (2005) (noting emergence of ability-to-pay principle in 18th and early 19th centuries and critiquing its rival "benefit" principle); Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793 (2005) (income tax in Progressive era advanced on basis of the ability-to-pay allocative fairness principle).

96. Ability-to-pay has constitutional status in (at least) Brazil, Germany, Italy, and Spain. *See* Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 FLA. TAX REV. 259, 301–28 (2006) (noting surprising outcomes of German cases); Frans Vanistendael, *Legal Framework for Taxation*, *in* 1 TAX LAW DESIGN AND DRAFTING 15, 22–23 (Victor Thuronyi ed., 1996).

97. That such a core (i.e., minimal) version of the ability-to-pay principle is a bedrock fairness notion in the United States is noted in J. Clifton Fleming, Jr., et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 306–07 (2001).

Parts VI and VII, but first it is useful to offer up more elaborate normative foundations for the principle.

C. Horizontal and Vertical Equity

In contrast to the horizontal equity notion of equal taxation of equal-tax-base individuals, the "vertical equity" problem of how *differently* situated taxpayers (in terms of the tax base) should be treated is not resolved by the concept of the tax base, but instead by the rate and exemption structure. The configuration of the rate structure requires consideration of external-to-tax norms, such as economic efficiency, welfare enhancement, or other distributional theory. It follows from this observation that *the concept of the tax base does not itself imply any particular rate structure, much less a uniform (flat) one*.

But another (and overlooked) point clamors for attention: *the distributional effect of the rate and exemption structure operates only in terms of the concept of the tax base*.[98] Thus, under an objective ability-to-pay *income* tax, the distributive effect of the rate structure bears on the net income (as opposed to, say, the subjective well-being or aggregate net wealth) of taxpayers. Thus, the choice of the tax base determines what is to be subject to the distributional effect of the rate structure. In this sense, the substantive allocative tax fairness principle "precedes" vertical equity. This point does not, however, imply that the choice of the tax base is solely dictated by internal-to-tax norms. Thus, debates about the priority of horizontal versus vertical equity[99] are sterile because both lack content until norms of all categories are brought to bear on what is to be the tax base.

D. The Top-Down Derivation of the Objective Ability-to-Pay Principle

The argument that horizontal tax equity is subordinate to vertical tax equity actually proves too much because, if government action can undo after-tax outcomes, it is not necessary that the allocative tax fairness (tax base) principle be linked to any external-to-tax norm. In other words, allocative tax fairness can be pursued as a good in itself. Nevertheless, government policy coherency is gained if the allocative tax fairness principle is aligned with external-to-tax norms. To achieve such coordination, the tax base principle might be "derived" from such norms. But which one(s)?

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98. Simons recognized this point. SIMONS, *supra* note 3, at 13–19.

99. *See* SIMONS, *supra* note 3, at 3–4. *See generally* James Repetti & Diane Ring, *Horizontal Equity Revisited*, 13 FLA. TAX REV. 135, 139–45 (2012).

Advocates of the economic-efficiency norm appeal to fairness intuitions by invoking the "level playing field" metaphor and conflating equal treatment of things with equal treatment of people. Often this works, mainly with respect to the breadth of the income tax base. However, the preferred tax base for economists would, by including nonmarket goods, be broader than any plausible tax base.[100] Therefore, complete harmony between economic efficiency and allocative fairness is unattainable. Furthermore, because economic efficiency is directed to the goal of maximizing material wealth, without regard to how it is obtained or distributed, total subordination of allocative fairness to economic efficiency would effectively wipe out allocative tax fairness (except by coincidence). Finally, as an analytical matter, it would be unnatural if an "end" (even if only an institutional one) were subordinated to a "means." The appropriate nexus of allocative fairness to external-to-tax norms, therefore, would be to the norm category of "social ends," specifically social justice.

The one issue that appears to be the universal concern of commentators on both tax and social justice (who, grudgingly or not, accept a market economy based on property rights) is that of top-down redistribution relative to market outcomes, an issue (typically, but misleadingly, referred to as one of "equity")[101] that government is uniquely situated to deal with. It happens that the objective ability-to-pay allocative tax fairness principle is wholly in accord with *all* views pertaining to this issue because the objective ability-to-pay tax base is the baseline for the redistribution among the population of material wealth, which is *the only personal attribute that government can effectively redistribute*. Even a principled opponent of redistribution should favor a tax base keyed to objective wealth (as measured in space or time periods) because, if combined with a flat tax rate (and no exemptions), the resulting tax would *not* alter relative market outcomes. Any tax base principle that does not refer to objective wealth would necessarily alter, on the sly, relative market outcomes.

100. See *supra* Part IV.B.

101. "Equity" implies entitlement (a "right"), but redistribution might be based on purely pragmatic grounds. In this article, it is not necessary to commit to any particular justification for redistribution (or the absence thereof). It is only necessary to note the universal concern with this issue.

E. Constructing the Objective Ability-To-Pay Principle from the Bottom Up

Here the aim is to construct the ability-to-pay substantive norm of tax fairness from the bottom up, i.e., in internal-to-tax terms. One begins with the observation that only personal *economic* attributes can operate as a relevant basis of apportioning the tax burden among the population in a systematic and fair way. Since taxes entail the sacrifice of money by individuals, the tax base should be conceptualized in terms of the money—as opposed to the welfare, or other characteristics—of taxpayers. Practically speaking, the government cannot appropriate or redistribute a person's welfare as conceived subjectively. Moreover, the government has no legitimate business in reducing the subjective welfare of its population because destroyed welfare simply disappears and cannot be re-transferred. Although government welfare-enhancing programs can take many forms other than cash payments to individuals, money is a prerequisite for all government programs of whatever nature (including tax credits). Money is wholly objective, universal, transferrable, convertible to other goods and benefits, and easy to account for.

From a welfarist perspective, money (as opposed to in-kind goods and services) is what can and should be redistributed because tax dollars come out of the transferor's lowest spending priorities and are available to satisfy the transferee's own spending priorities. From a liberalism perspective, a tax base keyed to money outcomes respects individual autonomy because it does not second-guess the earning and expenditure choices of individual taxpayers.[102]

The basic implication of taxes being cash exactions is that a suitable tax fairness principle has to produce a cash amount for a particular taxpayer that the taxpayer is able (or is deemed to be able) to pay over, in part, to the government. The objective ability-to-pay principle captures this notion. But what tax base best embodies this principle?

VI. WHAT TAX BASE BEST EMBODIES ALLOCATIVE FAIRNESS?

The previous Part argued that the allocatively fair tax base, to be compatible with internal-to-tax norms and external-to-tax norms, should be denominated in terms of individuals' objective ability-to-pay, a function of material wealth. Here the issue is how such wealth should be viewed, i.e., in space (under a periodic wealth tax) or in time (under an annual personal

102. *See* Sugin, *supra* note 52, at 250–51.

income tax or annual personal consumption tax). The claim here is that the objective ability-to-pay personal *income* tax is the appropriate index of allocative tax fairness.

A. *The Periodicity of Taxes*

It might be supposed that an annual wealth tax is an appropriate means of implementing the ability-to-pay principle. Such a conclusion would be incorrect solely on account of the reasons for favoring a realization income tax over an accretion income tax.[103]

At the level of political theory, the tax base should conform to the principle that a government is an agent of (and is accountable to) its constituents and, therefore, must operate on a periodic budget cycle. Government does not (and should not) own an endowment that would enable it to operate autonomously for an indefinite period (as is the case, say, with a charity).

Additionally, since a responsible government must operate on a periodic (say, annual) budget cycle, the funding of government must be conceptualized in the same terms. In other words, the tax base should be viewed as an economic output in real time (a flow), a portion of which is diverted to the government.[104] In the world of tax, the flow must be of money (and its deemed equivalent), which the government takes a portion of. In contrast to a tax-base concept based on flow, a tax base keyed to wealth or endowment is static, like a core sample, frozen section, or balance sheet, disconnected from the notion of continuous government finance, not to mention life itself.

A personal wealth tax destroys economic capital (and the size of the pot subject to redistribution) unless the tax rate is less than a safe rate of economic return. In that case, the so-called wealth tax is really a tax on an imputed rate of return, because the tax could not be sustained without a safe average return on wealth portfolios. The notion of ability-to-pay expresses the idea that taxpayers should contribute to government only out of what they *can presently* contribute to government (namely, cash or its deemed equivalent). Accordingly, imaginary or hypothetical flow (or return) would not conform to the ability-to-pay principle, which posits a tax on economic outcomes, not economic potential. Additionally, liberal values also favor imposing consequences on outcomes, rather than potential, as this approach

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103. *See supra* text accompanying notes 15, 64–76.

104. Haig conceived of income as a flow. *See* Haig, *supra* note 21, at 7. Simons disliked this metaphor but was insistent on the periodicity of the tax base. *See* SIMONS, *supra* note 3, at 50.

respects individual choices, as opposed to government ex ante interference with such choices. (By the way, the argument here is not that a wealth tax, or a wealth transfer tax, could serve no legitimate programmatic purpose whatsoever, but only that it is not the optimal allocatively fair tax base.)

The periodicity/flow point also illuminates an important facet of the meaning of ability-to-pay: it is not what a person *could* convert to cash (say, by a sale) at any particular point in time, but rather what a person receives, or is deemed to receive, or possibly spends or uses, in cash in real time, an observation that posits a realization principle (and that segues into the next topic).

B. Annual Personal Income Versus Annual Personal Consumption

The notion that government shares in the flow of money passing through individuals also dictates that tax fairness should not be conceptualized in terms of comparisons of present values of future cash flows, as is advocated by those favoring a personal cash-flow consumption tax (or an endowment tax).[105] Discounting future flows to present values is a useful investment heuristic. However, the government is not an investor and is, therefore, not indifferent to when during an investment/consumption cycle a tax is imposed. Present-value analysis arrests time, but the flow of real time lies at the very heart of personal, social, and (above all) political activity, as well as, of course, of the institutions of taxation and government.

The flow of money through a taxpayer can be reckoned either when the money is obtained by the taxpayer (under an "income tax") or when it is disinvested and spent on consumption (under a "cash-flow consumption tax"), in both cases with subtraction for costs of producing revenue. The ability-to-pay concept dictates that a person cannot avoid tax in the current year by making free choices pertaining to the uses of income that result in decreasing her own tax base. (Although deferral of realization might also be characterized as self-help tax base reduction, such is not the case: current income is not decreased; instead, a potential increase or decrease in income is postponed.)

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105. *See* BLUEPRINTS, *supra* note 4, at 39 (asserting that lifetime comparison is appropriate); Lawrence Zelenak, *Tax Policy and Personal Identity Over Time*, 62 TAX L. REV. 333, 333 (2009) (noting those who make such normative claims). Since equal taxes for equal lifetime incomes (reduced to present value) are obtained only if the tax rate is constant over time, advocacy of this approach is incompatible with a government that can change tax rules (even non-retroactively). More broadly, the lifetime-income view is implicit advocacy of an endowment tax.

Ability-to-pay exists by reason of, and in the moment of, the receipt of cash (or its deemed equivalent) during a taxable year and is not determined at the end of the year. The taxpayer receiving cash has the ability to pay tax (in the current year) with a portion of that cash, regardless of the disposition of that cash (or its avoidance by receiving in-kind rights in lieu of cash). The tax base is the same for a taxpayer whether cash is saved, invested, spent on consumption, transferred away, or allowed to go to waste. On an annual basis, which is the relevant government-finance perspective, an income tax does *not* discriminate among possible uses of income.

Consumption tax supporters claim that an income tax discriminates against investors, relative to spenders on current consumption because of the so-called double taxation of deferred consumption resulting from (1) the nondeductibility of the purchase price of investments (which represents the present value of all future yield ultimately spent on consumption) and (2) the inclusion in the tax base of the excess of future net yield over the present value thereof (the investment net income). But, as noted above, present-value analysis is not apt for comparing taxpayers in terms of what they should contribute to government on an annual basis. In real time, no double taxation occurs under an income tax: the investment income received in the future is new wealth *when received*. (By the same token, a consumption tax does not, notwithstanding the claims of its detractors, "exempt" income in real time because, given a positive net yield, the future taxable amount will exceed the currently invested, and deducted, amount.[106])

The immediate deduction for investment under a consumption tax would presumably be more salient to taxpayers than the alleged double taxation under the income tax. This must be so because consumption tax advocates argue that such a tax would significantly increase national savings and investment. Thus, *from a behavioral perspective* it is more accurate to state that a consumption tax discriminates *in favor of* investment than that an income tax discriminates against it. In short, the agenda of consumption tax supporters is programmatic, not one of allocative tax fairness.[107]

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106. Under a personal consumption tax, investments made are deducted; under an income tax, they are not.

107. The comparison between an income tax and a consumption tax, in tax fairness terms, is sharpened when one considers pure savings for deferred consumption. Suppose X and Y each earn $60,000 in Year 1 but Y (unlike X, who spends it all on consumption) puts $10,000 aside in a checking account before spending it on consumption in Year 3. No good reason exists to defer Y's tax on $10,000 until Year 3, or for allowing Y to defer tax by spending $10,000 on a fancy audio system that will yield enjoyment over 20 years. Andrews is unsure of the theoretically proper treatment of this scenario but concludes that additions to savings accounts should be deducted because they earn a return. *See* Andrews, *Consumption*

It is sometimes said that the realization principle (not taxing unrealized appreciation) is itself a consumption tax feature of the income tax by being the equivalent of a taxable receipt of the unrealized appreciation coupled with an offsetting deduction for the reinvestment of realized gain in the same property. Basically, this argument is circular because it assumes that unrealized appreciation in a year is current income. However, factually speaking, no receipt is obtained that would be taxed under a consumption tax, which itself contains a realization requirement at its very core.[108] Nor is there is any reinvestment (which, under a consumption tax, would be deductible). Unrealized appreciation is not an increase in the *taxpayer's* investment, as would be the case with a realization followed by a reinvestment of the proceeds. (Of course, the realization principle should be protected from abuse, a matter considered in Part VII *infra*.)

In conclusion, no allocative fairness reason exists to tax consumption rather than income,[109] which also happens to be the appropriate tax base with respect to redistribution.

VII. THE CONTOURS OF AN ABILITY-TO-PAY INCOME TAX BASE

The aim of this part is to show that a personal income tax based upon the objective ability-to-pay principle is not vague, indeterminate, or useless.

A. Gross Income Issues

1. Intangible Benefits

As noted earlier,[110] the following intangible benefits would be *non-income*: avoided costs (as opposed to incurred costs), avoided income (leisure), psychic benefits, the value of self-provided services, and the value of using assets owned, or services provided, by another. The category of non-income would also include in-kind support, consumption benefits received as business promotions, non-denominated government benefits, and employer-

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Tax, *supra* note 24, at 1160–62. This demonstrates that the consumption tax is about privileging investments relative to consumption, not about fair treatment of individuals.

108. Under a (cash-flow) consumption tax, borrowed cash, wages, and the reduction of assets to cash (potential consumption) are the central components of the tax base.

109. For a thorough critique of the fairness claims of consumption tax supporters, see Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961 (1992).

110. *See supra* text accompanying notes 45–63.

provided working conditions, equipment, and reimbursed business expenses. None of these entail an intake of cash or its deemed equivalent (such as occurs with in-kind employee compensation).

2. *Imputed Income from Consumer Assets*

Henry Simons appears to deviate from his general prescription that consumption income involves the receipt of cash or an asset (right) by arguing that the imputed income (the gross fair rental value) of owner-occupied homes should be viewed as income in the tax sense.[111] This conclusion is widely accepted in the tax literature, at least as an ideal.[112] It is noteworthy that Simons does not equate imputed income with "consumption value" but instead characterizes it as an investment yield in the form of a "service."[113] Although the value of a financial investment asset can be ascertained by discounting future cash returns to the present, it does not follow that all assets having value generate returns in the form of cash or wealth. Although ownership of a home entails the right to (rent-free) occupancy, such right is not separate from the property itself.[114] The "service" is provided by the homeowner to herself. Without an inflow of material wealth from the outside, the taxpayer has nothing to share with the government.

Homeownership entails deferred consumption. If one posits that the cost of a home is the present value of future net consumption value over time, then not being able to deduct the cost of a home is the way in which the income tax reaches such future net consumption value, just as in the case of any deferred consumption right. It follows that the commonly held view that ignoring imputed income discriminates against the renter relative to the homeowner is incorrect.[115] Actually, homeowners and renters *are* taxed the same ex ante, which is the relevant economics perspective. Purchasing a home is like

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111. SIMONS, *supra* note 3, at 110–22.

112. *See* BLUEPRINTS, *supra* note 4, at 7 (1977); GOODE, *supra* note 23, at 139–43; Richard A. Epstein, *The Consumption and Loss of Personal Property Under the Internal Revenue Code*, 23 STAN. L. REV. 454, 454 (1973).

113. *See* GOODE, note 22, at 139–43; Gerald M. Brannon, *Tax Loopholes as Original Sin: Lessons from Tax History*, 31 VILL. L. REV. 1763, 1766–67 (1986).

114. *See generally* Chancellor, *supra* note 23, at 561–65.

115. *See* SIMONS, *supra* note 3, at 112. This argument assumes that the present deductions for mortgage interest, I.R.C. § 163(h)(3), and property taxes, I.R.C. § 164(a), are eliminated.

paying prepaid rent.[116] In both cases, the rule is to disallow any deduction for the cost of personal consumption, whether current or deferred.[117]

Advocates of taxing imputed income often invoke a comparison between one who invests in a home and another who invests in an annuity used to fund the payment of rent on an equivalent home: not only is the cost of the annuity nondeductible (as with the cost of the home) but the excess of the annuity cash returns over its cost is taxed as income (and, when paid as rent, continues to be "after tax" by being nondeductible). However, the comparison only illustrates the truism of the disparate income tax treatment of consuming and investing. Whether taxing imputed income would result in an increase in conventional investment (relative to spending on housing), or whether that would be a good policy move, I would not venture to say, except to point out that the argument that homeownership is a suboptimal social investment because homes do not yield gain in the form of new material wealth proves my point as to why imputed income is not "income" in the tax sense.

Taxing imputed income from homes was appealing to Simons (and likely others) because of its perceived potential for redistribution. However, taxing items that are only statistically skewed towards the upper classes—a welfarist notion—violates *allocative* tax fairness. For example, a poor person who owns a recreational fishing boat or motor home would be taxed more heavily (in this respect) than a wealthy person who lacks an equivalent item. Generally, the burden of taxing imputed income would disproportionately fall on the middle class, for which home ownership constitutes a principal vehicle for "investment," relative to the wealthy, who enjoy low tax rates on capital gains and have other ready investment alternatives.[118]

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116. No meaningful difference (in substance) exists between owning and renting where the rental term (with renewals) equals or exceeds the asset's useful life and the lessee is responsible for maintenance costs. *See* Sun Oil Co. v. Comm'r, 562 F.2d 258, 269 (3d Cir. 1977); Rev. Proc. 2001–28, 2001–1 C.B. 1156 (lease can be installment sale, or vice versa). Hence, if payment is made in advance, it should be in the same amount in both cases.

117. Also, it should be pointed out that homeowners and renters are not alike, apart from the fact that both occupy a dwelling, because the risks, responsibilities, and rewards differ between them.

118. *See* James M. Poterba & Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, *in* RETHINKING ESTATE AND GIFT TAXATION 422, 440–41 (William Gale et al. eds., 2001) (indicating heavy investment of people with estates under $500,000 in residential real estate).

Finally, taxing imputed income could well backfire. Accurately measuring the gross rental value of homes would require vast resources.[119] Inclusion of gross imputed income would necessitate deductions for expenses, depreciation, and losses, the accounting for which would entail the expenditure of considerable resources and might even result in a net revenue loss.[120] And, if homes were to be treated as investments, then consistency would dictate that all consumer durables should be treated as investments, with resulting deductibility of transactional losses. However, the ownership of consumer durables (other than homes and vehicles) is not a matter of public record, rendering a tax on them a virtual impossibility.[121]

To add a legal point, a tax on fair rental values amounts to a property tax,[122] and it would therefore risk being held to be unconstitutional as a non-apportioned "direct tax."[123]

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119. Ironically, early "income" taxes in Germany (and the U.K.) included imputed income from homes precisely because homes could not be concealed, so that taxing them actually served the cause of administrative convenience, although in a very crude fashion.

120. *Cf.* I.R.C. §§ 469(a), (c)(2), (c)(7) (subjecting most rental activities to complex loss carry-forward rules).

121. Taxes on imputed income outside the United States are always on real estate and sometimes only on land. For a brief survey, see HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 215–17 (3d ed. 2010).

122. *See* I.R.C. § 164(b)(1); Reg. § 1.164–3(c) (defining a personal property tax as a tax imposed annually). The tax on imputed income proposed by Simons is precisely of this type. SIMONS, *supra* note 3, at 117.

123. *See* Eisner v. Macomber, 252 U.S. 189, 217–19 (1920) (holding that a tax on a pro-rata stock dividend, which is a tax on a percentage of the value of the taxpayer's stock ownership in a company, is a non-apportioned direct tax). A "direct tax" (construed to refer to property taxes and capitation taxes) is (unless it is an income tax) required to be apportioned among the states in accordance with population. *See* U.S. CONST. art. I, § 2, cl. 3; U.S. CONST. art. I, § 9, cl. 4; U.S. CONST. amend. XVI. *See generally* Joseph M. Dodge, *What Federal Taxes Are Subject to the Rule of Apportionment under the Constitution?*, 11 U. PA. J. CONST. L. 839, 932–37 (2009). Thus, an early and short-lived federal tax on imputed income from homes was in fact apportioned among the states in accordance with population. *See* Act of July 14, 1798, 1 Stat. 597, 597–604. Finally, in *Helvering v. Independent Life Insurance Co.*, 292 U.S. 371, 381 (1934), the Court opined that imputed income was not "income" within the 16th Amendment.

3. Price Discounts, Prepaid Consumption, and Insurance Benefits

The principle that consumption is derivative of income, and therefore is measured by what is paid for it (rather than the value obtained), leads to the conclusion that price discounts in commerce (including tuition reductions conferred by educational institutions) do not give rise to income.[124] Of course, price discounts can amount to disguised compensation (or other) income, and in such cases they should be taxed.[125]

A similar scenario to that of price discounts is presented by a "consumer club," in which the individual pays a fixed fee that gives her the right to liberally obtain (or not obtain) services or goods provided by the club. Examples are auto clubs, fitness centers, and country clubs. Here, the correct taxable amount is the fee paid, not the value of the consumption obtained.

Insurance involves the payment of an annual premium to an insurance company, which agrees to reimburse the insured for specified cash outlays (such as for medical care or tort liability).[126] It might appear that the insured would have gain equal to the excess of the reimbursement over the premium, and that the payment to the claimant would (depending on the facts) be a nondeductible personal expense. However, the correct analysis follows that of the consumer-club scenario. The payment of the premium is an "expense" by reason of the fact that the insured obtains the right to avoid personally having to pay covered claims during the short time period covered by the premium.[127] The insurance contract is not a gain-seeking wager

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124. Tuition and fee scholarships are generally excludible under I.R.C. § 117(a)–(b), and (d), but the exclusion implies that non-qualification results in inclusion, meaning that the value of below-cost institution-provided meals and lodging is income. I would disagree with this result: since these in-kind benefits are not obtained in a market transaction and cannot be appropriated by the government, they are no more income (in principle) than similar benefits obtained by (say) clients of a homeless shelter.

125. *See* I.R.C. §§ 83(a), 117(c).

126. The insurance company will normally pay a third-party claimant directly to prevent the insured from diverting the cash to some other use and will pay the insured only upon proof that the insured paid or lost a specified amount. *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, 342 (2007).

127. More elaborate versions of this analysis are found in Dodge, *supra* note 126, at 339–50; Halperin, *supra* note 23, at 35–37; Jeffrey Kahn, *Justifying the Exclusion of Insurance*, 125 TAX NOTES 1216, 1216 (Dec. 14, 2009).

because the insured cannot improve upon her initial position. The recovery is an offset against the payment (or basis of lost property) of the claim by the insured, which is a capital expenditure giving rise to the claim for reimbursement.[128] The taxpayer ultimately has obtained the service she paid for.

4. *Realization*

The realization concept would not countenance manipulation by arranging to receive in-kind value in lieu of current cash.

a. *Property Exchanges*

The value of property (including consumption rights) received in exchange for property would generally count as amount realized upon sale because cash is the commercial norm, as is demonstrated by the fact that deferred taxation of exchanges creates economic distortions, as evidenced by the services industry spawned by Internal Revenue Code (Code) section 1031 for like-kind exchanges of real estate.[129]

b. *Deferred-Payment Sales*

Deferred realization with respect to installment sales would be allowed only for unique illiquid assets for which bank financing is not obtainable.[130] Contingent-payment dispositions of speculative-value property should not be treated as sales but rather as leases or licenses, with gross receipts being treated as ordinary income.[131]

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128. *See* Clark v. Comm'r, 40 B.T.A. 333, 335 (1939), *acq.,* Rev. Rul. 57–47, 1957–1 C.B. 23.

129. By way of contrast, in-kind acquisitions from nature (say, from mining), "found objects," and property obtained by theft, would not be included in current income until realized (if ever) as these items cannot be viewed as being in lieu of receiving cash. *See* Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control*: *Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 4 FLA. TAX REV. 685, 685 (2000); Leandra Lederman, *"Stranger than Fiction": Taxing Virtual Worlds*, 82 N.Y.U. L. REV. 1620, 1641, 1655 (2007).

130. The taxation of an installment purchaser is discussed *infra* in the text accompanying notes 195–197.

131. The basis-recovery issue is discussed *infra* in the text accompanying note 197.

c. In-Kind and Deferred Compensation

This discussion of deferred compensation for personal services will ignore external policies (such as those relating to retirement income) and focus exclusively on tax values, for which the default principle would be that the value of in-kind or deferred-payment compensation would be currently includible unless a persuasive tax reason exists for deferral. The absence of current funding (creating a property right) is not by itself a persuasive reason for deferral[132] because a contract right is not, as such, significantly less risky than a property right. However, a contract right might be subject to various non-actuarial future contingencies (embodied in, say, a benefit formula) rendering it impossible to value in the present, and in that case deferral should be allowed. On the other hand, risk of forfeiture (for a funded right) alone should not be viewed as rendering a deferred-compensation right impossible to value,[133] because here the valuation problem can be finessed by including the right at its current value disregarding any risk of forfeiture, with any actual forfeiture of a previously included right giving rise to a loss deduction.

In the case of funded and unfunded rights that can be currently valued, the crucial issue is whether non-assignability (illiquidity)—a near-universal attribute of deferred compensation (by reason of its tying the employee to the firm's performance)—is a sufficient reason to defer realization.[134] The ability-to-pay principle generally dictates that an economic right should generally not be included so long as it remains illiquid. However, in contrast to the general thrust of the realization principle (where realization can be deferred by the taxpayer's choice), a deferred-compensation right should be deemed to be liquid at the earliest time the owner *could* obtain benefits by reason of her own actions or the occurrence of an objective triggering event or condition. For example, if the right allows the owner to obtain cash to pay for the owner's health care, the right would be deemed to be fully liquid when obtained.

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132. Under current law, non-funded (contractual) deferred compensation generally obtains tax deferral, although I.R.C. § 409A provides exceptions for arrangements that are indirectly funded or whose benefits can be accelerated. However, I.R.C. § 409A is fearsomely complex.

133. *See* I.R.C. § 83(a) (holding that in-kind investments and funded (nonqualified) plan interests obtain deferred realization so long as they are subject to a substantial risk of forfeiture).

134. Under current law, a non-assignable funded right is currently included unless it is subject to a substantial risk of forfeiture, which generally entails practical, if not legal, non-assignability due to the fact that assignees take subject to the risk. *See* I.R.C. §§ 83(a), 402(b).

d. Employee Stock Options

Under current law, if the grant of an employee stock option is included in income,[135] the exercise of the option (at a price below the fair market value of the stock) is not a realization event.[136] This rule should be overturned, as the excess of the stock value over the exercise price is employee compensation. The spread is not the unrealized appreciation of an investor because the obtaining of the option is not itself an acquisition of the stock itself (or any portion thereof) but only a right to buy it at a bargain price.[137] The option is a (no-lose) wager on the appreciation of the employer stock. Making a bet (with after-tax dollars) does not preclude income on the winning of the bet, even if the "prize" is in kind.

e. Put and Call Options.

In a classic (nonemployee) arms' length call option to buy (say) a parcel of real estate, the purchaser of the option will hope that the value of the underlying parcel becomes greater than the designated purchase price (plus the option price), in which case the option is likely to be exercised.[138] Otherwise, the option will lapse, resulting in a loss equal to the cost of the option. The buyer has made a capital expenditure in a contract right; if the option is exercised, the cost of the right should be added to the basis of the property under a transaction-cost rationale.[139] Contrary to current law, the

135. Inclusion occurs if the option has a readily ascertainable fair market value. *See* I.R.C. § 83(a), (e)(3). Treasury Regulation § 1.83–7(b) provides a formalistic set of rules for determining whether employee stock options possess a readily ascertainable fair market value. Whether the approach of the regulations is optimal is not addressed herein.

136. *See* I.R.C. § 83(e)(4).

137. That the option ceases to exist after its exercise does not negate the fact of a realization event, although it could (under current law) result in the gain being "ordinary" rather than "capital."

138. A "put" option is an option to sell property at a fixed price that would be exercised if the property's value fell below the fixed price (reduced by the cost of the option).

139. The exercise of the purchase option should not be viewed as a realization event to the purchaser because the acquired property is neither a substitute for cash compensation (or other income) nor property received in exchange for the option.

sale of the option should not be viewed as part of a property transaction[140] but as being a payment for a personal obligation (a service), and it should be included by the seller as current ordinary income without basis offset.

5. *Transfers Received*

A key difference between a "personal" income tax and a tax on national economic income is the inclusion in the tax base of transfers received (such as gratuitous receipts, life insurance proceeds, and tort recoveries), which increase the recipient taxpayer's ability to pay.[141] A pervasive problem here is how the realization principle should be applied.

For includible structured-settlement (i.e., deferred-payment) tort recoveries, the claimant should be taxed only upon the receipt of cash, as occurs under present law,[142] since the wages that are being replaced by the cash would only have been taxable when received.

As for gratuitous receipts, the starting points are that (1) in-kind bequests and gifts are not inherently tax avoidance schemes and (2) trusts are not true taxpayers for allocative tax fairness purposes. Accordingly, deferred realization of income is not only tolerable but also results in vast doctrinal simplification. In the case of outright in-kind gifts and bequests, deferred realization would occur by way of a zero basis for illiquid property received. In the case of trusts, beneficiaries would be taxed only upon receiving distributions, not upon receiving interests in trusts (many of which are contingent and difficult or impossible to value). Since a beneficiary would have a zero basis in her trust interest, all trust distributions would be includible in income, whether from "income" or "corpus." Inside-the-trust income could be ignored as not being that of any individual.[143]

In all gratuitous receipt scenarios, the transferor's basis would disappear, thereby avoiding administrative problems attendant upon deemed-realization-upon-transfer or carry-over-basis reform proposals.[144] Basis, as

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140. Under current law, the cash received by the option seller is viewed as part of an "open transaction" related to the possible acquisition of the property. *See* Rev. Rul. 58–234, 1958–1 C.B. 279.

141. SIMONS, *supra* note 3, at 125–35.

142. I.R.C. § 104(a)(2) ("[W]hether as lump sums or as periodic payments…").

143. If this approach is considered too lax, it can be remedied by a system of taxing inside-the-trust income pending future distributions, but such a withholding/credit system could be quite complex. *Cf.* I.R.C. §§ 665–667 (throwback rule for accumulation distributions from domestic trusts prior to 1998).

144. These proposals entail keeping track of historic basis over long stretches of time. Simons favored taxing unrealized gains to gratuitous transferors, as

with other tax attributes, should be viewed as being personal to the investor. (Incidentally, the prospect of losing basis at death should counter the investment lock-in effect, perhaps the most distortive aspect of the existing realization system.)

B. *Allowances off the Bottom*

The ability-to-pay concept not only mandates allowances off the bottom for subsistence consumption, but it also implicates the taxation of the family and certain personal deductions.

1. *Personal Subsistence Allowance*

The subsistence allowance should take the form of a universal, per-taxpayer fixed-dollar deduction (the "personal exemption") keyed to the level of subsistence (currently about $12,000).[145] The exemption would not be phased out because all taxpayers must maintain subsistence.[146] The existing standard deduction would be repealed as being redundant.[147]

2. *Taxation of the Family*

The notion that income equates wholly or partly with personal consumption would wreak havoc upon family taxation because income would be allocated according to beneficial enjoyment, a principle both unworkable and inconsistent with the ability-to-pay principle.

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well as taxing gratuitous receipts to the transferees. *See* SIMONS, *supra* note 3, at 163–67.

145. The U.S. "poverty guideline" for 2015 was $11,770 for an individual maintaining a household only for herself. *See* Annual Update of the HHS Poverty Guidelines, 80 Fed. Reg. 3236, 3237 (Jan. 22, 2015) [hereinafter 2015 Poverty Guidelines].

146. A phase-out amounts to a marginal rate increase that operates only in the "bubble" described by the phase-out range, which, under current I.R.C. § 151(d)(3), occurs roughly at the lower end of the top 1% of the population.

147. For 2015, the sum of the standard deduction for an unmarried individual ($6,300) and such person's personal exemption amount ($4,000) was $10,300. An unmarried person without children could also obtain a maximum earned income credit of $503, which is the equivalent of an additional deduction of $5,030 to a taxpayer in the ten percent marginal rate bracket. (This credit is subject to phase-out.) *See* Rev. Proc. 2014–61, 2014–47 I.R.B. 1.

a. Who Counts as a Taxpayer?

Husband and wife (however defined) would be treated as separate taxpayers, as would other members of the household. Treating a family as a single taxable unit requires that the unit's income be re-allocated among its members for purposes of applying the rate schedule(s), and any such re-allocation principle would be arbitrary.[148] An additional (insuperable) problem would be resolving who is to bear the ultimate tax burden for any such "entity" tax.[149]

b. Income Attribution

The objective ability-to-pay principle dictates that gross income be attributed to the earner of the income or the owner of income-producing property[150] because such person has the right to obtain and control the income. Deductions would be attributed to the payer if the payer is also liable for the payment or is the person who incurred the deductible cost.[151]

c. Support Received

Obtaining enjoyment from another person's spending or disposition of income is not itself income because it does not represent any ability to contribute to the federal Treasury. It follows that beneficial enjoyment by way of in-kind support (and, to a modest degree, cash support) is non-income of the beneficiary and is nondeductible consumption of the donor.[152]

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148. *See* Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63, 100–101 (1993).

149. Extending joint-and-several liability to all members of a household would often produce the unfair result of some household members paying the tax on the income of other household members.

150. *See generally* Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339, 357 (1994).

151. *See*, *e.g.,* Reg. § 1.164–1(a) (tax payments deducted only by person on whom the tax is imposed).

152. The payment of support is not a transfer "by gift" but rather is pursuant to a legal mandate. *See* Harris v. Comm'r, 340 U.S. 106, 112 (1950). The distinction between (excludible) support and (includible) gifts already exists under the federal gift tax, where a "cushion" between the two is provided by the annual exclusion (*see* I.R.C. § 2503(b)–(c)) and some version of this would need to be imported into the income tax.

d. Support and Gifts Provided

An ability-to-pay income tax must prima facie encompass all uses of income apart from the costs of producing income. A problem with the Simons tentative income definition is its implication that any such use that is not "consumption" is deductible. But transfers made also represent personal uses of income that should prima facie be subject to deduction disallowance. The prime example is that of gratuitous transfers of wealth.[153]

Nevertheless, as a general proposition, an involuntary exaction by government should reduce the personal tax base[154] because the exaction itself reduces the payer's current ability to pay.[155] It cannot be assumed that any direct link exists between child support payments and whatever psychic benefits might be attendant upon maintaining relationships with one's children. Accordingly, court-mandated child support (as well as alimony) payments should be deducted by the payer and included by the payee.

Non-coerced support is provider consumption, but consumption is deductible off the bottom to the extent it is subsistence. Here, although the subsistence is that of the dependent, it is being assumed by the support provider, who is entitled to the deduction by reason of paying for such subsistence. (A corollary is that the dependent loses her personal exemption.[156]) Since the dependent enjoys economies of scale by living in the provider's household, the dependency deduction would be much less than an independent individual's personal exemption.[157] To avoid having to account for actual support outlays, the dependency deduction should be (and is) fixed at a flat dollar amount, which has the beneficial side effect of rendering it unnecessary to distinguish between "support" and "gift" on the deduction side.

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153. Gratuitous transfers are nondeductible. *See* Reg. § 1.262–1 (referring to "family expenses").

154. *See* Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765, 767 (2006).

155. *See* Lawrence Zelenak, *Children and the Income Tax*, 49 TAX L. REV. 349, 361–69 (1994).

156. This occurs to some degree under current law. I.R.C. § 151(d)(2).

157. According to 2015 poverty guidelines, it cost about $4,200 to support a household dependent at the poverty level. *See* 2015 Poverty Guidelines, *supra* note 145, at 3237.

3. Economic Waste

Economic waste, which is neither personal consumption nor a wealth transfer, is another category of nondeductible cost. Thus, operating losses from an activity (tax shelter) having no chance of making a before-tax profit should be (and are) disallowed, even if the activity is not a pleasurable hobby.[158] Costs that are too remotely linked to income are another form of waste.[159]

Current law in this area is rather lax, an example being that income-related deductions of an individual are not confined to the activity that generates the related gross income. Thus, contrary to current law,[160] current net operating losses from a *business* should not be deductible against unrelated current wage or investment income. In the case of current *investment* losses, portfolio theory (diversification) implies that current investment losses be allowed to offset current investment income and gains, but not income from salary or (unrelated) business activity.

Net business and investment losses that cannot be used in the current year are essentially capital expenditures in search of related future income. Accordingly, carryover to future taxable years is appropriate,[161] if subject to a "related income" test.[162] Upon termination of a business or other income-producing activity, or after the expiration of a period of years, the carried-

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158. Such net hobby losses are disallowed, with no carryover, under I.R.C. § 183(a). *See*, *e.g.*, Brannen v. Comm'r, 722 F.2d 695, 705–06 (11th Cir. 1984) (movie tax shelter); Fox v. Comm'r, 80 T.C. 972, 1006 (1983), *aff'd*, No. 83-4151 (2d Cir. 1984) (unpublished opinion discussed in *Barnard v. Comm'r,* 731 F.2d 230, 231–32 (4th Cir. 1984)).

159. Presumably, the "ordinary and necessary" requirement of I.R.C. §§ 162 and 212 was aimed to filter out such costs. *See also* Frank v. Comm'r, 20 T.C. 511, 515 (1953); Rev. Rul. 77–254, 1977–2 C.B. 63 (costs incurred by a person, not currently engaged in a business, of investigating the possibility of acquiring a business or investment are disallowed where the costs bear no fruit or where the fruit ultimately obtained is too remote from the costs).

160. Net business and investment losses of an individual, to the extent not currently disallowed (*see, e.g.*, I.R.C. §§ 165(d), 183(b), 280A(c)(5), 469(a)(1), 1211(b)), can offset current income from whatever source.

161. Under current law, excess business net operating losses (NOLs) and excess net capital losses are carried over to other years. *See* I.R.C. §§ 172, 1212. All deduction carryforwards lapse upon the individual's death.

162. Under current law, only loss carryforwards from home rental activities and "passive activities" are confined to the activity. *See* I.R.C. §§ 280A(c)(5), 469(b).

forward losses should expire, as they can be deemed to have ultimately produced no income.[163]

4. *The Personal Deductions*

The existing personal deductions (not representing costs of income production) would be eliminated except insofar as they can be justified as "subsistence" or "involuntary exaction."[164]

a. *Personal Casualty and Theft Losses*

Existing law allows a deduction (not to exceed basis) for losses on personal-use assets that result from casualty and theft.[165] The purported rationale is that these losses represent decreases in wealth not attributable to ordinary personal consumption, in the sense of enjoyment.[166] However, the personal casualty loss deduction is inconsistent both with other rules involving lost (or gained) consumption value[167] and with the proper tax treatment of economic waste. It is also contrary to the general realization rule requiring a complete disposition of an indivisible asset.[168] The consumption value of personal-use assets is measured by cost, which represented nondeductible ability to pay in the year of purchase. As noted earlier in the

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163. Under current law, NOL carryforwards expire after 20 years. *See* I.R.C. § 172(b)(1)(A)(ii). Passive activity loss carryforwards are released from confinement to the activity upon total disposition of the activity. I.R.C. § 469(g).

164. *See* Theodore P. Seto & Sande L. Buhai, *Tax and Disability: Ability to Pay and the Taxation of Difference*, 154 U. PA. L. REV. 1053, 1083 (2006) (applying the notion of nondiscretionary outlay). The mortgage interest deduction is a clear candidate for elimination as interest payments are not involuntary and subsistence housing costs (of whatever nature) are already factored into the personal and dependency exemptions. Moreover, since consumption is measured by its initial cost (which, in the case of a debt-financed home, equals the present value of future principal and interest payments, plus the down payment), disallowing mortgage interest preserves horizontal equity between cash and debt purchasers. Another candidate for repeal is the I.R.C. § 212(3) deduction for costs of tax compliance.

165. *See* I.R.C. § 165(c)(3); Reg. § 1.165–7(a)(2), (5).

166. *See* Turnier, *supra* note 4, at 272.

167. No deduction exists for "lemons," items that go unused, and items destroyed or lost by heavy use, oversight, and carelessness; and no income exists due to consumer surplus and above-average use or utility. Simons agrees with these results. SIMONS, *supra* note 3, at 119–20.

168. The casualty loss deduction is obtainable even if the asset is not totally disposed of (or worthless); in such a case, the loss is the lesser of (a) the cost or (b) the decline in value caused by the casualty. *See* Reg. § 1.165–7(a)(2)(i).

discussion of economic waste, non-enjoyment is not a sufficient ground for deductibility. No diminution of ability to pay occurs in the later year of casualty or theft loss, except where cash is involved, or (perhaps) a need arises to replace a subsistence item.[169]

Unlike alimony and support, asset casualty and theft losses are not truly involuntary to the extent that the risks could normally have been insured against. This point raises a policy critique: the deduction is irrationally skewed in favor of high-bracket taxpayers, the ones ablest to purchase casualty and theft insurance. Additionally, the deduction discriminates against insured taxpayers in the same tax bracket.[170]

Simons did not favor the casualty loss deduction,[171] nor is it a common feature of other tax systems.[172]

b. Costs of Health Care

Personal health care costs include not only direct unreimbursed payments for health care but also health care insurance premiums, which are prepayments of such costs, in the manner of a consumer club.[173] Such costs pose four kinds of line-drawing issues, the first two of which will only be noted in passing. The first issue is that of "capital expenditure" versus "expense"; current law views most health care costs as expenses akin to "repairs." The second issue is that of "business" versus "personal," and, since health care costs (by definition) aim to improve personal welfare, current law treats them as personal, even in cases where such costs also might be characterized in terms of maintaining one's capacity to earn wages.[174]

A third line-drawing issue is the extent to which unreimbursed personal health care costs might be viewed as "subsistence." Such a characterization is proper where such costs are aimed to prevent premature

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169. Section 123, which excludes from income incremental living expenses paid for under casualty insurance policies, smacks of this rationale. *See* I.R.C. § 123.

170. Suppose that J (uninsured) buys ten crystal wine glasses for $1,000 total, and K buys nine glasses for $900 total plus nondeductible insurance for $100. Each of J and K loses one glass to theft. K uses her $100 insurance recovery to purchase a replacement glass. Both have expended $1,000 to obtain nine wine glasses. J and K will be taxed the same only if J's uninsured loss is nondeductible.

171. SIMONS, *supra* note 3, at 120.

172. *See* AULT & ARNOLD, *supra* note 121, at 283–84.

173. *See supra* text following note 125.

174. Costs that fall within the statutory definition of "medical care" under I.R.C. § 213(d) can be deducted, if at all, only under I.R.C. § 213 and not under any other provision.

death or incapacitation or to keep a person in normal functioning condition relative to the person's genetic and physical endowment and stage of life. The notion of subsistence would preclude deducting the unreimbursed cost of treatments that are elective, discretionary, lifestyle-enhancing, or directed to high-priority goals unrelated to subsistence (like being able to bear children or having frequent sex).[175] Admittedly, these lines might be very hard to draw and enforce.[176]

A fourth line-drawing issue, that of "involuntary exaction," adds little to the "subsistence" analysis, at least insofar as medical costs are "voluntary" to the extent that the taxpayer could have acquired health insurance coverage. Some persons cannot obtain insurance (or adequate coverage of certain health risks), but it would be hard to apply an "involuntariness" test on a case-by-case basis.

Perhaps the best approach from an objective ability-to-pay perspective would be, first, to allow an above-the-line deduction for health insurance premiums paid that cover subsistence health care (or an exclusion for employer-provided subsistence-health-care insurance). Since actual insurance policies and programs are not limited to subsistence care, this deduction should be capped at a certain dollar amount.[177] Second, an above-the-line deduction for unreimbursed subsistence health care costs should be allowed if certain conditions are met, such as low-income status or uninsurability of the health risk.

The tax issues ultimately cannot, in the larger policy sense, be disentangled from the larger web of federal health care policy, which currently uses carrots (including tax benefits) and sticks (including excise taxes) to increase the scope of health insurance coverage for those not

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175. This test is stricter than the current one of "affecting any structure or function of the body." *See* I.R.C. § 213(d)(1).

176. Any deduction should only be for the excess of subsistence health care costs in excess of the amount (if any) that is implicitly built into the subsistence allowance. *Cf.* I.R.C. § 213(a) (deduction is for medical costs in excess of ten percent of adjusted gross income). However, health care costs should not be included in the subsistence allowance to begin with because many individuals avoid such costs by being uninsured (and healthy), being covered by government health programs, or avoiding payment. Others are covered by employer-provided health insurance that is effectively deductible above-the-line by reason of being an excluded employee fringe benefit under I.R.C. § 103. If health care costs are not included in the subsistence allowance, then any deduction would be "above-the-line."

177. *Cf.* I.R.C. § 63(f) (additional standard deduction for the aged and/or blind, for assumed incremental health care).

covered by Medicare and Medicaid. Under a single-payer national health care system, all tax benefits would be eliminated.[178]

c. Taxes Paid

It might be supposed that taxes (like alimony and child support) ought to be deducted as an involuntary decrease in current cash income. However, by looking to why a taxpayer pays the taxes, certain categories of them can no more be seen as involuntary exactions than having to pay a commercial debt obligation. Thus, property taxes (on personal-use property) are voluntary because ownership of such property is voluntary. More decisively, since property taxes on business or investment property are characterized as (deductible) costs of maintaining such property, the same characterization (rather than that of "coercive tax") should hold for taxes on personal-use property, resulting in nondeductibility.

The same analysis leads to the conclusion that sales taxes (and the like), regardless of whether one views them as being voluntary,[179] are not really "taxes" but rather a part of the purchase cost. General income tax principles require that transaction costs be treated as part of the purchase price[180] Sales taxes are a clear transaction cost, and should be treated accordingly, a result that would avoid having to account for them separately, an impossible task in any event.

Of the common tax categories, only state (and local) income taxes[181] are involuntary exactions of current cash.[182] Such taxes should be deductible above the line.[183]

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178. *See* AULT & ARNOLD, *supra* note 121, at 284–86.

179. *See* Turnier, *supra* note 4, at 275–81 (viewing property and sales taxes as voluntary).

180. *See*, *e.g.*, Woodward v. Comm'r, 397 U.S. 572, 574–75 (1970); Temp. Reg. § 1.263(a)–2T(f)(3) (2011).

181. Federal Social Security and Medicare taxes are borderline between "taxes" and "deferred compensation."

182. That taxpayers can move to jurisdictions without income taxes is not sufficient to call such taxes "voluntary," since such a move entails significant monetary and psychological costs (including loss of the deduction).

183. Income taxes cannot be included in the universal subsistence allowance because they are not payable by low-income persons, and some states do not impose them at all.

5. *Deductions to Carve Out Other Spheres of Collective Activity*

a. *Taxes Once Again*

A political-theory rationale for deducting U.S. state taxes is to carve out state government activity from federal government activity. Since this carve-out is a feature of the basic institutional landscape conceding a measure of sovereignty to states, it would "precede" (as it were) the federal tax system. A deduction removes state (tax-financed) activity from having to contribute to the federal government.

This co-sovereignty analysis, although superseding the voluntariness analysis carried out above, does not *mandate* a deduction because the constitutional structure of the United States does not immunize state government finance from federal interference.[184] The rationale only "allows" the federal government to accommodate the states by way of a deduction. At the same time, if federal tax law were to, say, allow a deduction only for state and local sales taxes, it would subvert the "accommodation" rationale by instead attempting to coerce the states into adopting a particular method of finance.

b. *Charitable Contributions*

Charitable gifts are non-subsistence voluntary payments not aimed to generate income, and would be nondeductible. External-to-tax norms are the usual (if contested) rationales for the deduction (or perhaps for some other government subsidy).

As with state taxes, a non-instrumental rationale for the charitable deduction derives from pre-tax political values. The charitable sphere bears a relationship to the federal government that somewhat resembles that of state and local governments, in that it involves the pursuit of the public good.[185] The charitable sphere is accommodated, without giving it the status of a co-equal sovereign, by way of a deduction. Because the deduction removes

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184. *See* South Carolina v. Baker, 485 U.S. 505, 527 (1988) (holding that the 10th Amendment to the Constitution does not bar a federal tax on state bond interest).

185. *See* Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charitable Tax Exemption*, 23 J. CORP. L. 585, 587–89 (1998) (exemption/deduction scheme for charities is less intrusive than other government support mechanisms); Johnny Rex Buckles, The *Community Income Theory of the Charitable Contributions Deduction*, 80 IND. L.J. 947, 970–74, 979–86 (2005) (arguing that community income should be considered pre-tax).

(within limits)[186] the contributed amount from claims by the federal government, it fits better with foundational values of individual and associational autonomy than do such alternative mechanisms as tax credits or matching grants, which would effectively allow private persons to control federal spending.[187]

The oft-repeated argument that the deduction disproportionately favors those in higher marginal rate brackets is not (as is the case for state taxes) responsive to the pre-tax rationale for the deduction. The argument is circular by starting with the premise that contributions are within the normative personal income tax base and that the government, having a monopoly on the production of public goods, is "giving" its tax dollars away. This assumption is contrary (for better or worse) to political and social practice in the United States.[188] Nevertheless, as with state and local taxes, the deduction is not "mandatory," and, in any event, government oversight is necessary to keep the charitable sphere in line.

C. Realization of Deductible Costs

The thesis here is that certain existing rules pertaining to the realization of costs, namely, the accrual method of tax accounting, the exclusion of borrowed funds (and related rules), and depreciation deductions, deviate from the ability-to-pay norm and undermine the income tax as a whole. Since these topics are developed in a separate piece,[189] the discussion below is brief.

1. The Accrual Method

The accrual method is a realization system for gross income and expense deduction items (and of inventory transactions) that reckons inclusion or deduction at the time the *right* to receive cash, or the *obligation*

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186. The deduction cannot exceed a specified percentage of a taxpayer's net income. *See* I.R.C. § 170(b).

187. Instrumental considerations also favor the deduction approach because a deduction produces greater leverage on those who have the most discretionary income to give away.

188. Not surprisingly, the benefits for charities under the tax systems of continental Europe are more restricted than is the case with the United States. *See* AULT & ARNOLD, *supra* note 121, at 286–88.

189. *See* Joseph M. Dodge, *Toward Income Tax Accounting Consistency: Eliminating Accrual, Depreciation, and the Existing Tax Treatment of Borrowing*, 18 FLA. TAX REV. 1 (2015).

to pay cash, is fixed.[190] The accrual method, rather than being an "accretion" feature of the income tax, is in fact a realization rule that avoids valuations.[191] It is inconsistent and asymmetrical with core realization rules on the income/gain side that require the sale or disposition of an asset. Accrual allows deductions prior to any actual economic loss.[192] An objective ability-to-pay income tax would follow the cash method of tax accounting, in which income occurs with the receipt of cash (etc.) and expense deductions with the payment of cash.

2. *Borrowing*

Borrowed money, even to cash-method taxpayers, has long been viewed as non-income due to the simultaneous accrual of an offsetting liability to repay the principal, resulting in no current net "increase in wealth." A corollary of the borrowing exclusion is that debt-discharge income arises when such liability disappears without its being satisfied.[193]

a. *Cash Borrowing*

The exclusion for borrowed cash is inconsistent with the ability-to-pay principle because the liability to repay principal represents merely an expected or predicted future cost. An accounting liability does not tie up current cash funds or render one's assets unusable or valueless. Accordingly, borrowed cash would be included in current income, and principal repayments would be deductible when made.[194] Debt discharge income

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190. *See* Reg. § 1.446–1(c)(1)(ii). Since 1984, expense deductions cannot be accrued any earlier than "economic performance," which depends on the context. *See* I.R.C. § 461(h).

191. Accrued items are reckoned at their face amount rather than market value. Although it is said that face value equals fair market value if market-rate interest is charged, accrual is not contingent on any interest charge.

192. An analogous scenario to the acceleration of deductions is "deferral of prepaid income," another doctrine of business accounting. Such deferral is sometimes allowed for tax purposes, but it would not be allowed at all under an ability-to-pay income tax. *See generally* RCA Corp. v. United States, 664 F.2d 881, 885 (1981).

193. *See* Reg. § 1.61–12. The reach of debt-discharge income is uncertain, and it is subject to numerous exceptions. *See* I.R.C. § 108.

194. Interest is considered an expense relating to the asset or activity financed by the borrowing, and would be deductible or not accordingly. *See* I.R.C. § 163(a), (h)(1).

would cease to exist; the borrower would forgo principal-repayment deductions.

Borrowing cash on the security of the taxpayer's existing appreciated assets, which is a common way of avoiding realizing gain on such assets, would result in current ordinary income with no basis offset.

b. Purchase-Money Debt

Inclusion of purchase-money debt in income would render profitable investments into unprofitable ones, as well as creating an insuperable tax barrier to the debt financing of homes and cars.[195] However, these problems can be avoided by treating debt-financed property acquisitions as deferred investments. Both two-party and three-party purchase-money borrowing would be excluded from the borrower's current income on the ground that no cash is received (and then paid out) by the credit purchaser.[196] Principal payments on the debt would, along with any down payment, constitute the basis of the acquired asset. Thus, suppose that K borrows $1 million to invest in bonds yielding interest income at a rate equal to that of interest payments on the loan. The borrowed $1 million would be excludible, the interest income and expense would wash out, and principal payments would constitute the bond's basis (which would eventually total $1 million, fully offsetting the $1 million received upon maturity of the bond).[197]

This approach would render obsolete the *Crane* doctrine,[198] which is a principal foundation of tax shelters.[199] The remaining foundation of the

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195. *See* Joseph M. Dodge, *Exploring the Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated,* 26 VA. TAX REV. 245 (2006).

196. The funds from the purchaser's lender go directly to the seller (and/or seller's lienholders) and not to the purchaser. In a seller-financed sale, the buyer receives no cash spendable elsewhere.

197. If the asset is sold, with the debt being taken over by the purchaser, the seller's amount realized would not include the unpaid debt.

198. *See* Crane v. Comm'r, 331 U.S. 1, 1 (1947) (standing for the proposition that purchase-money debt is immediately included in the basis of the acquired property, even in the case of two-party debt, and regardless of whether the liability is recourse or nonrecourse).

199. Under the *Crane* doctrine, the debt supports interest and depreciation deductions. Two-party debt is susceptible to being unreal, infecting the interest and depreciation deductions. *See* Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of the Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA. L. REV. 263, 266–67 (1994).

Crane doctrine would crumble if depreciation were eliminated (as is suggested shortly).[200]

c. Credit Card Transactions

If credit card transactions were treated as two-party credit purchases, the cost (if needed for tax purposes) of any item would be virtually impossible to determine because credit card payments (if not for the full amount owed) would need to be allocated among all purchases. An ability-to-pay income tax would treat credit card transactions as third-party cash loans by the credit card issuer.[201] Accordingly, the taxpayer would include (or deduct) her net increase (or decrease) in credit card principal debt for the year, with all items being deemed to have been fully paid for.

3. Depreciation of Productive Assets

Under the current income tax, cost recovery with respect to determinable-life assets used in an income-production activity ("productive assets") takes the form of annual depreciation (or amortization) deductions.[202] Under an accretion income tax, depreciation is legitimate, but it would be measured by the annual decline in value of the asset. Instead of annual valuations (an impossible task), Congress has enacted formulaic methods for computing depreciation.[203] Professor Paul Samuelson claimed that a certain formula (based on a mathematical model[204] founded on dubious

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200. The *Crane* case was partly decided on the ground that basis had to include purchase-money debt in order for a rational depreciation system to function. That perception was incorrect because, if basis fell below zero because of depreciation deductions, the negative basis amount would be recaptured as income or gain.

201. This treatment is the same as under current law. *See* Rev. Rul. 78–38, 1978–1 C.B. 68.

202. I.R.C. § 167(a) allows the series of annual deductions for "exhaustion," "wear and tear," and/or "obsolescence," all of which denote the "wasting" of the asset over a period of time. Non-wasting assets (such as land and shares of stock) are not depreciable, and neither is wasting property held for personal use.

203. *See* I.R.C. §§ 168, 197.

204. The Samuelson model treats a productive asset as if it were a financial investment (like a mortgage) that incurs realizations, not with the passage of time, but with the liquidation of cash components of the investment.

assumptions[205]) yields a proxy for declines in fair market value.[206] However, even a perfect proxy for value fails to satisfy the realization principle.[207] Realization on the deduction side, in the case of a productive asset,[208] occurs only upon the sale or other final disposition of the whole property.[209]

The purported justification for depreciation is the external-to-tax norm of economic neutrality often invoked on behalf of an accretion income tax.[210] However, since depreciation in practice does not (and, given the flaws in the Samuelson assumptions, cannot) conform to the accretion ideal, it is not capable of achieving neutrality even within its limited domain.[211]

The more trenchant critique is that, from an economic neutrality perspective, depreciation cannot be considered in isolation. Even perfect depreciation would operate asymmetrically because, with one minor exception,[212] the income tax does not follow the accretion approach on the gain side, even where the gains are certain to occur with the passage of time.[213] Conforming one feature of a tax to an economic-neutrality norm

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205. A productive asset is not a bundle of rights to cash payments, the productivity of the asset does not terminate (or even decline) until disposition or abandonment, and its fair market value may fluctuate (even increase) due to factors other than whatever cash-flow characteristics the asset might possess.

206. *See* Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964).

207. *See* SIMONS, *supra* note 3, at 86–88 (critiquing E.R.A. Seligman).

208. As under current law, appropriate basis write-offs would continue for: (1) fixed-payment financial instruments (like bonds, mortgages, and annuities), (2) prepaid expenses, and (3) dispositions of separate-basis components of a larger whole (such as occurs with cost depletion of natural resources).

209. Annual value changes, not being final, are not realized. The passage of a year does not result in the disposition of any separate-basis component of a productive asset, which is indivisible. *See* Dodge, *supra* note 189, at 31–35.

210. Specifically, the claim is that depreciation based on changes in market values does not distort the prices of productive investments. *See* Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1853–59 (1990); *supra* note 205.

211. The Samuelson approach (as a proxy for mark-to-market depreciation) posits a declining-balance formula yielding decelerated depreciation, contrary to statutory accelerated and straight-line depreciation formulas.

212. The exception is accrual of original issue discount, but only in the case of certain fixed-dollar obligations. *See* I.R.C. §§ 1272(a)(1), 1373(a)(1).

213. Any rights to future cash or expectations of receiving future value could be subject to income accruals in a manner similar to original issue discount. Examples include the inside buildup of life insurance and annuity contracts, remainder interests, market discount bonds, and (most importantly) rights to deferred compensation.

does not move the tax as a whole towards overall neutrality.[214] Indeed, the existence of accrual and accretion features in a mostly realization income tax is highly distortive from a neutrality viewpoint.[215]

Also to be weighed on the side of eliminating depreciation are the vast gains for tax compliance and administration, especially for individuals who own rental real estate.

D. Taxation of Business Entities and Their Owners

From an allocative fairness perspective, only individual taxation matters, as was implicit in the earlier discussion of trusts.[216] Accordingly, the existing corporate income tax cannot be judged from a fairness perspective, especially as its incidence is not likely to be uniform.[217] However, the problem remains of how to tax equity interests in business entities held by individuals. A public corporation cannot realistically be forced to pay dividends, although shareholders can sell their shares on an exchange. Equity in nonpublic entities is, generally speaking, illiquid. Both pass-through and mark-to-market approaches violate the realization principle. But not imposing any tax until distributions are made to equity holders would invite indefinite deferral of income to individuals (and, under current law, conversion to low-tax capital gains or even forgiveness of gain under Code section 1014).[218]

The way to honor the realization principle for individuals across the board, while preventing its abuse, would be to subject virtually *all* business entities (and their equity holders) to a withholding/credit system, commonly referred to as an "imputation" system.[219] Such a system imposes an entity-

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214. This again is an application of the theory of the second best. See *supra* note 91 and accompanying text.

215. *See also* Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523 (2013) (arguing that tax law and economics should, due to contested norms, avoid seeking global economic efficiency and instead concentrate on discrete empirical problems involving behavioral responses to tax rules and tax enforcement).

216. See *supra* text accompanying note 143.

217. *See*, *e.g.*, Jennifer Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT'L TAX J. 185 (2013).

218. Simons devotes Chapter IX of his text to the problem of undistributed corporate earnings. *See* SIMONS, *supra* note 3, at 185–204.

219. *See* AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY (1993) (advocating this approach for corporations only and discussing technical issues);

level flat-rate tax on entity net income, which operates as a withholding tax pending distributions to equity holders. Distributions to individual equity holders, grossed-up by the entity withholding tax thereon, would be includible, but the equity holder would obtain a refundable tax credit equal to the gross-up (tax withheld) amount.

The imputation system would apply to all business entities with more than one equity holder. Exceptions would (perhaps) lie only for general partnerships and entities obtaining the unanimous consent of equity holders.

E. *International Taxation*

Fair taxation is generally thought of in terms of equal treatment by "the" government of equally-situated taxpayers, but this approach is non-sustainable in the international arena because both source and nationality (the two accepted jurisdictional bases for taxing income)[220] are "elective" to a meaningful degree, especially for the wealthy and corporations.[221] A taxpayer with economic activities in two or more countries can pay an aggregate tax lower than what would be imposed by any interested country on aggregate income. For example, suppose K, a resident of Country W that imposes no income tax, has $1.2 million of taxable income sourced equally among countries X, Y, and Z, each of which would have imposed a tax, at progressive rates, of $480,000 (at 40% average rate) if all $1.2 million of the income were to have fallen within its taxing jurisdiction. However, each of countries X, Y, and Z is only allowed to tax $400,000 of the total, and due to the fact that K is now in lower marginal rate brackets in each country (at 25% average rate), K's aggregate tax is $300,0000 [3 x ($400,000 x .25)], for a tax savings of $180,000.

The problem is solved if each interested country is allowed to *calculate* its tax on the basis of the taxpayer's *aggregate* (world-wide) taxable income but could only *impose* a tax equal to its share thereof. In the K example, if we assume that each of Countries X, Y, and Z has a one-third interest in K's aggregate taxable income, then X, Y, and Z would impose a tax equal to one-third of its hypothetical tax of $480,000 calculated on the basis of K's worldwide income of $1.2 million. In the end, K would pay

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Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses*, 69 TAX LAW. 345, 351 (2016) (imputation-credit system for all privately-held businesses).

220. For present purposes, it is not necessary to discuss the pervasive issue of double taxation of the same income that occurs when the nationality jurisdiction of one country overlaps with the source jurisdiction of another.

221. The conventional fairness-based solution is a residence-based system, but this is no longer adequate in the era of the internet because residence is itself malleable. *See* Fleming, Jr., *supra* note 97.

aggregate tax of $480,000. (Such an "equity-interest" system would pose technical and administrative challenges, to say the least.)

VIII. CONCLUSION

A theory that cannot explain significant and enduring features of positive tax law (such as the realization principle or the exclusion of off-market benefits)—except as being dictated by administrative convenience—is not a very good theory in either the positive (explanatory) sense or normative sense. Additionally, the co-optation of Simons's income by those whose prime normative directive is economic efficiency undermines not only Simons's agenda but also the status of the income tax itself. These problems, along with the loss of the integrity of the tax system, are addressed by restating Simons's personal income in terms of objective ability-to-pay personal income. An objective ability-to-pay personal income tax is not a tax based on "faculty," "ability" (income-producing potential), endowment, well-being, or utility. Instead, the tax base is the year's realized income (inflow of disposable cash or deemed cash-equivalent) decreased by the same year's realized costs of income production (expenses and losses, but not depreciation). The tax base is also reduced by costs of subsistence and involuntary exactions, although, at the border, issues exist as to what is truly involuntary. Finally, the tax base may be subject to pre-tax carve-outs for other government or quasi-government activity. "Consumption" under an objective ability-to-pay tax is not a category of income, and instead expresses only a rule of nondeductibility of the costs of consumption.

The notion of objective ability-to-pay is an internal-to-tax tax fairness norm that can be constructed from the top (social justice theory) down or from the ground (the function of taxation) up by considering the role of taxation (in a liberal society) to raise cash revenue in an annual budget cycle without unduly intruding into the private (nonmarket) realm. It also happens that an ability-to-pay personal income tax can, by way of allowances off the bottom, perform a "tentative" redistributive function. Furthermore, allied with progressive rates, it is ideally suited to off-the-top redistribution, although (with a flat rate) it can avoid playing any such role.

This vision of substantive tax fairness is not meant to always trump such external-to-tax norms as welfare and economic efficiency. Accordingly, the relationships among core tax norms are often going to be messy. Nevertheless, substantive tax fairness warrants a seat at the table of tax system design and should not be dismissed out of hand on the ground that it lacks specificity (a false accusation) or the trappings of science and math. An objective ability-to-pay income tax is compatible with, but clearly a second-

best accommodation to, economic-efficiency and welfarist norms, but the first-best approaches favored by them lead back to unworkable (and politically nonviable) tax systems. Mid-level norms of fairness, political culture, and pragmatism yield the good, if perhaps not the beautiful.