A COMPREHENSIVE INCOME TAX BASE FOR THE U.S.?: IMPLICATIONS OF THE REPORT OF THE ROYAL COMMISSION ON TAXATION

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TAX SCHOLARS are in agreement, at least in principle, that an equitable income tax system requires that the tax be imposed on a comprehensive tax base (*CTB*). There is also general agreement that our income tax laws have many significant departures from the *CTB* and that these need to be removed from the system. Furthermore, most U.S. tax scholars have stated that future departures from the *CTB* should be made only in those rare circumstances where a tax provision is the only course consistent with important national priorities or where the *CTB* is administratively impossible.

In addition to tax scholars, many presidents and other political leaders have voiced belief in the *CTB*. Often this agreement is more general and less rigorous in detail than that of the tax experts.

Other less serious supporters of the *CTB* are those groups that are present beneficiaries of departures from the *CTB*. They defend their privilege as at least no less justifiable than others. They ask "why me first?" and insist that the *CTB* be accomplished *before* their privileged position is removed. The familiar cry is "what about oil depletion?"

The public, including the press, also supports the *CTB* in a general fashion. Most of its members, without much detailed knowledge, believe that the law is riddled with loopholes and that the tax system "soaks" them while the "others" get away with much less tax liability.

However, while this seemingly widespread agreement on the *CTB* prevails, little progress has been made toward its implementation. In fact, with the serious disappointment following the lack of substantial progress under the Kennedy and Johnson Administrations, it seemed that the *CTB* was destined to be a subject for classroom discussion and prominent display in political platforms and no more.

However, several events have served to keep interest in the *CTB* at a high level in many quarters. Not the least of these events was the Report of the Royal Commission on Taxation [1] which recommended late in 1966 that Canada adopt a comprehensive tax base; more comprehensive perhaps than any ever recommended by U.S. scholars. Since this was part of what was probably the most extensive and fully reasoned examination of a modern tax system, the recommendation was bound to create new interest in *CTB*.

At the same time seemingly impossible pressures were brought to bear on the tax resources of our federal, state and local governments. These arose out of the combined impact of the Viet Nam war and the urgent need for vastly increased expenditures to cope with the problems of our cities, poverty, racial inequities, increasingly dangerous pollution of our natural environment, lagging medical care, and inadequate transportation and education systems. These needs for increased revenues have led to increasingly vocal demands for the elimination of special privileges and loopholes in our tax law.

The most dramatic aspect of this new

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[1] Report of the Royal Commission on Taxation (Queens Printer, Ottawa 1966) (cited herein as the "Commission Report").

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interest is the wide-spread support of political leaders for a "minimum tax" on those among the wealthy who pay little or no taxes. On January 17, 1969, the outgoing Secretary of the Treasury warned the Joint Economic Committee of the possibility of a taxpayer revolt by the "millions of middle-class families with income of $7,000 to $20,000 who now pay over half of our individual income taxes" if we do not soon reform our taxes. The Secretary attributed the danger not to the absolute level of taxes but rather to concern and anger about high income recipients who pay little or no federal taxes. The "minimum tax" proposals are indirect approaches to broadening of the income base and are by their very nature only a partial closing of the gaps. The reform recommendations left behind by the outgoing Treasury contain such a recommendation.[2]

In the same vein are the proposals of Senator Russell Long for a simplified optional tax from which the minimum tax proposals evolved. Unlike the minimum tax proposals, the optional plan would not necessarily impose an increased tax on those enjoying large tax benefits. Rather it would have sought to entice people to abandon their complicated tax saving gimmicks in exchange for a lower rate schedule. Since the minimum tax proposals would operate efficiently only if the alternative rates were near zero, they had their problems and would, if enacted, undoubtedly only have made real reform more difficult to attain. Again, a modified version of this in the form of a "maximum tax" of 50 per cent[3] is contained in the reform left over from the Johnson Administration.

Questions raised by an influential U.S. tax scholar about whether the general agreement on the *CTB* is more apparent than real has also re-enforced the new interests in the *CTB*. Professor Bittker's 1967 article[4] has led to a serious re-examination by tax scholars of the extent of the agreement on *CTB*, whether there exist objective criteria for departures from it, and its usefulness as a standard for tax policy.

The focus, frequently, is on the use of *CTB* in examining and evaluating the plethora of proposals for non-revenue uses of the tax system in the attack on

[2] Preliminary reports indicate that the minimum tax would be one-half the ordinary income tax rates applied to taxable income augmented by exempt interest, the excluded half of capital gains, excess of percentage depletion over cost depletion, and unrealized gains on property donated to charity. In effect, the proposal would allow a taxpayer to have up to one-half of his income consist of these four items without any change from existing law. A recommendation of perhaps greater impact is for a broad allocation of deductions among ordinary and exempt or capital gain income. While a commendable first step, the minimum tax would be only a partial closing of the *CTB* gap. It is highly likely that those affected will fight as hard to block these two changes as they would a direct frontal attack on them.

[3] The "maximum tax" would be an overall 50 per cent on a base which would be the four items covered by the "minimum tax" proposal described in footnote 2. The proposal is only likely to cut taxes for extremely high ordinary income earners whose *effective* rate of tax today exceeds 50 per cent (taxable income above $150,000 on joint return). The strategy is good —if top rates are to be reduced, those who already enjoy low effective rates of tax because of substantial income from these four items are not in need of any further reduction.

[4] Bittker, "A 'Comprehensive' Tax Base as a Goal of Income Tax Reform," 80 Harvard L. Rev. 925 (1967). This sparked quick defenses of the *CTB*. Musgrave, "In Defense of an Income Concept," 81 Harv. L. Rev. 44 (1967); Pechman, "Comprehensive Income Taxation: A Comment," 81 Harv. L. Rev. 63 (1967); Galvin, "More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and ABA's CSTR," 81 Harv. L. Rev. 1016 (1968). And a rebuttal by Professor Bittker, "Comprehensive Income Taxation: A Response," 81 Harv. L. Rev. 1032 (1968). It is interesting to note that after this debate the ABA's Substantive Tax Reform Project has described its efforts as "base broadening." See A. F. & D. J. Ott, "Simulation of Revenue and Tax Structure Implications of Broadening the Federal Income Tax Base" (Amer. Bar Foundation, 1968).

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the serious problems of our time. These include low income housing, unemployment, balance of payments, financing of education, and pollution. In some ways the pressure for action in some of these areas plus the generally unbending opposition of tax scholars to the use of tax incentives was responsible for the questions raised by Professor Bittker.

Since the new Administration of President Nixon appears to be strongly committed to the use of tax incentives to induce private enterprise to play a greater role in solving many of our current problems and since Chairman Mills of the Ways and Means Committee of the House of Representatives is opposed to such "backdoor financing," there will undoubtedly be serious debate in the political arena soon. Preliminary sparring had already occurred in the last few years on suggested tax incentives for low-income housing, pollution abatement equipment and higher education expenses. However, the forthcoming debates are likely to be the crucial stages in the controversy in view of the strong support they may receive from the President. The recent scheduling of very extensive hearings on substantive tax reform by the Ways and Means Committee [5] may be an effort to use an offensive on positive reform as the best defense to further encroachments in the form of such tax incentives.

It is the purpose of this paper to reexamine the usefulness of the *CTB* as a guide to the formulation of tax policy in the United States, and the impact, if any of the recommendation of the Canadian Royal Commission. It is also the purpose of this paper to note briefly the usefulness for the future tax policy of "full accounting" for the indirect budgetary cost of tax incentives as distinguished from a blanket reliance on a *CTB* principle.

[5] Press Release No. 2, of the Committee on Ways and Means (January 29, 1969).

Why a Comprehensive Tax Base?

The justifications for a *CTB* are many.[6] They are fundamentally related to the attractiveness of income taxes relative to most other forms of taxation. The equitable virtue of an income tax is that it can be assessed on individuals according to their ability to pay as measured by annual increments in wealth. However, here the *CTB* is necessary. If departures from *CTB* are significant, they will defeat this basic justification for heavy reliance on an income tax.

Its economic justification is that it is neutrally poised vis-a-vis different investments and economic activities. Only profits are taxed and profits from all sources are taxed in the same fashion. Therefore, those activities giving rise to the greatest profits will still be the most attractive. Thus, it interferes as do all taxes with employment and investment choices but only in a neutral fashion. Here again the *CTB* is a prerequisite since if profits from certain sources are taxed differently than others, economic efforts may flow to the favored source.

The preference for an income tax does not always require a progressive tax. In fact, many of its proponents would support a proportional tax on incomes. For example, not really knowing what are its effect on incentives to work and invest, some would argue that economic neutrality can best be maintained with a proportional income tax. However, to others the progressive element is vital for equitable and perhaps economic stability reasons. Departures from *CTB* can offset progressivity very seriously and thus diminish a critical aspect of the income tax for such supporters.

Part of the justification for an income tax is based on unprovable premises concerning its incidence. The possibility that

[6] For a full discussion of the advantages and disadvantages of an income tax and the *CTB*, see Goode, THE INDIVIDUAL INCOME TAX (The Brookings Institution, 1964).

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income taxes are "passed along" to consumers or "passed back" to suppliers is normally excluded. This possibility, especially plausible in the case of the corporate tax, undercuts the equity argument, to some extent, and also to a lesser degree perhaps the economic neutrality aspects. However, *CTB* is important even if incidence is not as assumed since departures from *CTB* could produce distortions in resource allocation also.

Administrative feasibility is not one of the great virtures of an income tax. The income tax is simpler to administer than the Haig-Simons theoretically perfect tax —one imposed on consumption and net additions to economic power during the year. But it is also probably more difficult to collect than many indirect taxes —such as sales, excises, turnovers. And a *fully* comprehensive tax base would be an administrative nightmare. This is not to say that a much more comprehensive base—a "broadened" but not perfectly comprehensive base—would be more difficult to administer. Indeed, as will be discussed below, in most respects it can be concluded that the proposed Canadian system would be far easier to administer than the present U.S. system.

Political Feasibility of a CTB

Undue concern for political feasibility can be overdone and itself become a determining factor in tax policy. The failure of the Treasury to boldly attack percentage depletion in the last eight years may be a case in point. But political feasibility is a factor that cannot be ignored in making short range predictions. High income taxes are not politically attractive even with a pain-killing withholding system. No tax is pleasant but highly visible taxes are most unpleasant. Income taxes, like property taxes, are too visible and, therefore, never very pleasant. The *CTB* is much less politically palatable than the present system. This may be irrational since a *CTB* with low rates may benefit a greater number than those hurt by the switchover. But political feasibility is not a question of numbers or rationality. Thus even if the majority wished to remove loopholes of the few, the result would not necessarily follow in the absence of dramatic changes in the financing and conduct of political campaigns in this country. Furthermore, many tax benefits are now fairly widely enjoyed—absence of imputed rentals from the tax base, exclusion of social security payments, deductibility of real estate tax and interest payments on personal homes, deductibility of church dues, the tax benefits of pension and profit-sharing plan benefits and numerous other tax free "fringes" such as medical care and group life insurance. Efforts to eliminate these would not necessarily receive widespread political support even if lower rates for most were promised.

Complexity is another fact of life for an income tax system of a sophisticated economic society. Complexity is not a friend of the *CTB*. Complexity helps to make achievement of the *CTB* politically difficult. The public, the Congress and even the experts sometimes simply can't understand what's involved. How many tax scholars really understand the manner in which insurance companies are taxed? And the *apparent* greater complexity of the *CTB* insofar as the tax base is concerned often frightens the public. Proponents of the present base easily shrug off promised lower rates by arguing that they would be temporary, only to be followed by higher rates on the broadened base. While the public seems to support elimination of loopholes, we are a long way from a public clamor for a *true CTB*.

Thus, the political situation in the U.S. is not now one that awaits the clarion call for a *CTB*. An operating Canadian *CTB* might have a stronger impact. But apparently the political scene north of the border is little different from ours. While there is still discussion of implementing some recommendations of the

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Commission, we are not likely to see enactment of its major proposals soon.

The significant effect of the Canadian study will be in its lasting influence on our tax scholars and advisers. Its thorough and careful reasoning and its comprehensive scope undoubtedly destine the Report for lasting importance in this manner. Regardless of agreement or disagreement with any of the particular recommendations, anyone advising on or making tax policy decisions, or teaching or writing in the tax field will have to be aware of the views of the Commission to do his job properly.

The Proposed Canadian System

The Royal Commission arrived at its comprehensive tax base by first considering the objectives of a tax system. Among those it ranked equity first and foremost. Equity requires horizontal (individuals and families in similar circumstances bear the same taxes) and vertical equity (those in different circumstances bear appropriately different taxes). The Commission forthrightly recognized that decisions about which personal circumstances should be recognized in allocating tax burdens among individuals and families and about how tax burdens should differ among those in different circumstances could not be made on the basis of pure logic or objective proof. The Commission stated they are "both questions of belief rather than of fact. We can do no more than recommend what we believe to be fair."[7]

The Commission employed the concepts of discretionary and non-discretionary economic power. Non-discretionary economic power was defined as the power to command goods and services for non-discretionary needs—family obligations and responsibilities and to provide the "necessities" of life. Discretionary economic power was the residual after meeting non-discretionary needs. The Commission further sought partially to avoid the controversy about progressive versus proportional taxation. It assumed that the fairest system is one in which all individuals and families pay taxes that are a constant proportion of their discretionary economic power. However, since it assumed that non-discretionary needs rise with increasing income but at a rate slower than the rise in income itself, its proposal results in a system of rates which are progressive when total income is considered.

The Commission recommended that the base for tax be the value of the annual net gain or loss in units of discretionary economic power regardless of how or from what source obtained. Thus, it recommended a comprehensive tax base as a guiding standard.

Aside from allowing for an increase in non-discretionary expenditures with rising income, the principal general departure from the comprehensive tax base was to allow for differences between units with heavy family obligations and those with light obligations. These differences would be recognized through the adoption of different rate schedules, tax credits for dependents and educational expenses and deductions for unusual medical expenses.

Major Changes in Tax Base

While the Commission would make many changes in either the present Canadian or U.S. systems to achieve the recommended comprehensive tax base, the basic thrust of its comprehensive base can be gleaned from an examination of five major items.

1. *The Integrated Tax.* The income of intermediaries (corporations, trusts, etc.) would currently, or on a postponed basis, be brought into the tax base of individuals.[8] Like U.S. partnerships or U.S. trusts which distribute all their income, intermediaries would not be taxable. But they would, on a current basis, collect withholding taxes on the ultimate tax

[7] Commission Report, Vol. I, p. 5.

[8] Commission Report, Vol. 4, Part B.

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liability of their shareholders or beneficiaries. Since withholding would be made at a 50 per cent rate, the highest individual marginal rate, there would be no advantage to accumulating income in intermediaries.

The principal change under this heading would be the integration of the corporate and individual income taxes through the elimination of a separate corporate tax. The withholding tax at the corporate level would be 50 per cent, identical with the highest marginal rate on individuals. Thus the distribution of dividends (grossed-up to include the withheld taxes) would not result in any additional tax liability for shareholders and most would receive a refund.

The effect of such a change on the U.S. tax system, from a lawyer's viewpoint, would be an enormous simplification of the law. More importantly, it would produce the same tax result for a variety of situations similar in substance but different in technical form which today may result in vastly different tax consequences.

Undoubtedly among the most complex provisions in our law today are those contained in Subchapter C of the income tax portion of the Internal Revenue Code. This subchapter deals with corporate formations, distributions, redemptions, liquidations, divisions and reorganizations. The elimination of a separate corporate tax would immediately wipe out much of the relevance of these provisions. The balance would drop by the wayside with the introduction of the second major recommendation discussed below, the elimination of lower rates of tax on capital gains.

Since these corporate provisions relate to transactions largely engaged in by sophisticated and wealthy taxpayers, the complexity by itself is perhaps not a major fault. However, the complexity does serve to hide and accomplish major inequities as between different taxpayer groups. Further, the economic waste that results from the devotion of large amounts of the time of executives and professionals to the task of manipulating these provisions is not small. Of what economic or social value are the intricate concepts of "earnings and profits," "collapsible corporations," "partial liquidations," all designed to distinguish dividend distributions from capital distributions by corporations? They are fascinating intellectual games for tax lawyers and perhaps interesting diversions for the taxpayer but the policy ends they serve are less than clear. Complex problems also arise in the "frontier" areas between those situations in which the dual corporate and shareholder taxes apply and those in which the corporate tax may be avoided. Related equally intricate and worthless (from a policy viewpoint) provisions that would disappear would be those dealing with personal holding companies, multiple corporations, and accumulated earnings. Few would decry their departure. The job would be completed by the Commission's virtual elimination of the tax-free corporate merger. This change—removing the tax inducements to the increasing tendency toward larger corporations, the so-called "conglomerates"—might well have other legal and economic consequences.

An integrated tax system could present some new practical problems—what to do with changing shareholders, how to divide profits among different classes of stockholders. The latter problem would incidentally be offset by the reduction of the pressures on the current line between debt and equity caused by the fact that interest is deductible, while dividends are not. In sum, any new problems would be dwarfed by those eliminated by the Commission's recommendations.

2. *Capital Gains.* The Commission would do away with any distinction between ordinary income and capital gains on the disposition of property.[9] In Can-

[9] Commission Report, Vol. 3, ch. 15.

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ada this would mean changing the rate from the present zero rate to a full ordinary income rate. In the United States it would mean increasing the tax rate on capital gains from 25 per cent (or less) to the full marginal rate (which the Commission would set at a maximum of 50 per cent).

While recommending the full taxation of realized gains from the disposition of property, the Commission did not recommend annual taxation of unrealized gains. However, it would tax unrealized gains at the death of the owner unless the property stayed within the family unit (generally the spouse and minor children), on gifts made during lifetime outside the family unit, and also on the taxpayer's permanent departure from the country.

The Commission noted that its recommendations concerning capital gains taxation could be adopted without severe economic disruption only in conjunction with its other recommendations, including reduced marginal personal rates of tax, extremely liberal averaging and loss provisions, and full credit to residents for the Canadian corporation tax. Since the Canadians were moving from a position of zero to full taxation, they could recommend, without too much administrative confusion, that only gains accruing after the effective date of the new proposal be subject to full taxation. Such a recommendation in the U.S. context would create some complexities but would not be impossible. The Commission's suggestions for solving the problem of valuing property at the effective date are quite practical. The Commission would allow taxpayers to settle these valuations either with the tax officials or, if not, through current court proceedings. In the alternative if the taxpayer wished to wait until the property were disposed of his gain on ultimate realization would be deemed to have occurred evenly over the period the property was held.

It would be a gross understatement to say that this change would simplify the U.S. income picture. Much of all tax planning has as its goal the conversion of gain into capital form or to escape entirely the tax on such gain through holding until death. The theoretical distinction between capital and income is one that disintegrates on close inspection. Efforts to draw the distinction in the tax law are and must be arbitrary. Adding to the inequities of the basic distinction is special legislation by which the capital gain treatment has been extended in favor of certain groups—for example, inventors but not authors, Christmas tree growers but not painters, recipients of lump-sum distributions from corporate pension plans but not retirement payments to members of professional partnerships, racing horse sales but not jockey's salaries. The removal of the capital gains distinction and of the separate corporate tax together with the reduction of the highest personal rate to 50 per cent, the same as the corporate withholding rate, would end most of today's intricate income tax planning involving corporations. In addition, the elimination of the distinction would go a long way toward ending the "real estate tax shelter" which depends on the possibility of ultimate sell out at a capital gains tax.

One necessary price for the elimination of the capital gains distinction would be the liberal averaging and loss provisions recommended. While these would introduce some new complexities, the simplifications would overwhelmingly exceed these. Furthermore, these complexities, unlike many of the present law, would serve an equitable purpose and thus be tolerable on that basis.

3. *Gift and Inheritances.* Under the all inclusive definition of income used in Internal Revenue Code ("all income from whatever source derived") and its constitutional and statutory interpretation by our courts, it is likely that gifts and inheritances, presently explicitly excluded,

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could be made part of gross income. The Royal Commission's recommendation that gifts and inheritances be included in income [10] could thus be accomplished by a simple repeal of Section 102 of the Internal Revenue Code with appropriate legislative history indicating the congressional intent to have gifts and inheritances taxed. At the same time, the Royal Commission would eliminate all estate and gift taxes. While some relatively minor complexities would be added to the income tax system as a result of the inclusion of such gifts as income, the simplification that would result overall would be enormous. A few obvious examples are the following. For taxable gifts, the donor would no longer have to keep life-long records of gifts as is now required in order to compute the tax on any gift. The donee's cost or basis for tax purtoses would be fair market value at the time of the gift rather than the existing rule which requires the donee to use the same cost that his donor had. The latter figure is often lost in the deep mists of the donors past. The complexity of the estate and gift tax, one largely eroded by sophisticated planners and extremely technical loopholes, would largely be removed in one stroke. Thus the problem of "generation-skipping" through the trust would be handled easily since each distributee would always have to include whatever he received in income and the device of withholding from the trust would remove any advantages of delay. Estate planning would still have to concern itself with taxation, but it would be considerably simplified for both the lawyer and the client alike. For example, one of the new planning problems would involve the effort to spread gifts to keep rates low for the recipients. But the comprehensive averaging systems allowed under the Royal Commission report [11] and the exclusions for intrafamily gifts might make even these problems minimal as compared to the current problems.

The philosophy of the estate and gift tax, obscured in the past and now probably controversial, would be removed. In its stead would be substituted the widely accepted concept of "ability to pay" based on annual increments in economic power. The announcement in the U.S., however, of this approach for gifts and inheritances is not likely to produce deafening applause. Efforts to create interest in the improvement of the present estate and gift tax laws have met surprisingly strong opposition from a largely conservative legal profession and financial community. Unlike the thirties, there now are no public demands in this country for heavy inheritance taxes. Suggestions of an accessions tax (in which death taxes depend on the cumulative gifts and inheritances received by each donee) have been considered by the American Law Institute briefly but dismissed as too revolutionary.[12] Surely an accessions tax as a substitute for the present estate and gift tax is a far less drastic move than would be the Royal Commission's recommendation. Even though the Royal Commission recommendation may have the virtue of simplicity as compared to an accessions tax proposal, it would still most likely meet very solid opposition. It would require at least a generation of education before one could hope to be able even to discuss it rationally. In short, it cannot now be seriously considered in the U.S. although it should be discussed frequently by scholars and teachers.

4. *Social Security, Employment Insurance and other Government Transfer Payments.* The suggestion of the Commission that all government transfer payments be included in income [13] would, of course, not mean that they would be

[10] Commission Report, Vol. 3, ch. 17.
[11] Commission Report, Vol. 3, ch. 13.
[12] Described in Andrews, "The Accessions Tax Proposal," 22 TAX L. REV. 589 (1967).
[13] Commission Report, Vol. 3, ch. 18.

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taxed. Personal exemptions and devices such as the U.S. minimum standard deduction could continue to be used to avoid taxation of such benefits in most instances. However, where appropriate, that is when added to substantial income from other sources, the inclusion would result in tax liability. This would create a more equitable system. Presently two taxpayers, one working and receiving only wages, and the other retired and receiving social security and investment income may be taxed quite differently even though their annual receipts are equal. Furthermore, the disparity operates only in favor of the high income aged, a small percentage of their total numbers, and so is "upside down" aid to the aged. Inclusion of social security payments in income would eliminate this irrationality.

Problems would be created if one felt obliged to give credit for the contributions made by the individual to the social security or other transfer system. To the extent that the financing of social security and other problems become separated from the funded or "social insurance" concept, this concern would, of course, diminish. The connection between the taxes paid and benefits received would then be too remote. Or the problem could be handled by arbitrary allowances for assumed contributions. But this would detract from the progressiveness of the system. It would be far better to simply allow general levels of non-taxability to do the job where appropriate and, in particular, devices such as the minimum standard deduction.

5. *Special Incentives for the Natural Resource Industries and Others.* The Commission stated that it should be "a goal of the tax system to avoid tax concessions to particular industries and to particular kinds of income." [14] With this in mind, the Commission examined forthrightly the Canadian three-year exemption from tax for new mines and percentage depletion allowances not related to cost.[15] It concluded that these were ill advised — "inefficient" and "excessive." Recommendations were made, however, for generous immediate writeoffs for exploration and development (transitionally) costs.

The effect of percentage depletion on the U.S. system is large both in revenues and even more so in its impact on taxpayer confidence in the equity of our tax laws. Even though it may not be the biggest loophole, it is so regarded by the public. Removal of percentage depletion might create serious dislocations for investors in natural resources but it need not create any complexities for tax law administration. With hindsight, the difficult problems of cost depletion that led to the percentage depletion monster could have been avoided by generous write-off provisions for actual costs well in advance of actual depletion of the property. On the other hand, with the repeal of percentage depletion a vast body of complex tax law relating to natural resources that frequently bears little resemblance to the "normal" tax world could be substantially reduced if not eliminated. The effects on tax administration and equity would thus be extremely favorable.

However, it will take considerably more than a Royal Commission to dislodge the oil and other resource lobbies in the U.S. The impact of example might be stronger if Canada were to adopt the Commission proposals. But even then the political prospects are not good. It is noteworthy that in two major sets of reform proposals, the Kennedy-Johnson Administrations never attacked percentage depletion directly. The Johnson Administration did not even include such proposals in the tax reform package it bequeathed to the successor Nixon Administration in 1969. These failures to even propose reform are probably accurate reflections of current political realities in the U.S. but they are wasted

[14] Commission Report, Vol. 2, p. 11.

[15] Commission Report, Vol. 4, ch. 23.

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opportunities for beginning the long process of building the public support that such major efforts require. In the long run, greater urbanization and increased representation of urban society in the Congress could shake the strength of the present oil power structure. The continued existence of the "symbolic loophole" will unfortunately in the meantime serve to discourage taxpayer support for other significant tax reforms. In a press release dated January 29, 1969, the Ways and Means Committee announced extensive hearings on tax reform. Included in the list of subjects on which testimony is solicited is possible revision of percentage depletion. This should probably not be taken as a sign of impending doom for this part of our way of life but rather as a gesture on the part of the Committee, a showing of its intent to examine all aspects of the tax system.

Gaps in the Commission's "Comprehensive" Tax Base

While closing many significant gaps, the Commission left many holes in the theoretically perfect base. Some of these are relatively insignificant. A few, listed below, are more important.

1. *Annual Unrealized Appreciation.* While always stating that it is theoretically correct annually to tax unrealized appreciation in the value of property, most tax scholars shy away from the possibility of taxing such income. Since most earned income is normally included in the base, this means that the usual concept of a comprehensive tax base is unbalanced in favor of property ownership. Of course, the magnitude of the present distortion would be greatly reduced if the Canadian system were adopted. Unrealized gains could not escape taxation entirely as is presently possible. Gains would be taxed at death, at the latest. Furthermore, such gains when realized would be taxed at the ordinary rates and not a special capital gains rate. There would remain the substantial factor of interest, when taxes are postponed for a number of years as a result of not taxing annual unrealized gains. The problem might be increased if the taxation of capital gains at ordinary rates served to encourage more holding of property until death. However, the Canadian Commission like others before them also shyed away from the practicality of taxing unrealized gain or using some other alternative to approximate this.

This fear may have been overstated. It is true that arguments about valuation of property are often difficult and prolonged under our tax system. However, these arguments are usually as to the value of a gift for gift tax purposes or the value of property in an estate for estate tax purposes. The valuation problems that would arise under an annual tax on unrealized gain are very different. Since an estate or gift tax is only imposed once, the stakes are very high. On the other hand, income tax arguments about unrealized gain for a particular year would not be in an "all or nothing" context. If the government did not succeed in taxing the gain in year one it might succeed in year two. This would take some of the pressure off both the government and the taxpayer and considerably ease the problem although admittedly not eliminate it (witness the arguments about depreciation.)

It should be noted that most investments are in publicly traded stocks, with the exception of private homes. Thus, the problems would not apply to most of the population, especially if there were generous exclusions. As to private homes, there are interesting possibilities for cooperation between the federal and local governments. Local property tax valuation procedures leave much to be desired and do not work very equitably. However, if the federal government were interested in valuing real property, the possibility of federal funding of local assessors' offices to employ better personnel and computers is presented. Or

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the federal valuation figures might be adopted for local purposes. Thus, one of the indirect benefits might be an improvement in the equity and efficiency of the local property tax.

Some have suggested that we periodically tax at least the unrealized gains in publicly traded stock where fair market can easily be ascertained. This would militate against investments in such stock and in favor of the kind of property which would not be valued annually. This would introduce a new distortion into our system and it probably would be better not to tax any unrealized gain if it were not possible to tax all.

Once the impossibility of taxing unrealized gains is accepted, it becomes important to determine the magnitude of this exception and what countervailing balances, if any, are needed in the system to compensate the non-propertied taxpayer. The same could be said of imputed rents, discussed below. This is the kind of argument which gives substance to the problems raised by Professor Bittker in his Harvard articles. It is beyond the scope of this article to attempt to measure the magnitude of the discrepancy and to determine what counter-balancing methods would be appropriate. Fringe benefits for wage earners are obviously one approach. Generous averaging procedures for earned income giving similar interest benefits (such as our pension plan provisions) might be another.

2. *Liberalized Depreciation, Deduction of Exploration and Development Costs for Natural Resources, and Research and Development Expenses.* The Canadian Commission made persuasive arguments for certain benefits to encourage risky investment. The Commission felt that Canada is in the position of needing a vast amount of industrial development and continued high development of its natural resources. Arguing that such investments are often difficult and risky, for example, exploring for natural resources in far distant parts of the Dominion, or in competition with giant U.S. competitors, the Commission recommended that certain tax benefits designed to encourage the taking of such risks be continued although its principal conclusions hold that such incentives are best given through direct grants. Thus, it recommended the continued deduction of exploration and development (for a transitional period) expenditures for the mining and oil industries, although these costs would normally have to be capitalized.[16] Similarly, continued liberalized depreciation practices especially for small new firms and immediate write-off of research and development expenditures were recommended.[17]

It is quite clear that all the usual problems connected with tax incentives—inefficiency, possible windfalls, obscurity in the planning of national budget, misallocations of resources, etc—apply to the limited incentives that the Commission recommended. The only difference between these and others not so favored by the Commission was its sense of urgency about the need for encouragement to risk taking in certain areas. Transposed to the U.S. context, the investment tax credit or tax incentives for the solution of many of our urban problems might have as much urgency, and can not be dismissed merely because they depart from the *CTB*. Rather, the implication from the Canadian Report would appear to be that they should be judged on their own individual merits. Moreover, assuming less than a full *CTB* its arguable that they be judged on the basis of relative urgency as compared to other incorrigible discrepancies. Thus, it is not sufficient to prove that a tax incentive for low-income housing is inefficient as compared to a direct method. Undoubtedly the Commission might concede that a tax incentive in the form of

[16] Commission Report, Vol. 4, ch. 23.
[17] Commission Report, Vol. 4, ch. 22.

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quick write-offs for mineral exploration is also theoretically inefficient as compared to direct subsidies.

3. *Imputed Rentals.* The Commission did not dispute that homeowners have an advantage over renters since no income is imputed on the homeowner's equity. It noted that the exclusion results in the loss of material revenues and is a substantial tax preference in favor of home owners. However, it nevertheless failed to recommend taxation of imputed rentals because it did not believe it was administratively feasible to do so. It also concluded that it was administratively impossible to compensate for not doing so by giving renters some offsetting advantage.

The Canadian system does not allow deduction of the homeowner's interest or property taxes. The Commission recommended that this feature of the U.S. system be kept out of Canada. One senses that pressures in this direction may be strong in Canada and that the Commission did an important job by taking a firm position against the U.S. rule which very seriously increases the magnitude of the inequities as between renters and owners.

If reform in this area should ever be attempted again (the Treasury unsuccessfully proposed a 5 per cent of adjusted gross income floor on itemized deductions in 1963), the Commission's firm stand would be helpful and should not be discounted. The Commission's *CTB*, however, is sharply deficient in its failure to include imputed rents. The Commission's lack of boldness here contrasts sharply with its courageous and creative approach to other equally difficult problems. It would have been better if it had suggested an approximate method for computing the imputed rents to meet the valuation difficulties.

On the U.S. scene, the Canadian affirmation of the inappropriateness of deductions for residential property taxes and interest payments does not seem to have had any noticeable direct effect. Both the scheduled Ways and Means Committee hearings and the reform proposals left behind by the outgoing administration appear to be indirectly aimed at reducing the inequity of the renter's position by raising the standard deduction. This change would be extremely salutory even though not as precise as a disallowance of mortgage and interest deductions, and the inclusion of imputed rent. Tactically, the approach is a sound one—the political pressures against a liberalization of this kind are not likely to be strong even though the approximate effect is equivalent to the disallowance of part of the homeowner's itemized deductions. Compensatory adjustments for renters are far more difficult to handle under the Canadian system.

4. *Miscellaneous Deductions—Charitable, Medical and Educational.* A true *CTB* might not exclude (or allow deductions for) amounts of income devoted to such personal (non-income producing) allocations as charitable gifts and medical expenses. Educational expenses fall into a vague borderline and could be described as part income producing and part personal. In any event, the latter would seem to be capital expenditures.

Furthermore, allowing deductions for medical or charitable expenses departs from equity for other reasons. Since they are worth more at higher incomes than in the low or zero tax brackets, they are regressive. Deductions as well as credits partake of other disadvantages of tax incentives such as inefficiency (they may reward what would have been done in any event). They may be ineffective—a medical expense deduction is no help to an ill person with no income.

The issues that separate the "true *CTB* believers" from the mere "broad base" supporters are usually in this area. Many persuasive arguments can be made for the exceptions to a *CTB* for items such as medical expenses, charitable gifts and

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certain educational expenses. For example, it can easily be argued as did the Commission that a taxpayer who must spend all his income on medical expenses is unable to pay taxes—he has no discretionary income. Or that charitable gifts are necessary to our pluralistic way of life, that this goal by definition requires that the funds devoted be private but that their social utility means that they should not be treated as personal consumption. The *CTB* in the pure sense nevertheless suffers from such non-income producing departures. The answer is probably that the *CTB* is not the sole principle on which an income tax system is to be built. That "ability to pay" is, for example, the primary criterion and that the *CTB* is merely a good approximation of this *ordinarily*. This rationale perhaps takes care of the medical expense point. The charitable point is more harmful to *CTB*—its justification is no different than that given for any other important and socially useful goal for which incentives are sought. It is only a matter of proof—does the goal strongly require private expenditures rather than direct government grants and is it an urgent or vital national need?

Conclusions

1. *No Inviolable CTB Principle*. The Canadian Report gives strong support to tax reform in this country. It does support the argument that a broad if not comprehensive tax base is usually the fairest arrangement. It does not answer the academic controversy over whether a comprehensive tax base is a real possibility or even desirable. In its support of some tax incentives, it leaves open the question of whether future tax incentives might be acceptable. Each must always be decided on its own merits, with a strong presumption in favor of a *CTB*. There is, unfortunately, no objective standard by which we can accept or reject the departures from the *CTB*.

Where the Canadian Commission was prevented from accomplishing a full *CTB*, in the case of imputed rentals, it did not attempt compensating adjustments elsewhere in the system. But it did recognize that these compensatory departures from *CTB* would be desirable if practical. Thus in the case of voluntary (charitable gifts) and involuntary (imputed rents) departures from *CTB*, the Commission avoided promulgating an inflexible *CTB* principle.

2. *Tactics*. The tactics of the Canadian Commission, an all out attack on *all* of the soluble problems of the tax system, touch on some of the great dilemmas for tax reformers. For example, it is clear on the one hand that it is difficult to eliminate some loopholes while not repealing other equally important ones. It is also clear that a very large number of changes must be made before sufficient revenues are freed up so that some advantage in the new system can be seen by most taxpayers. But in an economy as complex as ours and with a tax system as sophisticated as is ours, and with our legislative system, it is not really likely that a truly overall attack could be accomplished in one piece of legislation.

The experience of the last eight years tells us something about tactics for future tax reform. Tax reform cannot be part of a program that requires quick action on the part of Congress such as was true in the case of the Administration proposals of 1961 (that led to the Revenue Act of 1962) or the Administration proposals of 1963 (that led to the Revenue Act of 1964). In each case the Administration was asking for quick approval of vital tax cuts for fiscal reasons, the investment credit in one case and rate reductions in the other, and at the same time was asking for controversial reforms. Under these circumstances those on the defensive had all the advantages. If tax reform proposals are presented in a balanced package with no request for an overall tax increase or reduction, the

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chances for reform are improved. In that case the Congress does not have the politically easy route of serving the dessert without requiring that the spinach be eaten. And the political power of those insisting on the closing of loopholes because of the advantages that will be made available to them from the revenues thus raised may be able to overcome the opposing political forces. The lesson seems to have been learned in the United States. The reform bill left by the Johnson Administration for consideration by the present Congress is a balanced bill which does not require any overall tax revenue increase or decrease. It is simply up to the Congress to choose between the present system and a more equitable system.

The Canadian Report also points up other difficult questions of tactics. It is clear that certain changes have drastic economic consequences. Recognizing this, the Canadian Commission attempted to balance off desirable and undesirable economic results. For example, it was recognized that the introduction of an ordinary income tax on gains arising out of investments in corporate stock might have undesirable effects on the Canadian investment situation. However, the extremely liberal averaging proposals and the bold plan for corporate-individual integration were thought to more than compensate for the adverse effects of the capital gains change. In many such situations the Commission was careful to point out that one step demanded the other and that neither could be taken independently without undesirable tax consequences or economic consequences. On the one hand, if the integrated tax were to be adopted without the imposition of a full capital gains tax on corporate equities, there might be undue windfalls to corporate investors. On the other hand, if the capital gains change were made without the corporate-individual integration change, there might be unfair and adverse consequences on corporate investors. This is a problem that we will have to cope with in many situations if reform is to be seriously attempted in this country. To some extent we have learned this lesson quite well. Proposals for changing the tax exempt status of state and local bonds now assume that there will be compensating changes elsewhere in the law so that the ability of these governments to borrow will not be reduced. The proposals for a federal bank to handle state and local borrowing with subsidies derived out of the revenue savings resulting from the repeal of the exemption is an example of this type of approach.[18] The tax reformer may have to become skilled at many other tasks in order to sell his product.

3. *Full Accounting for Tax Benefits.* Perhaps the most significant development in terms of potential for tax reform in this country are the recent demands for a "full accounting" for tax provisions.[19] And perhaps the most significant tax policy contribution of the Kennedy-Johnson Administration will be its leading the way in the last hours of its tenure to the creation of a complete national budget which includes direct and indirect (tax) expenditures. "Full accounting" budget figures were submitted by Treasury Secretary Barr to the Joint Economic Committee on January 17, 1969.[20] They revealed such startling facts as the following: tax expenditures on the category of "community development and housing" were equal to or projected to exceed direct expenditures for the fiscal years

[18] For example, a National Urban Development Bank has been proposed by Treasury and other officials.

[19] See, for example, Remarks of Honorable Stanley S. Surrey, Assistant Secretary of the Treasury, New York, November 15, 1967, entitled "The United States Income Tax System—The Need for a Full Accounting."

[20] These were an extension to 1969 and 1970 of similar data for fiscal year 1968 which were included in the Annual Report of the Secretary of the Treasury (1968).

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1968 through 1970; tax expenditures for "commerce and transportation" similarly equaled or were expected to exceed direct expenditures for these three fiscal years; estimated costs of the present treatment of capital gains for individuals were placed in a range of $5.5 to $8.5 billion.

If data such as this finally finds a permanent place in our national budget, perhaps the most significant objection to non-revenue uses of the tax system will have been overcome, and at the same time the prospects for elimination of those which are least desirable will be substantially improved. At least they will be placed in a relatively similar position to direct expenditures—after all many direct expenditures manage to continue for many years long after their priorities should have placed them in the out basket.

The emphasis on a full accounting will be particularly helpful in the forthcoming debates on the new Administration's plans for tax incentives to solve many of our critical problems. The emphasis on a full accounting will hopefully also be influential in the forthcoming hearings scheduled by the Ways and Means Committee of the House of Representatives which are designed to take testimony on virtually all aspects of our tax system. In these hearings, it is also undoubtedly true that many of the ideas developed by the Royal Commission will be presented to our Congressional tax writers.

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