

2023

## Capital, an Elusive Tax Object and Impediment to Sustainable Taxation

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### Recommended Citation

Ordower, Henry (2023) "Capital, an Elusive Tax Object and Impediment to Sustainable Taxation," *Florida Tax Review*: Vol. 23, Article 19.

Available at: <https://scholarship.law.ufl.edu/ptr/vol23/iss2/19>

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# FLORIDA TAX REVIEW

Volume 23

2020

Number 1

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## CAPITAL, AN ELUSIVE TAX OBJECT AND IMPEDIMENT TO SUSTAINABLE TAXATION

by

Henry Ordower\*

### ABSTRACT

*Sustainable taxation requires stability and predictability. Sustainable taxation is a tax or taxes that collect sufficient revenue to support the governmental goods and services the society needs and wants. The taxes must provide for: 1) even-handedness—something akin to horizontal equity; 2) distributional fairness—a concept emerging from notions of vertical equity; 3) transparency in application so that the populace understands and accepts the tax and the need for it; and 4) collection mechanisms that do not favor some societal groups, especially those with resources to secure creative tax advisors, over others who lack the resources. Narrow base taxes—fuel, alcohol, tobacco—cannot meet these criteria and the broad base taxes currently applicable—value added, payroll, and income—also fail to meet one or more of the criteria. While specialized taxes like environmental taxes and sin taxes—alcohol, tobacco—serve useful regulatory functions and may achieve their behavioral objectives in part, they do so primarily by increasing the cost of engaging in the undesirable behavior and pricing some actors out of the activity. Using a pricing rather than a direct regulatory mechanism, the specialized taxes change the conversation from social rejection of the behavior to acceptance as long as the actor is*

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\* Professor of Law, Saint Louis University School of Law. Thank you to my spouse, Ilene Ordower, for editing; David Kullman, law librarian, for research assistance; Hannah Meehan for final review research assistance; and to Yvette Lind and Neil Buchanan for arranging the Sustainable Taxation Conference.

willing and able to pay the high price. Is it all right to pollute if one pays to do so? Direct regulation might prove less regressive and less likely to be viewed as simply a matter of price and more as a matter of societal mainstream and commitment to addressing a problem.

To secure sustainable taxation this Article recommends a non-preferential income tax on a comprehensive income tax base. While by no means a new idea, the growing resource disparity between affluent individuals and individuals with limited resources renders the idea of a non-preferential income tax on all income including realized and unrealized gains all the more compelling. This Article outlines a method for transition to the recommended tax base from the current realization-based tax base and suggests that in limited cases a taxpayer might defer payment of tax on some items of income but not defer inclusion of the items in the tax base. As it describes its tax plan, this Article reflects on the objectives and shortcomings of the targeted taxes and purposive tax base modifications that have proliferated during the 20th century. This Article concludes that a non-comprehensive tax base may accomplish narrow objectives successfully but is unlikely to become functionally sustainable to support essential governmental goods and services. Neither are targeted taxes and purposive tax base modifications fully justifiable. They are likely to distribute tax burdens unevenly among taxpayers without any compelling reason for preferring some taxpayers to others. The narrowness of the base of such taxes frequently leads to regressive tax incidence.

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## INTRODUCTION

A well-functioning tax system is critical to a well-functioning society, but a tax system cannot operate efficiently if it is unfair. Any tax system that

does not distribute its burdens fairly will have hostility rather than support from its taxpayers. Complexity, opportunities for some to capture unintended tax benefits, and perceptions that tax distribution is not even-handed contribute to dissatisfaction with taxes and active tax avoidance and evasion.<sup>1</sup> Avoidance and evasion threaten tax systems. Constant change to control the threat characterizes many existing systems. Much of the threat comes from the affluent. Affluent members of society have the mobility to take their capital and go elsewhere, depriving their home country of capital resources. They demand a decrease in tax on capital, and taxes on less mobile labor must increase to make up the shortfall.

Sustainable taxation requires stability and predictability. Sustainable taxation is a tax or taxes that collect sufficient revenue to support the governmental goods and services a society needs and wants. The taxes must provide for: 1) even-handedness—something akin to horizontal equity;<sup>2</sup> 2) distributional fairness—a concept emerging from notions of vertical equity;<sup>3</sup> 3) transparency in application so that the populace understands and accepts the tax and the need for it; and 4) collection mechanisms that do not favor some societal groups, especially those with resources to secure creative tax advisors, over others who lack the resources. Narrow base taxes—fuel, alcohol, tobacco—cannot meet these criteria and the broad base taxes currently applicable—value added, payroll, and income—also fail to meet one or more of the criteria. While specialized taxes like environmental taxes and sin taxes—alcohol, tobacco—serve useful regulatory functions and may achieve their behavioral objectives in part, they do so primarily by increasing the

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1. Henry Ordower, *The Culture of Tax Avoidance*, 55 ST. LOUIS U. L.J. 47 (2010) (arguing that tax avoidance is embedded into modern cultures).

2. Compare the formulation of this requirement the German Constitutional Court adopted with respect to the German income tax: “Steuerpflichtige bei gleicher Leistungsfähigkeit auch gleich hoch zu besteuern (horizontale Steuergerechtigkeit), während (in vertikaler Richtung) die Besteuerung höherer Einkommen im Vergleich mit der Steuerbelastung niedriger Einkommen angemessen sein muss.” BVerfGE 107, 27 ¶ 50, Dec. 4, 2002, [http://www.bverfg.de/e/rs20021204\\_2bvr040098.html](http://www.bverfg.de/e/rs20021204_2bvr040098.html) (translation by the author: “taxpayers who have the same ability to pay should be taxed equally (horizontal equity), while (in the vertical direction) taxation of higher incomes should be measured against the taxation of lower incomes.” Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 FLA. TAX REV. 259, 302 (2006)).

3. See *supra* note 2 discussion.

cost of engaging in the undesirable behavior and pricing some actors out of the activity. Using a pricing rather than a direct regulatory mechanism, the specialized taxes change the conversation from social rejection of the behavior to acceptance as long as the actor is willing and able to pay the high price. Is it all right to pollute if one pays to do so?<sup>4</sup> Direct regulation might prove less regressive and less likely to be viewed as simply a matter of price and more as a matter of societal mainstream and commitment to addressing a problem.

To secure sustainable taxation this Article recommends a non-preferential income tax on a comprehensive income tax base. While by no means a new idea,<sup>5</sup> the growing resource disparity between affluent individuals and individuals with limited resources renders the idea of a non-preferential income tax on all income including realized and unrealized gains all the more compelling. This Article outlines a method for transition to the recommended tax base from the current realization-based tax base and suggests that in limited cases a taxpayer might defer payment of tax on some items of income but not defer inclusion of the items in the tax base. As it describes its tax plan, this Article reflects on the objectives and shortcomings of the targeted taxes and purposive tax base modifications that have proliferated during the 20th century. This Article concludes that a non-comprehensive tax base may accomplish narrow objectives successfully but is unlikely to become functionally sustainable to support essential governmental goods and services.<sup>6</sup> Neither are targeted taxes nor purposive tax base modifications fully justifiable. They are likely to distribute tax burdens unevenly among taxpayers without any compelling reason for preferring some taxpayers to others. The narrowness of the base of such taxes frequently leads to regressive tax incidence.

Some taxes serve a predominantly political objective, others a behavioral one. Their proliferation may target narrow, albeit pressing,

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4. Consider carbon offsets that might make one feel more comfortable with the personal choice to travel by air.

5. HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (Chicago, 1938) (defines income for purposes of the income tax base as: “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question”).

6. This Article will not try to define essential governmental goods and services, but, at a minimum, military, fire and police protection, courts, and a legislature would fall into that category.

issues such as environmental degradation;<sup>7</sup> others may support targeted economic development.<sup>8</sup> Yet, even carefully crafted, socially desirable, and focused tax choices distract and occasionally misdirect political and social attention from more durable solutions that may lead to long necessary, broad, and sustainable tax reform. Beneficent tax provisions targeting critical issues often burden those with limited resources disproportionately relative to the burden on those with greater resources. Even when Congress chose to make healthcare insurance a substantially universal requirement in the United States, it used the tax infrastructure to support that requirement. Individuals who fail to buy health insurance must make a shared responsibility payment collected through the income tax but not enforced with penalties for failure to file or pay.<sup>9</sup> In *National Federation of Independent Business v. Sebelius*, the U.S. Supreme Court held the Affordable Care Act to be constitutional and the payment supporting the healthcare mandate to be a tax despite it applying narrowly only to those individuals without health insurance.<sup>10</sup> The Tax Cuts and Jobs Act of 2017 reduced the amount of the payment to zero leaving the tax infrastructure in place but gutting any impact of the payment.<sup>11</sup>

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7. Ian Parry, *Putting a Price on Pollution: Carbon-Pricing Strategies Could Hold the Key to Meeting the World's Climate Stabilization Goals*, 56 FIN. & DEV., Dec. 2019, at 16, 17.

8. Opportunity zones, for example. See I.R.C. § 1400Z-1 (deferring taxation of capital gain when gain is invested in a qualified opportunity fund and eliminating capital gain on appreciation of the opportunity fund investment).

9. See I.R.C. § 5000A (requiring a payment collected through the income tax infrastructure but amended in 2017 to set the payment amount at zero).

10. Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U.S. 519 (2012) (holding the Affordable Care Act constitutional). Recently, a lower court decision ruled the Affordable Care Act unconstitutional after the reduction of the shared responsibility payment to zero eliminating the healthcare insurance mandate. Texas v. United States, 340 F. Supp. 3d 579 (N.D. Tex. 2018), *aff'd in part, remanded in part*, Texas v. United States, 945 F.3d 355 (5th Cir. 2019); see also Abby Goodnough & Robert Pear, *Texas Judge Strikes Down Obama's Affordable Care Act as Unconstitutional*, N.Y. TIMES (Dec. 14, 2018), <https://nyti.ms/2A2iHfc>.

11. Section 11081 of Pub. L. No. 115-97, 131 Stat. 2054 (2017) amended subsection (c) of I.R.C. § 5000A to set the applicable dollar amount

As a result, targeted taxes undercut their own benefits by violating equality principles as they become regressive relative to resources. Despite their virtues, such targeted taxes tend to be unsustainable as a solution even to the narrow problem they address. Often such taxes are used as a proxy for something else—environmental regulation, for example—without being the most direct and certain way to deal with that something else.

Part I of this Article sorts taxes by their objectives, examining how well or poorly they serve their objective as this Article reviews the incidence of the taxes. Part II addresses the legislative addiction to using the tax infrastructure and complexity. Part III considers broad tax bases and observes the shortcomings of existing broad bases in the context of providing sustainability for taxes. Part IV focuses on favored capital under the income tax and the manner in which the income tax disfavors labor as capital income and labor income have split and continue to separate, creating a dual income tax.<sup>12</sup> Part V concludes by recommending a sustainable and transparent income tax that neither perpetuates societal disparities between affluent and non-affluent individuals nor limits the ability of those without capital to accumulate tax favored capital.

## I. TAX SORTING AND SUSTAINABILITY

While taxes serve primarily to fund public goods and services, legislatures often use taxes to serve other functions as well. Sometimes those other functions are free from revenue production goals. Tax systems in developed economies have substantial administrative infrastructures. Rather than creating a new administrative infrastructure to regulate an activity, legislatures may and often do rely instead on the existing tax infrastructure as they regulate or extend subsidies to activities. To fit the regulation or subsidy into an existing tax system, the tax infrastructure may permit the capture of a tax subsidy or avoidance of tax burden by unintended taxpayers. Many examples of this phenomenon exist. The longstanding example of tax-exempt bonds described in the next paragraph illustrates the point.

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at zero. Pub. L. No. 115–97 is an unnamed tax act commonly referred to as the Tax Cuts and Jobs Act of 2017 (TCJA).

12. See Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J.L. & SOC. POL'Y 41 (2010); Edward D. Kleinbard, *The Right Tax at the Right Time*, 21 FLA. TAX REV. 208 (2017).

### A. Tax Subsidies

The United States subsidizes the borrowing cost of state and local governmental units by excluding the interest that is paid from the recipient's income.<sup>13</sup> This exclusion from taxation permits a governmental unit to borrow at a rate lower than it would pay if the interest it paid were fully taxable to the recipient. While some doubt existed historically as to whether the United States constitutionally could tax the interest, the decision in *South Carolina v. Baker* dispelled any such lingering doubts.<sup>14</sup> Assuming, for example, that the market interest rate were 10% and the maximum income tax rate were 30%, the state interest rate should be 7% so that the state captures the tax subsidy from the gross income exclusion. States rarely can find sufficient buyers for their debt who are 30% bracket taxpayers, so they must offer a higher interest rate to attract lower bracket taxpayers. If the state may sell all its debt if it targets 20% bracket taxpayers, the interest rate it will pay to make the exempt interest comparable to the 10% market rate is 8%. Nothing prevents a lender who does pay the maximum rate of 30% from buying the 8% debt and receiving the equivalent of an above market rate of 11.43%. That high bracket taxpayer/lender captures part of the federal subsidy directed to the state. The United States cannot shift the excess tax saving to the state as a subsidy. Instead it is a deadweight loss that does nothing to advance the U.S. goal of subsidizing states' borrowing costs. A direct subsidy of an interest rate differential would be more efficient and would not enhance the resources of wealthier taxpayers who otherwise are taxable at the highest marginal rates of tax.

An income tax might have a primarily revenue raising function, but the legislature often deploys deductions and exclusions from the income tax base to stimulate the economy rather than providing direct subsidies that would require their own administrative infrastructure. A simple example is the depreciation deduction.<sup>15</sup> A deduction for gradual consumption of durable property used to produce income makes

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13. I.R.C. § 103 (excluding interest on state and local obligations from the gross income of the recipients).

14. *South Carolina v. Baker*, 485 U.S. 505 (1988) (holding United States may tax interest on state or local obligation not issued in registered form).

15. I.R.C. §§ 167 & 168.



sense where the goal of the income tax is to tax only the taxpayer's net income. Consumption of the durable property is one of the costs of producing the income. Determining how much of the durable property is consumed as income is produced always has been challenging. Mismatching of allowance and economic consumption has been common and a source of disagreement between the taxpayer and tax collector. In 1981, Congress stabilized the depreciation allowance system in the United States by introducing determinable useful lives and allowable methods of depreciation and by eliminating salvage value when it introduced the accelerated cost recovery system (ACRS).<sup>16</sup> The depreciation system abandoned the notion of accurately matching income and expenditure. It substituted a system providing economic stimulus rather than measuring net income.

In a graduated income tax, deductions<sup>17</sup> like ACRS and exclusions like state and local interest payments benefit higher marginal bracket and generally wealthier taxpayers more than lower bracket taxpayers. Since adoption of ACRS in 1981, Congress has modified useful lives and permissible methods on several occasions, each time causing market disruptions as the changed methods affect the initial and resale values of the underlying durable goods. Shortened lives and acceleration increase value; lengthened lives and slowed-down recovery decreases values because of the time value of the deduction. Repeated revisions of tax provisions affecting property values do not contribute to a predictable and sustainable system as each modification produces extra-market winners and losers. While changes in direct subsidies might do so as well, they are likely to target a specific industry. Such a targeted subsidy is subject to greater public scrutiny than is a general tax change and is more likely to benefit its target only without providing broader opportunities for tax planners to seize the benefit for non-targeted taxpayers.

### *B. Non-Revenue/Subsidy Functions*

Taxes also may serve a primarily non-tax function. Until the beginning of the 20th century when the income tax amendment to the U.S.

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16. I.R.C. § 168 (1981) (added by the Economic Recovery Act of 1981, Pub. L. No. 97-34, § 201, 95 Stat. 172, 203 *et seq.*).

17. I.R.C. § 199A (providing a 20% deduction for qualified business income may alter this observation in some instances); *see infra* discussion note 85 and accompanying text.

Constitution permitted a direct income tax without apportionment,<sup>18</sup> tariffs were the principal revenue source for the federal government.<sup>19</sup> While tariffs historically served the function of protecting American industry by levelling prices for U.S. manufactured goods with the prices that other countries with lower production costs might offer for comparable goods or making them more expensive than domestic goods, revenue production often was at least an equally important function of the tariffs. Import duties<sup>20</sup> have begun again to flourish in the United States, but currently, rather than a primary or even comparable revenue producing function, new tariffs have been deployed politically to support American demands for trade concessions from the United States' trading partners.

During the latter decades of the 20th century, legislatures increasingly relied on existing tax infrastructures to address issues that are not fundamentally tax or revenue issues. Legislatures designed some taxes to discourage bad behaviors or encourage good behaviors and other taxes (or adjustments to existing taxes) to provide targeted funding for favored projects and incidentally to withhold funding from disfavored projects. Each tax or adjustment comes with its own distributional characteristics. Few if any taxes are progressive while many are regressive relative to wealth or resources of the taxpayer.

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18. U.S. CONST. amend XVI (permitting federal income tax without apportionment otherwise required by U.S. CONST. art. I, § 2, cl. 3).

19. In many of the years before 1913, tariffs generated nearly 100% of federal revenue. BUREAU OF THE CENSUS, BICENTENNIAL EDITION: HISTORICAL STATISTICS OF THE UNITED STATES: COLONIAL TIMES TO 1970, ch. Y at 1106–08 (1975), [20. In the United States, the provisions governing customs duties are in title 19 of the U.S. Code while most other federal taxes appear in title 26 of the U.S. Code \(known as the Internal Revenue Code\). Despite separate codification, customs duties are considered to be taxes on the import of raw materials and goods. \*Custom Duties\*, WEBSTER'S NEW WORLD DICTIONARY \(4th ed. 1960\). Tariffs are taxes or schedules of duties. \*Tariffs\*, WEBSTER'S NEW WORLD DICTIONARY \(4th ed. 1960\). The words duty and tariff tend to be used interchangeably, but the U.S. Constitution refers to duties, not tariffs. See U.S. CONST. art. I, § 8, cl. 1 \(delegates the power to impose taxes, duties, and excises to Congress\).](https://www.census.gov/library/publications/1975/compendia/hist_stats_colonial-1970.html#:~:text=This%20bicentennial%20edition%2C%20includes%20more,periods%20from%201610%20to%201970; see also Henry Ordower, <i>Taxing Others in the Age of Trump: Foreigners (and the Politically Weak) as Tax Subjects</i>, 62 ST. LOUIS U. L.J. 157, 162 & n.32 (2017).</a></p></div><div data-bbox=)

A tax on alcoholic beverages is an example of a tax not designed primarily to raise revenue but to modify undesirable behavior. Rather than prohibiting the behavior,<sup>21</sup> the tax increases the cost to consumers of imbibing alcoholic beverages relative to other consumables. Some consumers are likely to modify their behavior in response to the tax and purchase less alcohol because they lack funds to buy or are unwilling to devote so much of their resources to consumption. The tax can be targeted to discriminate among different types of alcoholic beverages depending on the legislature's view of the degree of undesirability of the alcohol type.<sup>22</sup>

Except in the unlikely event that data on specific buying preferences of various social or economic groups in the society might enable a legislature to discriminate against or in favor of specific groups, an alcohol tax does not distinguish among consumers. Since it is imposed at a flat rate, possibly adjusted by the type of beverage, the tax adversely impacts a consumer with limited resources more than it does a consumer with abundant resources. The tax is regressive and is more likely to deter undesirable behavior by those with limited rather than abundant resources.<sup>23</sup> However, the increased cost of the tax might stress households in which the individuals are unwilling or unable to modify their

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21. Compare the failure of Prohibition in the United States. U.S. CONST. amend. XVIII (1919) (repealed by U.S. CONST. amend. XXI (1933)).

22. Börje Olsson et al., *Introduction: Nordic Traditions of Studying the Impact of Alcohol Policies*, in NORDIC COUNCIL FOR ALCOHOL & DRUG RESEARCH, PUB. 42, THE EFFECTS OF NORDIC ALCOHOL POLICIES: WHAT HAPPENS TO DRINKING AND HARM WHEN ALCOHOL CONTROLS CHANGE? 5, 6 tbl.1 (Robin Room ed., 2002), <http://www.dldocs.stir.ac.uk/documents/nad42.pdf> [hereinafter NORDIC COUNCIL PUB. 42]. See generally NORDIC COUNCIL PUB. 42, *supra* (featuring some of the Nordic alcohol control systems in 2002 and showing tax differences for differing types of alcoholic beverages).

23. Similarly, cigarette taxes have limited success in reducing adult smoking but greater effect on children. Kevin Callison & Robert Kaestner, *Do Higher Tobacco Taxes Reduce Adult Smoking? New Evidence of the Effect of Recent Cigarette Tax Increases on Adult Smoking* (Nat'l Bureau of Econ. Research, Working Paper No. 18326, 2012), <https://www.nber.org/papers/w18326.pdf>; S.C. Tobacco Collaborative, *Raising Cigarette Taxes Reduces Smoking, Especially Among Kids (and the Cigarette Companies Know It)*, CAMPAIGN FOR TOBACCO-FREE KIDS, [https://www.tobaccofreekids.org/microsites/passthebuck\\_sc/resources/sccigtaxandkids.pdf](https://www.tobaccofreekids.org/microsites/passthebuck_sc/resources/sccigtaxandkids.pdf) (last visited July 30, 2020).

behavior and they redirect limited household resources to alcohol purchase. Where the tax becomes too burdensome for most consumers, some may seek off-market sources of the product that are less expensive. Off-market providers of the products do not collect and pay the tax either because they smuggle the products from a jurisdiction that does not impose the tax or that imposes the tax at a lower rate, they steal the products, or they manufacture the products in or distribute them from unmonitored and possibly higher health risk facilities, as occurred during the period of Prohibition in the United States. Because alcohol is addictive for some consumers, the tax may be responsible in part for collateral crime, as individuals seek to raise revenue to buy the product.

An alcoholic beverage tax is not sustainable. If successful in modifying behavior, as it has been in Scandinavia,<sup>24</sup> it produces a diminishing revenue flow and, ideally, results in its own obsolescence as alcohol consumption, and possibly alcoholism, diminish. It is not a reliable source of long-term revenue to support governmental provision of goods and services, and it is not sustainable because it is regressive.

Similarly, as an alternative to direct regulation of pollutants and polluting behaviors, legislatures have sought to use the tax administrative infrastructure to supplement or replace regulation. Environmental taxes, alongside direct regulation, hold promise in controlling environmental degradation, but their success so far has been limited. In the United States, there are both federal and state fuel taxes.<sup>25</sup> Fuel tax increases have some impact on consumption in the United States. As taxes and fuel prices rose following the 1973 oil crisis,<sup>26</sup> demand increased for vehicles with improved fuel economy. Yet, abundant and competitive oil production in recent years has stabilized fuel prices and even caused them to decline as

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24. See Randy W. Elder et al., *The Effectiveness of Tax Policy Interventions for Reducing Excessive Alcohol Consumption and Related Harms*, 38 AM. J. PREVENTATIVE MED. 217 (2010) (finding reverse correlation between price and consumption of alcohol, but correlation is weaker as disposable income increases).

25. *State Motor Fuel Taxes: Rates Effective 01/01/2020*, AM. PETROLEUM INST., <https://www.api.org/~media/Files/Statistics/StateMotorFuel-OnePagers-January-2020.pdf> (last visited July 30, 2020) (showing both state by state rates and combined with federal taxes). States tend to dedicate fuel taxes to road maintenance and construction.

26. *Oil Embargo, 1973–1974*, OFF. HISTORIAN U.S. DEP'T ST., <https://history.state.gov/milestones/1969-1976/oil-embargo> (last visited July 30, 2020).

consumers returned to less fuel-efficient vehicle options. Consumers continue to purchase large and fuel-inefficient vehicles.

More direct use of the tax infrastructure to regulate fuel consumption and its accompanying pollution comes in the form of the federal gas guzzler tax that increases the cost of vehicles with low fuel efficiency ratings.<sup>27</sup> Complementing the gas guzzler tax is a temporary credit for initial sales of electric vehicles. The credit expires when the manufacturer reaches a certain level of production.<sup>28</sup> The tax credit encourages development of electric vehicles. Nevertheless, alternative fuel-efficient vehicles, including hybrids that use gasoline and electricity and electric vehicles, have found a limited market. Electric vehicles have remained expensive even when the manufacturer passes the tax credit subsidy on to the consumer. The vehicles are out of economic reach for the great bulk of the populace. For others, the limited availability of facilities and the time necessary for charging batteries have undermined broad acceptance of electric vehicles for those who have the resources to acquire them. Direct fuel efficiency regulation for vehicles has served as a passive control on fuel consumption alongside increased taxes.

The impact of fuel efficiency standards and tax incentives and disincentives tends to be regressive relative to resources. Lower income taxpayers often buy the vehicles that higher income taxpayers relinquish and hold vehicles in service longer than higher income taxpayers who can replace their vehicles in favor of better fuel economy so that the lower income taxpayers bear the heaviest burden of fuel tax increases and general price advances. There have been no incentives to enable low income individuals to acquire fuel-efficient vehicles while, for many, a car is essential to enable them to work because of a dearth of practical mass transit options. The United States has been slow to develop affordable and widely available mass transit. Where high efficiency mass transit becomes available, demand for housing near the transit causes housing prices to rise. Higher housing costs exclude lower income individuals from access to that mass transit.

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27. I.R.C. § 4064 (excise tax on sale by manufacturer of low fuel economy vehicles).

28. I.R.C. § 30D (plug-in vehicle credit).

## II. INCOME TAX INFRASTRUCTURE AND NON-TAX PURPOSES

The preceding part of this Article illustrates the range of purposes for which the legislature has used the tax infrastructure. Rather than considering delivery of any subsidy directly or controlling undesirable behavior with a direct enforcement mechanism, Congress automatically seems to turn to the income tax to deliver the subsidy with an exclusion from tax,<sup>29</sup> a deduction,<sup>30</sup> or a credit<sup>31</sup> or deters undesirable behavior with a tax<sup>32</sup> or the denial of a deduction.<sup>33</sup> Many people find the income tax to be complex and intimidating. Some leading scholars have offered thoughtful recommendations to eliminate part of that complexity by removing the requirement that all taxpayers engage with the income tax directly. Michael Graetz recommends eliminating the return filing requirement for most taxpayers.<sup>34</sup> Joseph Bankman has been a proponent for initial return preparation by the tax agency rather than the taxpayer.<sup>35</sup> Over the years, politicians have offered proposals to make the federal income tax return postcard sized with only a line or two to fill.<sup>36</sup> Rather than simplification, however, tax legislation tends to make taxing more complex both in its detail and by adding taxes to address

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29. I.R.C. § 103 (subsidy to state and local governments through exclusion of interest payments from lenders' incomes).

30. I.R.C. § 168 (accelerated depreciation allowance).

31. I.R.C. § 30D (plug-in vehicle credit).

32. I.R.C. § 4064 (gas guzzler excise tax).

33. I.R.C. § 280E (denying a deduction for business expenses associated with dealing in controlled substances).

34. See MICHAEL GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2010).

35. E.g., Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn*, 107 TAX NOTES 1431 (June 13, 2005).

36. Richard A. Gephardt (Dem. MO) touted such a return in his unsuccessful presidential campaign of 1988. See Anne Swardson, *New Tax Law Is the Product of a Hundred Political Battles*, WASH. POST (Feb. 29, 1988), [http://www.washingtonpost.com/archive/business/1988/02/29/new-tax-law-is-the-product-of-a-hundred-political-battles/dc23ee14-28f3-49ef-88b1-c8a5c55383bd/?tid=ss\\_mail](http://www.washingtonpost.com/archive/business/1988/02/29/new-tax-law-is-the-product-of-a-hundred-political-battles/dc23ee14-28f3-49ef-88b1-c8a5c55383bd/?tid=ss_mail). And the notion resurfaced in conjunction with the TCJA in 2017. See Brian Naylor, *GOP's Dream: Postcard-Size Tax Return*, NPR (Nov. 3, 2017), <https://www.npr.org/2017/11/03/561712483/gops-dream-postcard-size-tax-return>; see also I.R.C. § 5000A.

specific revenue, political, or social needs. As the number of taxes grows, it becomes more difficult to determine which taxpayers are paying which taxes and what their overall tax burden may be. When taxes deliver subsidies, tax planners often misdirect part of the subsidy to taxpayers who are not the subsidy target.<sup>37</sup>

Tax-based subsidies for specific investments sacrifice full use of the intended subsidy in the subsidized activity in exchange for the simplicity of an existing administrative mechanism. Tax planning generates deadweight loss as the tax planners seize a portion of the subsidy as they structure investments to comply with tax subsidy requirements while possibly not embracing the underlying objective of the subsidy.<sup>38</sup> Recently when New York City required that new residential developments have a specific portion of lower income, “affordable” rental units as a condition to receiving certain tax benefits, some developers designed the project with separate entrances and facilities to segregate the low income tenants from the market rate tenants to make the higher market rental units more desirable; New York City changed the tax subsidy law to prohibit the practice prospectively.<sup>39</sup>

### III. BROAD TAX BASES FOR A SUSTAINABLE TAX

A modern government cannot collect all its revenue from its wealthiest taxpayers even if it were committed to redistribution under progressive taxes. As Professor Sven-Olof Lodin argued in 1977, with only some

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37. The tax shelter industry in the United States exemplifies this phenomenon. See Ordower, *supra* note 1, at 55.

38. Klaus-Dieter Drüen, *Unternehmerfreiheit und Steuerumgehung*, 2008 STEUER UND WIRTSCHAFT 154, 158, observed: “Steuerumgehung volkswirtschaftlich betrachtet den Wettbewerb und führt zur ineffizienten Allokation von Ressourcen, weil beträchtliches Personal in Unternehmen, Steuerberatung und Staat fern von wirtschaftlicher Nutzenmaximierung gebunden wird.” (Author’s translation: “From an economic perspective, tax avoidance disrupts competition and leads to inefficient allocation of resources as considerable personnel in business, tax planning industries, and the state remain far from economic production maximization activity.” Ordower, *supra* note 1, at 48 n.4.).

39. Melkorka Licea, *‘Poor Door’ Tenants of Luxury Tower Reveal the Financial Apartheid Within*, N.Y. POST (Jan. 17, 2016), <https://nypost.com/2016/01/17/poor-door-tenants-reveal-luxury-towers-financial-apartheid/>.



10% of the population in 1973 earning income greater than SEK 40,000,<sup>40</sup> the bulk of government revenue must come from lower and moderate income groups.<sup>41</sup> Professor Lodin concluded that the form of tax used to raise the revenue from the low to moderate income population might be of no significance.<sup>42</sup> Lodin acknowledged, however, that “the heavy taxation of the lower-income-receivers would probably not have been psychologically possible if the taxation of the higher incomes had not been made even more severe.”<sup>43</sup> Consistent with that view of the necessity of taxing high incomes severely was the commonly held view through much of the 20th century that the tax system should not favor income from capital over income from labor.<sup>44</sup> The image of “the idle rich” was commonplace. Estate or inheritance taxes enjoyed some, albeit limited, success in preventing the accumulation and transmission of vast, dynastic, accumulated wealth, although increasingly aggressive tax planning undercut the effectiveness of those taxes.<sup>45</sup>

Much has changed both in Sweden and the United States since that time. Capital and its owners have captured tax legislation. Any negative image of the “idle rich” as exploiters of labor transmuted to a myth.<sup>46</sup> The wealthy have transformed into job creators and assumed the role of the drivers of production and growth. Without the productive wealthy members of society, the country would not thrive.<sup>47</sup> That

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40. Sven-Olof Lodin, *Swedish Tax Reforms 1971–77—Why So Many?*, 21 SCANDINAVIAN STUD. L. 177 (1977).

41. *Id.* at 183.

42. *Id.* Lodin’s study mentions the role employer taxes play in the adjustment of income tax rates but neither identifies the inverse relationship between employer taxes and wages nor the distributional effects of increasing value added taxes.

43. *Id.*

44. ANDREW W. MELLON, *TAXATION: THE PEOPLE’S BUSINESS* 56–58 (1924).

45. Ordower, *supra* note 1, at 69–70.

46. *The Myth of the “Idle Rich,”* MORGAN STANLEY (Jan. 23, 2015), <https://www.morganstanley.com/ideas/myth-of-the-idle-rich> (reporting on a survey of ultra-wealthy individuals with inherited wealth who are productive and altruistic).

47. The theme that seems to prevail is from AYN RAND, *ATLAS SHRUGGED* (1957) (in which the industrialists avenge efforts to regulate them by dropping out of the society, creating their own, and leaving the rest of the United States to decay).



argument has favored reducing regulatory and tax burdens on the wealthy to enable them to use their resources more effectively to create jobs and stimulate economic growth. Simultaneously, capital mobility has undercut any lingering commitment to taxing labor more lightly than capital. Labor is relatively immobile and easy to tax. National borders, family ties, cultural barriers, and costs of relocation have left labor as a fungible, predictable, and measurable tax object. In advanced economies even if existing labor were to emigrate, immigration demand quickly would replace the lost labor as immigrants from less affluent countries seek the higher wages in the advanced economies. Robust tax competition among jurisdictions has fueled a bidding war for capital and made capital difficult to tax.<sup>48</sup> Ease of communication and transportation over large distances through technological improvement and development of stable legal and financial systems in many previously difficult to access, low tax jurisdictions have become more attractive to those with the means to move their capital and sometimes themselves without giving up many of their ties to their home countries.

During the final decades of the 20th and first decades of the 21st centuries, taxes on capital and capital investment have declined while relationally taxes on labor have increased in the United States and other economically advanced countries, Sweden included. Opportunities to defer or permanently exclude capital income from taxation abound. Estate, gift, and wealth<sup>49</sup> taxes have declined or disappeared.<sup>50</sup>

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48. Competition for capital among state and local jurisdictions in the United States, for example, has magnified the bargaining power of major industrial interests. See Karen Weise et al., *Amazon's Hard Bargain Extends Far Beyond New York*, N.Y. TIMES (Mar. 3, 2019), <https://nyti.ms/2E19V8T>.

49. Limited wealth taxes are common in the United States at the state or local level and are imposed on real property and vehicles, but personal property taxes on other property for which there is no government registry have not been successful.

50. Sweden repealed its inheritance tax in 2004 and its wealth tax in 2007. See Magnus Henrekson & Daniel Waldenström, *Inheritance Taxation in Sweden, 1885–2004: The Role of Ideology, Family Firms, and Tax Avoidance*, 69 ECON. HIST. REV. 1228 (2016); David Ibrison, *Sweden Axes Wealth Tax*, FIN. TIMES (Mar. 28, 2007), <https://www.ft.com/content/d6f77584-dd4a-11db-8d42-000b5df10621>. The United States had no wealth tax and reduced the maximum estate tax rate to 35% from 70% and now taxes estates only in excess of \$10 million, adjusted for cost of living, rather than the earlier \$600,000. I.R.C. §§2505, 2010(c); see also Darien B.

Consumption taxes and wage taxes carry larger shares of the governmental revenue burden. This shift of tax burdens from capital to labor is the focus of this part.

Estate, gift, and wealth taxes all historically used progressive tax rates and fell largely on the wealthy. Gift taxes remain within the control of the donor. If intrusively high, gift taxes interfere with the normal practice of gift giving from wealthier to less wealthy individuals—ordinary behavior within families—potential donors simply may choose not to make gifts. The United States sought to limit the impact of the gift tax on day-to-day small gifts with an annual per donor/per donee exclusion.<sup>51</sup> The primary role of a gift tax remains as a backstop to the estate or inheritance tax.

Estate and inheritance taxes are more difficult to avoid than gift taxes.<sup>52</sup> Death is actuarially predictable so that the taxes can provide a reasonably steady revenue stream. Exemptions for some property passing to surviving spouses and dependent children are essential lest families losing a breadwinner be left without sufficient economic resources, so the

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Jacobson et al., *The Estate Tax: Ninety Years and Counting*, SOI BULL., Summer 2007, at 118; *How Do the Estate, Gift, and Generation-Skipping Transfer Taxes Work?*, TAX POL'Y CTR., <https://www.taxpolicycenter.org/briefing-book/how-do-estate-gift-and-generation-skipping-transfer-taxes-work> (last visited July 31, 2020).

51. I.R.C. § 2503 (the annual exclusion of \$10,000, adjusted for inflation); Boris I. Bittker, *The \$10,000 Annual per-Donee Gift Tax Exclusion*, 44 OHIO ST. L.J. 447, 447 (1983) (discussing change from \$3,000 exclusion to \$10,000 in 1981).

52. Charitable testamentary gifts are deductible from the estate in full. I.R.C. § 2055. If the state probate court permits, the will may instruct the burial of valuable items with the decedent so they are not included in the decedent's estate for tax purposes. Treas. Reg. § 20.2033-1 (cemetery plot and burial casket not included in estate because not salable). Presumably, if the decedent were buried in her Ferrari, the Ferrari would not be part of the taxable estate because it is used for burial and cannot be sold. Rebecca Salinas, *This Week in 1977, Socialite Sandra West Was Buried in her Ferrari in San Antonio*, MY SAN ANTONIO (May 19, 2020), <https://www.mysanantonio.com/news/local/history-culture/article/This-week-in-in-1977-socialite-Sandra-West-was-7528939.php>. Under the predecessor statute, property that may not pass through the estate was not includable. *Crooks v. Harrelson*, 282 U.S. 55 (1930) (applying section 402 of the Revenue Act of 1918 requiring that property be subject to distribution to be part of the taxable gross estate).

taxes primarily affect wealthier taxpayers. With current concentrations of wealth in economically advanced societies, an estate or inheritance tax might reach most of that concentrated wealth and produce adequate revenue to fund governmental needs if the tax rates are sufficiently high. Political attacks on the estate tax have been relentless over the past decades and have included valuation litigation. In Germany, the Constitutional Court ordered the legislature to remedy valuation flaws affecting the estate tax and other taxes on several occasions.<sup>53</sup> In the United States, wealthy taxpayers, frequently providing “dark money,”<sup>54</sup> engage in extensive publicity to characterize the tax pejoratively as an inherently unfair “death” tax threatening every taxpayer’s ability to pass a business or farm to his or her heirs. The rhetoric persuaded many middle and lower-income taxpayers to vote against their economic interests and support repeal of the estate tax even though most never would become subject to the tax.<sup>55</sup> Extensive lobbying accompanied the publicity. While not a complete success in the United States, the United States has reduced the incidence of the tax and Sweden repealed it.<sup>56</sup>

Incidence of a consumption tax, whether as a value added tax, sales tax, turnover tax, or other manifestation, falls largely on middle and lower-income taxpayers who consume all or almost all of their resources to meet their daily expenses. If the tax base includes goods, services, and real and personal property rentals, the consumption tax reaches nearly all the income of low and moderate-income individuals who must consume all their resources. Higher income taxpayers are likely to save and invest a portion of their resources so that even if there

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53. Consider BVerfGE 93, 165, June 22, 1995, [http://www.bverfg.de/e/rs19950622\\_2bvr055291.html](http://www.bverfg.de/e/rs19950622_2bvr055291.html), holding the German inheritance tax to violate the equality principle in Art. 3, section 1 of the German Basic Law because it fails to value property consistently, discussed in Ordower, *supra* note 2, at 264; and the constitutional valuation issue continues with respect to the German Valuation Law (Bewertungsgesetz) applicable to both property taxes and estate taxes, BVerfGE 148, 147, Apr. 10, 2018, [http://www.bverfg.de/e/ls20180410\\_1bvl001114.html](http://www.bverfg.de/e/ls20180410_1bvl001114.html).

54. Citizens United v. Fed. Election Comm’n, 558 U.S. 310 (2010) (holding that restrictions on political expenditures by organizations is not permissible and the organizations need not disclose their donors). The decision permits large contributions to organizations for political use without transparency, hence “dark money.”

55. Ordower, *supra* note 1, at 117.

56. See Henrekson & Waldenström, *supra* note 50.

were a broad financial transactions tax embedded into or complementary to the consumption tax,<sup>57</sup> the growth in resources as investments appreciate in value would not become subject to the consumption tax. Recent efforts in several jurisdictions to enact a financial transactions tax have proven difficult and industry resistance to the tax strong.<sup>58</sup>

Consumption taxes for moderate and low income taxpayers are attractive because they are administratively efficient. They are relatively easy to collect because the vendor or service provider collects the tax along with payment for the goods or services and remits the tax to the tax collector.<sup>59</sup> A purchaser who lacks liquidity to pay the tax cannot acquire the item taxed. Unlike income and wealth taxes, little or no self-reporting is necessary. The recent U.S. Supreme Court decision in *South Dakota v. Wayfair, Inc.* eliminated much of the self-reporting in state sales and use taxes in the United States by permitting states to require out-of-state vendors to collect and remit use taxes on sales to residents of states into which the vendor will ship goods.<sup>60</sup>

Consumption taxes tend to be regressive relative to the taxpayers' resources. While consumption taxes raise revenue from the bulk of the population as is essential to sustain government goods and services,<sup>61</sup> the tax leaves concentration of resources and resource growth intact and violates longstanding principles of distributional fairness in taxation. Some commentators have sought to design a progressive consumption tax, but progression is narrow, affecting only those who consume goods and services subject to a consumption tax and not those who consume little relative to their resources but have stores of wealth. Proposals for

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57. See generally Leonard E. Burman et al., *Financial Transaction Taxes in Theory and Practice*, 69 NAT'L TAX J. 171 (2016).

58. E.g., Tim Worstall, *How Many Times Must We Say This? A Financial Transactions Tax Raises No Revenue*, FORBES (Aug. 28, 2017), <https://www.forbes.com/sites/timworstall/2017/08/28/how-many-times-must-we-say-this-a-financial-transactions-tax-raises-no-revenue/#5d6bade81a7b>.

59. Considerable tax fraud is present even within value added taxes. See Richard T. Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution*, 42 TAX NOTES INT'L 443 (May 1, 2006); *The EU Runs a Large Trade Surplus with Itself—One Reason Is Apparently Large-Scale VAT Fraud*, KIEL INST. WORLD ECON. (Jan. 7, 2020), <https://www.ifw-kiel.de/publications/media-information/2020/the-eu-runs-a-large-trade-surplus-with-itself-one-reason-is-apparently-large-scale-vat-fraud/>.

60. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).

61. Lodin, *supra* note 40.

a progressive consumption tax seek to promote savings—a worthy objective for middle and moderate income taxpayers—but an objective that has led to concentration of wealth rather than taxation based on any ability to pay principle. Consumption taxes meet some but not all sustainability criteria and do not offer sustainable taxation.

The income tax also has a broad base and the potential to raise adequate revenue for government alone or in conjunction with other taxes. Existing income taxes lack the collection efficiency of consumption taxes because they often rely heavily on self-reporting except as they apply to wage earners where withholding provides comparable third-party collection and remittance.<sup>62</sup> For low, moderate, and many other middle income taxpayers, wages are the taxpayer's primary source of income. For those taxpayers, withholding is effective to collect the income tax. For self-employed taxpayers and taxpayers with significant income from investment capital, withholding misses the mark but could be made more robust. By substituting a withholding obligation for existing information reporting,<sup>63</sup> an income tax could approximate the third-party collection efficiency of a consumption tax.

Most jurisdictions overlay income taxes with a consumption tax<sup>64</sup> and often with specialty taxes<sup>65</sup> and taxes on parts of taxpayer wealth.<sup>66</sup> Taxes on capital, income from capital, and increases in the value of capital have remained stagnant or moderated as taxes disproportionately affecting middle, moderate, and low income taxpayers proliferate. This recurring theme of shifting tax burdens from capital to labor seems unlikely to remain sustainable as it segregates those with accumulated wealth from those with little or no capital. The standard of living in advanced economies for the bulk of the population has improved over the centuries, but the hope of becoming wealthy may be less attainable than it was when capital was not so concentrated. A tax system that supports concentrating wealth is distributionally

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62. I.R.C. § 31 (credit for wage withholding); I.R.C. § 3402 (withholding on wages at source).

63. I.R.C. § 6041 (payments in excess of \$600); I.R.C. § 6041A (wages and payments for services); I.R.C. § 6042 (dividends); I.R.C. § 6045 (brokers); I.R.C. § 6049 (interest).

64. Imposed at state and local level in the United States by most states.

65. Alcoholic beverages, tobacco, gasoline, for example.

66. State or local property taxes in the United States.

unsustainable, especially in the absence of a strong welfare state that provides some redistribution of wealth through extensive governmental benefits even if only within income classes.<sup>67</sup>

U.S. distribution of tax burdens under the income tax skews in favor of higher-income taxpayers relative to the mid-20th century income tax. Capital gain continues to enjoy favored treatment.<sup>68</sup> In the 1960s, for example, the maximum rate of tax on ordinary income was 70%.<sup>69</sup> Congress assumed that the high rate of tax led many highly compensated and self-employed individuals to seek investment opportunities generating deductible tax losses.<sup>70</sup> The investments were commonly referred to and marketed as “tax shelters.” In early years of the investment, tax shelters generated deductible losses taxpayers could use to offset their income from performance of services and reduce their current tax burden. Shelters generally offered tax deferrals rather than exclusions. After a number of years the tax shelters would produce taxable income without cash with which to pay the tax, but the taxpayer could invest and retain the earnings on the deferred tax liability generated in

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67. A common characterization of Scandinavian welfare systems.

68. This Article refers to capital gain imprecisely. A capital gain is gain from the sale or exchange of any capital asset as defined under I.R.C. § 1221 to include all property not within one of the exceptions in I.R.C. § 1221. Net capital gain under I.R.C. § 1222(1) is the income that receives favorable treatment. Historically, non-corporate taxpayers received a deduction for 50% or 60% of their net capital gain, but currently, net capital gain is taxed at a lower rate than other income for most taxpayers under I.R.C. § 1(h). Net capital gain is the excess of net long-term capital gain (I.R.C. § 1222(7)) over net short-term capital loss (I.R.C. § 1222(6)). Net long-term capital gain is long-term capital gain (I.R.C. § 1222(3)) less long-term capital loss (I.R.C. § 1222(4)) during a year, with long-term meaning that the taxpayer has held the property for more than one year before selling it. Other capital gain is short-term, so net short-term capital loss is short-term capital loss (I.R.C. § 1222(2)) less short-term capital gain (I.R.C. § 1222(1)).

69. I.R.C. § 1 (1966).

70. Decreasing rates of tax have not stanching taxpayers’ urge to avoid taxes. Many designer tax shelters of the 1980s and 1990s, like the “son-of-boss” transactions, sought to avoid payment of favored capital gain. A presidential candidate John Edwards is representative of taxpayers who sought to avoid a 2.9% Medicare tax on income from services. Ordower, *supra* note 1, at 119.

the early investment years.<sup>71</sup> In 1969 Congress reduced the maximum rate of tax on income from services to 50% while retaining a 70% rate maximum for investment income.<sup>72</sup> The rate split favoring income from services reduced tax shelter investments somewhat since a tax shelter would defer 50% tax but would require a payment of 70% tax when the shelter began to produce taxable income.<sup>73</sup>

In 1981, however, Congress eliminated the rate split by reducing the maximum rate on investment income to 50%.<sup>74</sup> A further maximum rate reduction in 1987 to 28%<sup>75</sup> included the short-lived elimination of a rate preference for capital gain. High income taxpayers with significant income from invested capital experienced a maximum rate reduction of 42% with an 8% increase in the tax on their capital gain. With many ways to control the timing of the inclusion of capital gain in income, the rate reductions benefitted higher income taxpayers significantly. Maximum rates have increased and the maximum rate on capital gain decreased since 1986.

The second portion of the income tax is separate from the general computation of taxable income and affects only income from the performance of services. The Social Security tax and its complementary Self-Employment tax have their origins in the Social Security

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71. *Id.* at 55.

72. Lawrence B. Lindsey, *Is the Maximum Tax on Earned Income Effective?* (Nat'l Bureau of Econ. Research, Working Paper No. 613, 1981), <https://www.nber.org/papers/w0613.pdf> (arguing that the split tax leaves much earned income taxable at the same rates as investment income). When a shelter burned out and began producing income without cash, many investors simply failed to report the income. *Id.*

73. Emil M. Sunley, Jr., *The Maximum Tax on Earned Income*, 27 NAT'L TAX J. 543 (1974). Traditional tax shelter investments did not lose their attractiveness until many years later when the maximum income tax rate declined to 28% and the passive activity loss limitations under I.R.C. § 469 (added by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233-41) required matching of tax deductible losses to economic losses.

74. Economic Recovery Act of 1981, *supra* note 16, § 101.

75. Tax Reform Act of 1986, *supra* note 73, § 302. Because of a phase out of the marginal rate brackets at higher income levels by adding an additional tax, there was a 33% rate bubble within a specific income range.



retirement program.<sup>76</sup> Collection of retirement benefits under Social Security requires that the individual has paid Social Security taxes rather than falling into one of the exempt categories of workers.<sup>77</sup> There is no immediate correlation between tax payments and the amount and duration of the benefits. The tax is a wage income tax, and its collections become part of general revenue through a system of internal accounting transfers credited with interest. The tax has only two rate brackets, a positive rate and a zero rate.<sup>78</sup> The positive rate applies to services income up to a limit.<sup>79</sup> Service income in excess of that limit is not subject to the tax nor is income from capital. Thus, the tax favors higher income taxpayers and all taxpayers to the extent of their income from capital and most who own significant sums of income producing capital are affluent. Relative to resources the tax is regressive and distributionally not sustainable.

Performing services as an employee is a trade or business.<sup>80</sup> Yet, the tax law disfavors employee business expenses relative to other business expenses. It excludes employee business expenses from classification as deductible adjustments to gross income.<sup>81</sup> Instead, employee business expenses are itemized deductions<sup>82</sup> and miscellaneous itemized deductions subject to two limitations on deductibility. As miscellaneous itemized deductions, they are not deductible until 2026.<sup>83</sup> When they become deductible, they are itemized deductions if they exceed two percent of the taxpayer's adjusted gross income.<sup>84</sup> As itemized deductions, they produce a tax benefit only if the taxpayer's itemized deductions in the aggregate exceed the standard deduction.

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76. *Retirement Benefits (2020)*, SOC. SECURITY ADMIN., <https://www.ssa.gov/pubs/EN-05-10035.pdf> (last visited July 31, 2020).

77. I.R.C. § 3121(b) (excluding certain employment, such as that of federal judges, the President, and Vice President).

78. I.R.C. § 3101 (wage tax); I.R.C. § 1401 (self-employment tax).

79. The cap on the tax is set under section 430 of the Social Security Act, and for 2020 is \$137,700. *See* 42 U.S.C. § 430; *Maximum Taxable Earnings*, SOC. SECURITY ADMIN., <https://www.ssa.gov/benefits/retirement/planner/maxtax.html> (last visited July 31, 2020).

80. *See* I.R.C. § 62(a)(1).

81. *Id.* Generally referred to as above-the-line deductions that always produce a tax benefit.

82. I.R.C. § 63.

83. I.R.C. § 67(g) (establishing the suspension of deduction).

84. I.R.C. § 67.



Further discriminating against labor relative to capital intensive businesses and some self-employment is the new 20% deduction for qualified business income.<sup>85</sup> The trade or business of performing services as an employee is expressly excluded from the deduction.<sup>86</sup>

#### IV. THE CAPITAL CONUNDRUM

Income from capital, including both periodic income (such as interest, dividends, rents, and royalties) and gain from the disposition of property, is not subject to the Social Security portion of the income tax.<sup>87</sup> In several respects U.S. tax law further favors each type of income from capital.

##### *A. Periodic Income*

Since 2001, dividends from domestic corporations are subject to a reduced rate of tax.<sup>88</sup> The reduced rate ameliorates the impact of a shareholder level tax following on a corporate level tax often referred to as double taxation of corporate profits. The recent reduction in the corporate tax rate to 21%<sup>89</sup> undercuts that double taxation argument in that currently the combined tax on a corporation distributing all its after tax income to non-corporate shareholders is lower than the maximum rate of tax on income from other sources, including specified service business income.<sup>90</sup> Income from an unincorporated, capital intensive trade

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85. I.R.C. § 199A(d) (added by the TCJA and excluding specified service business income from professional services (medicine, law, architecture, accounting, etc.) in excess of certain thresholds).

86. I.R.C. § 199A(d)(1)(B).

87. A 12.4% tax on gross wages and self-employment income with a cap. I.R.C. § 1401(a).

88. I.R.C. § 1(h)(11) (imposing a maximum rate of 20%). The statement oversimplifies the rate preference. The rate preference applies to foreign corporations that have U.S. source income. In addition, corporate shareholders receiving dividends from other corporations may deduct some or the entire amount of the dividend. I.R.C. §§ 243, 245A.

89. I.R.C. § 11 (as amended by TCJA).

90. That is 21% corporate tax followed by a 20% individual tax on the 79% remaining—a total of 36.8%. I.R.C. § 199A(d)(1)(A) (legal services, for example).

or business yields a 20% deduction for qualified business income.<sup>91</sup> To the extent a business places depreciable personal property into service, it receives an immediate deduction for the cost of the depreciable property under the current bonus depreciation rules<sup>92</sup>—a significant timing advantage over other depreciation methods.

### B. Capital Gain

The U.S. income tax gives capital gain a position of privilege and protection that it has enjoyed consistently and, except for that brief period after 1986, a preferred rate structure.<sup>93</sup> Even that period when the maximum rate applicable to capital gain was equal to that applicable to other income, the realization requirement for inclusion of capital gain in income<sup>94</sup> left the timing of inclusion within the control of the taxpayer while income from services was periodic and immediately includable. Capital can be preserved and increased without significant interference from tax, but taxes slow the initial accumulation for those without capital by diminishing net disposable income from services that one might invest in capital.

One powerful privilege of capital is that appreciated property, which would generate capital gain if sold during a taxpayer's lifetime,<sup>95</sup> is no longer taxable, except to the extent of post-death appreciation in value, if sold following the taxpayer's death. This disappearance of capital gain occurs because the decedent's adjusted basis in all the decedent's property changes to the fair market value of the property on the date of the decedent's death.<sup>96</sup> This new adjusted basis at death rule

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91. I.R.C. § 199A(a)(2).

92. I.R.C. § 168(k)(1) (allowing a 100% depreciation allowance for most personal property until 2024 and then phase down to 80%, etc.).

93. *Supra* note 75 and accompanying text.

94. I.R.C. § 1001.

95. I.R.C. § 1011 (adjusted basis is cost under I.R.C. § 1012 plus or minus adjustments under I.R.C. § 1016 (depreciation allowances, for example)). If a taxpayer's amount realized (sale price) on the sale or exchange of property exceeds the taxpayer's adjusted basis in the property, the excess is gain. I.R.C. § 1001. Gain is includable in income unless a statute otherwise prevents inclusion. I.R.C. § 1001(c).

96. The excess of the amount realized over adjusted basis becomes zero as the adjusted basis becomes fair market value on date of death. I.R.C. § 1014.

motivates taxpayers to continue to hold property to get the new basis at death for the beneficiaries of their estates longer than they otherwise might do when, absent taxes, holding the property may not be the best economic choice for the property. Instead of selling, taxpayers may monetize their property through borrowing secured by the property. Borrowing is not a taxable event.

Congress may have assumed that a preferential tax rate for capital gain would encourage taxpayers to sell when economically desirable to shift the property to its most productive use. Similarly, other special capital rules enable taxpayers to transfer property without incurring any incidence of taxation on the transfer.<sup>97</sup> In some deferrals the property may be shifted to more productive use while gifts shift the incidence of capital gain taxation to the donee from the donor under whose ownership the property appreciated in value. While shifting of income from capital and capital gain to another taxpayer subject to a lower tax rate, for example, through a gift of the property is permitted,<sup>98</sup> shifting income from the performance of services is not.<sup>99</sup>

Charitable gifts of property over which the donor may retain limited but indirect control do not trigger the recognition of gain from the disposition of the property.<sup>100</sup> Yet, the donor often receives a

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97. *E.g.*, I.R.C. § 351 (transfer to a controlled corporation); I.R.C. § 721 (transfer to a partnership); I.R.C. § 1015 (transfer by gift); I.R.C. § 1031 (like kind exchange of real property).

98. The donor does not recognize gain from transferring property by gift. The donee does not have income from the gift under I.R.C. § 102 but does succeed to the donor's adjusted basis in the property received (I.R.C. § 1015), resulting in built-in gain potential.

99. *Lucas v. Earl*, 281 U.S. 111 (1930) (holding that an assignment of income from services from one spouse to the other would not be valid for tax purposes). Joint return filing rendered the issue moot by permitting general splitting of income between spouses. I.R.C. § 6013.

100. No specific statutory authority exists for this proposition or for the non-recognition of gain by the donor of a non-charitable gift. Under the gain inclusion provision I.R.C. § 1001, there is a disposition but the amount the donor realizes from the disposition is zero so that the donor's adjusted basis always will be greater than or equal to the amount realized and theoretically would have a non-deductible loss under I.R.C. § 165(c) (no deductible loss if the transaction was neither in a trade or business nor a transaction entered into for profit). The donee succeeds to the donor's adjusted basis so any built-in gain is preserved for recognition when the donee sells the

deduction for the charitable gift equal to the fair market value of the property on the date of the gift.<sup>101</sup> The deduction reduces the donor's taxable income from other sources by the value of the donated property. The resulting tax reduction is a tax-based subsidy of the charitable gift, and the donor controls the expenditure of that amount of governmental revenue free from any governmental policy decision on expenditures. The redirection of government revenue through the tax deduction may be fully contrary to current government expenditure policies but nevertheless available as long as the charitable donee meets the very general charitable recipient requirements.<sup>102</sup> An individual without capital also may make deductible charitable contributions, but in most cases of lower, moderate, and middle income taxpayers, the charitable contribution deduction results in little or no tax savings because it generates a tax benefit only when the donor's itemized deductions,<sup>103</sup> including the charitable contribution deduction, exceed the standard deduction.<sup>104</sup> Few taxpayers itemize deductions.<sup>105</sup>

The ability to defer inclusion of capital asset appreciation in income and the rate preference applicable to capital gain encourage extensive tax planning to convert what might be ordinary income into capital gain. Congress repeatedly has enacted legislation to prevent conversion. For example, depreciation allowances on personal property are subject to recapture as ordinary income when the taxpayer disposes of the personal property.<sup>106</sup> Nevertheless, a much criticized opportunity to convert services income into capital gain remains available in the private equity and, to a lesser degree, hedge fund

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property. Sale by a charitable donee will not become taxable because the donee is exempt from tax. I.R.C. § 501.

101. I.R.C. § 170(a), (e).

102. I.R.C. § 501(c)(3) (charitable purposes for organizations exempt from tax and permitted to receive deductible contributions including churches, educational institutions, and civic groups among others).

103. I.R.C. § 63(d).

104. I.R.C. § 63(c) (an inflation adjusted \$12,000 per taxpayer).

105. See David Rae, *The Standard Deduction Is Rising for 2020: Here's What You Need to Know*, FORBES (Dec. 18, 2019), <https://www.forbes.com/sites/davidrae/2019/12/18/standard-deduction-is-rising/#71a391426078> (noting expectation that "more than 90 percent of taxpayers will simply take the standard deduction for tax years 2019 and 2020").

106. I.R.C. § 1245.

industries,<sup>107</sup> as investment managers receive a share of the profits of the fund in the form of an interest in the investment fund entity. This “carried interest” is not taxable when received,<sup>108</sup> but as the manager receives a share of the profits, the tax transparency rules preserve the character of the income of the entity in the hands of the partners.<sup>109</sup> In the case of a private equity fund, the income tends to be capital gain from the sale of the acquired corporate business.

### C. Changing the Base and the Conversation

Why favor capital? Capital receives favorable income tax treatment in many ways: deductions, rates, and timing. Deductions and rates both go to the question of how much, and timing goes to when and if.<sup>110</sup> Elimination of both rate preferences and deferral would broaden the tax base considerably, generate the same revenue at lower marginal rates, and would have a comparatively small impact on taxpayers with little property. Favorable treatment of capital gain when includable in income, along with the ability of taxpayers to defer recognizing capital gain, severely hampers the development of a comprehensive tax base.<sup>111</sup>

The rate preference for capital gain is a mainstay of the U.S. tax system. The rate preference at one time may have ameliorated the effect of very high progressive tax rates on concentrated income.<sup>112</sup> Current income tax rates have retreated considerably.<sup>113</sup> Yet the preference for capital gain has endured and expanded to other income from capital.<sup>114</sup> Professor Blum concluded in 1957 that the rate preference was

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107. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1 (2008).

108. Rev. Proc. 93-27, 1993-2 C.B. 343.

109. I.R.C. § 702(b) (character and source of partnership allocations flow through to partners).

110. See *supra* note 96 and accompanying text.

111. SIMONS, *supra* note 5, at 50.

112. Walter J. Blum, *A Handy Summary of Capital Gains Arguments*, 35 TAXES 247, 260 (1957).

113. The maximum tax rate in the 1950s was 91%. See *Historical Highest Marginal Income Tax Rates*, TAX POL’Y CTR. (Feb. 4, 2020), <https://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates>.

114. *Supra* notes 87-93 and accompanying text.

unjustified as he cataloged the arguments.<sup>115</sup> The validity of Blum's arguments remains compelling. The rate preference is not supportable under a sustainable tax system. Income is income, and the rate preference for capital gain discriminates against those who have little or no capital. Inertia and political influence supported by the threat posed by capital mobility best explain the continuation of the capital gain preference.<sup>116</sup> Arguments that reduced rates on capital gain prevent capital flight remain overstated. Evidence has been to the contrary. Concealment of capital offshore<sup>117</sup> and expatriation to avoid taxes<sup>118</sup> as well as corporate inversions to avoid the U.S. taxation of worldwide income<sup>119</sup> seem unlikely to stop even with rate reductions.<sup>120</sup> There is little or no evidence that rate reduction correlates with job creation and a better economic life for all.

Rate preferences for capital gain are only one aspect of the capital preference. Elimination of the ability to escape tax on accumulated appreciation at death also is critical. Whatever assumptions one once made about lack of records to support new basis at death rules no longer are valid. With respect to securities, brokers now are required to retain basis records for their clients.<sup>121</sup> There no longer is a general roll-over for personal residences,<sup>122</sup> so taxpayers selling a personal residence must report their gain when they sell and may exclude part of the gain but must have retained their records.<sup>123</sup>

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115. Blum, *supra* note 112.

116. *Id.* at 266.

117. The Foreign Account Tax Compliance Act, Pub. L. No. 111-147, § 501 *et seq.*, 124 Stat. 71, 97-117 (2010), has enjoyed some success in compelling U.S. taxpayers to report their offshore accounts. *See* I.R.C. § 6038D.

118. I.R.C. § 877A (expatriation tax includes all deferred gain and capital appreciation in income at the moment of expatriation).

119. I.R.C. § 7874 (continuation tax on expatriated entities).

120. The reduction of the corporate tax rate from 35 to 21% by the TCJA (I.R.C. § 11) and the corporate dividends received deduction for foreign source income of a foreign subsidiary may reduce the push for corporate inversions. However, the combination of the base erosion tax under I.R.C. § 59A and the inclusion of global intangible low-taxed income under I.R.C. § 951A may offset that effect.

121. I.R.C. § 6045(g).

122. I.R.C. § 1034 (1996) (repealed by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312(b), 111 Stat. 788, 838).

123. I.R.C. § 121 (limited gain exclusion).

Better would be the annual inclusion of appreciation and deduction of depreciation in the value of each taxpayer's property. Purging the realization requirement would yield a comprehensive income tax base and serve as a more complete measure of each taxpayer's income.<sup>124</sup> Valuation problems abound but not for property with an active trading market. For other intangible investment property, self-interest of fund managers<sup>125</sup> has developed reasonably accurate techniques for evaluating securities for which no trading market exists. Databases exist throughout the United States for real property values to facilitate assessment of *ad valorem* property taxation at the local level. Improvement and consolidation of those databases and annual updates would not be a formidable task given advances in computer technology. For other property, large database management would become necessary but, once developed, a database should be relatively straightforward to adjust for value changes.<sup>126</sup> Certainly some income still would be excluded from the base although including imputed income from an owner's use of her personal residence easily could become the next step in taxing capital once a national database is in place.<sup>127</sup>

The recently enacted transition tax<sup>128</sup> offers good insights into making the transition to a comprehensive base palatable. Averaging the inclusion over several years, temporarily reducing the tax rate, and deferring payment in appropriate circumstances until an actual sale yields proceeds with which to pay the tax would all ease the transition to non-realization based taxation.<sup>129</sup> The transition tax also dispels any lingering doubts concerning realization as a constitutional requirement as it follows on an uneven flow of income without realization statutes,

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124. SIMONS, *supra* note 5, at 50.

125. Private equity and hedge funds in which the manager's compensation depends on the advance in value.

126. Possibly even to the tax collector reporting value to the taxpayer annually under a system that might warm Joseph Bankman's heart. *Supra* note 35 and accompanying text.

127. Henry Ordower, *Income Imputation: Toward Equal Treatment of Renters and Owners*, in *CONTROVERSIES IN TAX LAW: A MATTER OF PERSPECTIVE* 47 (Anthony C. Infanti ed., 2015).

128. I.R.C. § 965 (added by the TCJA and requiring 10% shareholders of foreign corporations to include their shares of accumulated foreign income in 2018).

129. Henry Ordower, *Abandoning Realization and the Transition Tax: Toward a Comprehensive Tax Base*, 67 *BUFF. L. REV.* 1371 (2019).

such as foreign personal holding companies,<sup>130</sup> mark-to-market for certain investment property,<sup>131</sup> positions held by securities dealers,<sup>132</sup> and expatriation as a taxable event,<sup>133</sup> but approaches the facts of the *Eisner v. Macomber*<sup>134</sup> decision that required realization as a condition to inclusion in taxable income.

## V. CONCLUSION: A SINGLE SUSTAINABLE INCOME TAX

Following transition to this comprehensive tax base, integration of the three separate elements of the income tax into a single tax is the final step. The comprehensive base and elimination of rate preferences integrates taxation of capital gain with taxation of other income. The Social Security tax is the third element. Continuation of the separate base for the Social Security tax no longer remains compelling. There is precedent for grafting what once was a wage tax onto a much broader base to include investment income when revenue was needed to fund a more comprehensive health insurance system.<sup>135</sup> Following that restructuring, integration of the three elements would simplify the income tax greatly, make the income tax treatment of all taxpayers comparable and even-handed, and treat all income equally for all purposes. Even if the transition were accompanied by further flattening of rates,<sup>136</sup> use of a single base would be simpler, distributionally fairer, and more transparent than the existing income tax. The tax would meet all the requirements for sustainability and would remain sustainable once established if the legislature would use the tax infrastructure only for revenue purposes and create a new and transparent administrative infrastructure to deliver subsidies and advance non-revenue related policies.

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130. I.R.C. § 551 (2003) (repealed by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 413(a)(1), 118 Stat. 1418, 1506).

131. I.R.C. § 1256.

132. I.R.C. § 475.

133. I.R.C. § 877A.

134. 252 U.S. 189 (1920).

135. I.R.C. § 1411.

136. The rate system would have at least two brackets—a zero bracket and a positive bracket—as there would be some individuals with small incomes who should not be taxed at all.