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PERSONAL DEDUCTIONS AND TAX REFORM: THE HIGH ROAD AND THE LOW ROAD

WILLIAM J. TURNIER†

THE extensive system of personal deductions provided by our Internal Revenue Code is one of the distinguishing features of our income tax system. The British, for example, allow a personal deduction only for interest on modest sized mortgages on personal residences.¹ Moreover, the Canadians do not allow a deduction for any interest incurred to finance living expenses, or for state and local taxes. The Canadians do, however, allow a deduction for charitable contributions and medical expenses.² Although the present round of tax reform proposals in this country has only addressed these deductions to a limited extent, they are commonly the focal point of many proposals to overhaul the Internal Revenue Code.³ Undeniably, the relative obscurity, vis-à-vis the general public, of items such as the investment tax credit and bad debt reserves, when contrasted with the wide-spread common knowledge of, and experience with, charitable contributions and mortgage interest deductions is to a large degree responsible for this phenomenon. All too often, most popular self-proclaimed tax reformers give only scant consideration to the proper theoretical role of personal deductions in an income tax, and seek to bundle all personal deductions together labeling them as unholy deviations from what should be a sacrosanct norm.

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2. See CANADIAN MASTER TAX GUIDE 1985, 143, 409 & 414 (1984). The Canadian deduction for medical expenses is subject to a deductible amount equal to 3% of income.
of taxation of all income.  

It is the purpose of this article to examine the role which personal deductions should perform in an ideal tax system. The article will argue that personal deductions should perform three basic functions in a tax system. First, they should be a means whereby receipts are adjusted so that the base which is subject to tax is indeed income. Second, they should be a means whereby the base is made consistent with the fiscal role which has been assigned to an income tax in our society. Lastly, they can, on occasion, provide a means whereby our tax system is made compatible with fundamental values embraced by our society. After this test has been developed, it will then be fully applied to the personal deductions allowed by existing law in order to determine their legitimacy in a tax system. Next, the present reform proposals for the treatment of personal deductions will be evaluated based on the test developed. Finally, as a means of exploring the likelihood of significant reform or change in this area, an examination of the political dynamics of tax reform, as they affect personal deductions, will be conducted. It is hoped that this portion of the paper will be useful not only for evaluating present reform proposals but also for the purpose of determining the likelihood of proposals for change in this area in the future.

I. Personal Deductions: Their Theoretical Role

Personal deductions can be assigned three appropriate roles in an ideal tax system. First, if one establishes the goal of taxing income as defined under Haig-Simons, and then commences the base determination process with receipts, it will of course be nec-

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4. See, e.g., R. Freeman, supra note 3, at 13; S. Surrey, supra note 3, at 37.
5. Readers interested in a more extensive discussion of this portion of the article are referred to Turnier, Evaluating Personal Deductions in an Income Tax—the Ideal, 66 CORNELL L. REV. 262 (1981). In that article, the author expresses some refinements on the views set forth in this article.
6. Professor Haig defined income as “the money value of the net accretion of one’s economic power between two points in time.” See Haig, The Concept of Income, in THE FEDERAL INCOME TAX 11 (R. Haig ed. 1921) reprinted in AMERICAN ECONOMICS ASS’N, READINGS IN THE ECONOMICS OF TAXATION 59 (R. Musgrave & C. Sharp eds. 1959) [hereinafter cited as ECONOMICS ASS’N]. Professor Simons added to Haig’s articulation of the definition of income the element of consumption, a refinement which he rightly credits Haig with originally conceptualizing. See H. SIMONS, PERSONAL INCOME TAXATION 61-62 (1938) (noting that although the expression of Haig’s definition lacks clarity, it was intended to include the idea of consumption). Simons then formally defined income as “the algebraic Sum of (1) the market value of rights exercised in consumption and (2) the change in value of the state of property rights between the beginning and end of the period in question.” See id. at 50.
necessary to allow a deduction not only for necessary business expenses, but also for other items which are essential to insure that income only, and not receipts, is being taxed. Personal deductions can be of great assistance in taxing only income as contrasted with receipts. Second, we must concede that there are a number of definite reasons why our society has adopted and maintained an income tax as the means whereby it raises the overwhelming portion of federal governmental revenue. Personal deductions can also serve the role of insuring that the base which is subject to the income tax is consistent with the basic reasons why our society has opted for that tax. Finally, since one must readily concede that a pristine income tax system is hardly one of our society's most fundamental concerns and objectives, it will be necessary to consider the issue of whether personal deductions should sometimes be allowed as a means whereby the income tax system is made supportive of, and subservient to, greater societal concerns. None of these three functions of personal deductions can be said to be of primary importance. Therefore, an appropriate decision with respect to the validity of the deductible status of any of the personal deductions can only be made by balancing and weighing each of these three factors as they affect the status of individual deductions.

A. Refining the Base

Economists and other tax theoreticians are in basic acceptance of the Haig-Simons definition of income as the appropriate definition to be employed in designing a tax system. Professor Simons has defined income 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 the end of the period in question."7 Earlier economists had basically defined income as a flow of satisfactions, i.e., intangible psychological experiences and benefits.8 Simons derived his definition in response to the need to provide a quantifiable definition of income which could serve to place a value on income in the marketplace. In explaining his definition of income, Simons noted that:

Personal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has

7. See H. Simons, supra note 6, at 50.
8. See Economics Ass'n, supra note 6, at 55-59.
to do not with sensations, services, or goods but rather with rights which command prices. Its calculation implies an estimate (a) of the amount by which the value of a person’s store of property rights would have increased, as between the beginning and end of the period, if he had consumed (destroyed) nothing, or (b) of the value of rights which he might have exercised in consumption without altering the value of his store of rights. In other words, it implies an estimate of consumption and accumulation. Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods); accumulation denotes the change in ownership of valuable rights as between the beginning and end of a period.\textsuperscript{9}

We observe that Simons’ discussion of this issue, while it does not contain a definition of consumption, does characterize consumption as involving the destruction of goods or services. For our purposes, we might define consumption as consisting of the use of goods and services in the satisfaction of wants or in the process of production and resulting in the diminution or destruction of their utility. Concededly, it is difficult to measure both consumption and accumulation. Consequently, in designing our income tax system we have settled on taxing the inflow of wealth to an individual and then allowing a deduction for business expenses which are necessary to generate that inflow of wealth and also for other items, namely personal deductions, the exclusion of which is necessary to insure that only consumption and increases in net worth are subject to taxation. Professor William Andrews, in a leading article, describes this role of personal deductions in the following fashion:

An ideal base for distributing personal tax burdens may be aggregate personal consumption plus accumulation of real goods and services. But it is not feasible to measure that quantity directly. We rely on money expenditures to provide a practical measure of the real consumption and accumulation which such spending buys. However, it is not practical to record and audit even personal expenditures directly. Consequently, we rely on the long run equivalence between money income

\textsuperscript{9} See H. Simons, supra note 6, at 49-50.
and money expenditures for consumption and accumulation and compute the tax on the basis of the former.

The appropriate role of personal deductions in an ideal income tax base is . . . to adjust for discrepancies between money income and real consumption and accumulation resulting from expenditures for items that we do not wish to take into account as part of the aggregate personal consumption or accumulation we wish to tax.10

A few examples of this function of personal deductions will prove helpful at this point. If one considers the casualty loss deduction,11 for example, one can see that in the case of a robbery of a payroll from a wage earner, the victim (whose net worth is definitely decreased) is not the consumer of the funds which were stolen. The thief, of course, is the consumer of these funds and sees his net worth increased by the amount of the theft. All casualty losses are not analyzed so easily. Some incidents, such as fender benders, frost-damaged ornamental shrubs and silk ties which are burned by the careless spark from a cigarette, are basically acts of consumption of the assets which are subject to the casualty loss.12 Passing on to the medical expense deduction,13 it must be noted that this expenditure does, indeed, involve the

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11. I.R.C. § 165(c)(3) (West Supp. 1986). Section 165(c)(3) states:
   (c) In the case of an individual, the deduction under subsection (a) shall be limited to . . .
   (3) except as provided in subsection (h) losses of property not connected with a trade or business or a transaction entered into for profit if such losses arise from fire, storm, shipwreck, or other casualty or from theft.

Id.

12. For further discussion of the role of casualty losses in relation to personal deductions in the ideal tax system see infra notes 104-08 and accompanying text.
   (a) Allowance of deduction.—There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152), to the extent that such expenses exceed 5 percent of adjusted gross income.
   (b) Limitation with respect to medicine and drugs.—An amount paid during the taxable year for medicine or a drug shall be taken into account under subsection (a) only if such medicine or drug is a prescribed drug or is insulin . . .

spender in the consumption of medical goods or services for a personal benefit, and, therefore, a deduction is unnecessary to cause receipts to equal income. The interest deduction\(^{14}\) as applied to the home mortgage is another example of a deduction which is not necessary to cause receipts to reflect income. The borrower is, of course, the consumer of the time value of the borrowed funds which are being used to achieve a personal benefit, namely to permit him to engage in personal consumption prior to his generation of the receipts necessary to finance such consumption. Consequently, allowance of a deduction is unwarranted on this ground. The charitable contribution deduction,\(^{15}\) on the

\(^{14}\) I.R.C. § 163 (West Supp. 1986). Section 163 provides:

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) Installment purchases where interest charge is not separately stated—

(1) General rule.—If personal property or educational services are purchased under a contract—

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained, then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12. For purposes of this paragraph, the term "educational services" means any service (including lodging) which is purchased from an educational organization described in section 170(b)(1)(A)(ii) and which is provided for a student of such organizations.

(2) Limitation.—In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

\(^{15}\) I.R.C. § 170 (West Supp. 1986). The relevant text of § 170 is:

(a) Allowance of deduction.—

(1) General rule.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution
other hand, is a deduction which is warranted under the Haig-Simons definition of income. The donor of funds to a charity is not the consumer of the donated funds. These funds, of course, will be consumed by the charity and, indirectly, by the recipients of its charitable activities.

In closing out discussion of this issue, a word of caution is in order. Although the Haig-Simons definition of income has been accepted for almost a half century as the bedrock definition of income for virtually all modern economic and tax scholarship, if one accepts another definition of income as the logical starting shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

(c) Charitable contribution defined.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

(1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

(2) A corporation, trust, or community chest, fund, or foundation—

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) which is not disqualified for tax exemption under section 501(c)(3) by reason or attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office. A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B). Rules similar to the rules of section 501(j) shall apply for purposes of this paragraph.

Id.

16. Theoretically, as consumers of these goods and services, the recipients are realizing the income which is to be enjoyed in their destruction. See Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 938-40 (1967).

17. See Andrews, supra note 10, at 344.
place, radically different results can follow. For example, consider the following definition of income by William Hewett, an early twentieth-century American economist. According to Hewett, "net individual income is the flow of commodities and services accruing to an individual through a period of time and available for disposition after deducting the necessary costs of acquisition." Under Hewett's definition of income, not only would interest on the home mortgage and the medical expense deduction not be allowed, but also the casualty loss and the charitable contribution deduction would not be allowed, since, after deducting for the cost of acquisition (business expenses), all funds were originally available for disposition. A similar result would be obtained if we accept the definition of income offered by J.R. Hicks, a noted British economist, who defined an individual's income as "the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning."

In light of growing concern by many theoreticians to produce an extremely comprehensive tax base and the current concerns about language and its ability to predetermine, or accommodate itself to, so-called neutral legal results, one can expect that in the near future less attention might be paid to the Haig-Simons definition of income, and that income definitions such as those offered by Hewett or Hicks might gain greater acceptance. One can even speculate that the great deference shown to the Haig-Simons definition of income is perhaps less attributable to its "correctness" than it is to the fact that the Haig-Simons definition of income describes and justifies the results which have been produced by the existing political process as it responded to the pressures from politically and economically powerful interest groups. In defense of the Haig-Simons definition of income, one can assert that under it the aggregate of net individual income will equal societal net income, a result thought desirable by tax theoreticians. The same result would not be obtained under either the

19. See J. Hicks, Value and Capital 172 (1939).
Hewett or the Hicks definition. Moreover, because of the widespread fundamental acceptance of the Haig-Simons definition by virtually all tax theoreticians, including some leading proponents of a comprehensive tax base, for present purposes it seems more appropriate to use it, rather than the Hicks or Hewett definitions of income, as our basic starting place.

B. Consistency of Tax Base with Fiscal Role of Income Tax

Although the taxation of all income might be the commendable goal of an income tax system, we must keep in mind that our society has assigned several principal fiscal roles to the income tax. It would be erroneous to contend that the tax base of the income tax ought to be inconsistent with the basic reasons why our society has adopted and maintained an income tax. Personal deductions can provide a means whereby the tax base is adjusted so as to make it consistent with these basic concerns.

In examining our income tax system, it is possible to discern at least three different major fiscal roles which our society has assigned to the income tax. First, we have opted for an income tax system on the grounds that it is a tax system which is most suited to taxing individuals based on their ability to pay their fair share of the tax burden. Not only have we chosen an income tax for that reason, but also we have included in its structure a number of special features, such as a progressive rate structure, personal exemptions and the standard deduction or the zero bracket amount, which result in the tax burden more closely reflecting ability to pay. Second, an additional important consideration in the choice of an income tax as our principal source of federal govern-

23. For example, a charitable contribution which is not allowed to be subtracted from receipts by the donor would nonetheless be includible in income by the beneficiary who, like the donor, would have the funds available for consumption.

24. What is being suggested is similar to using legislative intent to construe statutes. Just as statutes ought not to be construed in a fashion which would subvert their basic purpose, so too the tax base ought not be constructed so as to undermine the basic societal roles assigned to the income tax.

25. For a discussion of the “ability to pay” rationale as it applies to the income tax, see infra notes 29-37 and accompanying text.

26. The impact of these three items in producing a federal income tax burden reflective of varying ability to pay can be demonstrated by comparing two married taxpayers with two minor dependents. Assume that the first taxpayer earned $20,000, that the second earned $200,000 and that no other deductions were claimed. For purposes of simplicity, we will also assume that the zero bracket amount remained at $3,400 and the personal deduction and exemption amounts remained at $1,000. The rate structure applicable in 1986 would result in the taxpayer who earned $20,000 paying a tax of $2,461 and the taxpayer who
mental revenue was Congress' belief that it would provide a relatively efficient means for raising vast sums of money. 27 Finally, although not one of the reasons for adoption of an income tax, our society clearly maintains an income tax and uses it as an automatic as well as a discretionary means whereby the economy can achieve stable growth, avoiding both dramatic economic contractions and rampant inflation. 28

1. *Ability to Pay*

Professor Seligman, in his outstanding study of the income tax, established that the basic theme which underlies the evolution of tax systems in the West is a search for a tax system based on ability to pay. 29 The head tax which was the first tax imposed by most primitive societies was a fairly reasonable system of taxing based on ability to pay in primitive economies in which there was little disparity in individual wealth or earning power. 30 As meaningful disparities in wealth developed, and noncommunal property systems developed, society moved toward a property tax as its principal source of revenue. 31 The shift from the property tax to an expenditure tax or consumption tax represents another step in attempting to tax on the basis of ability to pay. 32 The gross receipts tax represented still another attempt to develop a tax predicated on ability to pay in a society which had only minimal understanding of the difference between gross and net income. 33 As the concept of net income became more refined, the gross receipts tax yielded to an income tax as the tax best calculated to impose a burden on taxpayers predicated on ability to pay. 34

The income tax, when adopted in this country, was hailed because of its correlation with ability to pay. 35 The shift away from

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27. See infra notes 39-41 and accompanying text.

28. For a discussion of society's use of the income tax in this area, see infra note 47 and accompanying text.


30. *Id.* at 5.

31. *Id.*

32. *Id.* at 10.

33. *Id.* at 11-13.

34. *Id.* at 14-15.

35. *See, e.g.,* CONG. GLOBE, 38th Cong., 1st Sess. 252 (1861) (remarks of Mr. Pike); *id.* at 255 (remarks of Mr. Freesenden); *id.* at 301 (remarks of Mr. Wyck-
tariffs as a principal source of federal revenue toward the income tax can also be understood as part and parcel of the basic evolution of a tax system predicated upon ability to pay. Moreover, as previously mentioned, many of the basic structural elements of the income tax, such as a progressive rate structure and personal exemptions, dependent deductions and the zero bracket amount or standard deduction, are also indicative of the fact that our society has continued to view the ability to pay concept as one of the core concepts around which our income tax should be built. Lastly, it should be noted that even early tax theoreticians considered ability to pay to be one of the significant features that should be incorporated into any fair tax system. For example, as early a writer on the subject as Adam Smith suggested that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities."

2. Efficient Major Fund Raiser

One of the most important goals of any tax system is to raise revenue in an efficient fashion. Money unnecessarily spent on tax administration and compliance is money which could have been spent on providing governmental services or saved or consumed by private individuals. Adam Smith in *The Wealth of Nations* also made efficiency one of the four hallmarks of a good tax system. As Smith observed, "every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state." In appraising the impact of particular deductions on the efficiency of a tax system, we must take into consideration not only the burden imposed on the government in its administration

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37. *A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* bk. V, ch. 2, pt. I, at 449 (H. Schneider ed. 1948). Smith's principal endeavor on this issue was to reject claims that certain classes of income should be subject to no tax or tax at more favorable rates. It is possible to construe his statements as arguing the case for a proportional or flat income tax. This may or may not be taking his ideas out of context. *Wealth of Nations*, in which Smith made a case for an income tax was, nonetheless, a relatively progressive treatise on this score. It was published in 1776, twenty-three years before Britain adopted the first modern income tax. See 39 *George III*, ch. 13, § 22 (1799).

38. See *A. SMITH, supra* note 37, pt. IV, at 450.
of the tax laws but also the burden imposed on taxpayers in their compliance with the tax laws.

One of the basic reasons why this country first adopted and has continued to embrace an income tax system is because of its ability to raise vast sums of money in a relatively efficient fashion. When the Civil War cast upon the federal government the need to raise vast sums of money, Congress, for the first time, opted for the adoption of an income tax.\(^{39}\) Moreover, when the populists and the progressives sought to reduce substantially the tax burden of the tariffs, they embraced the income tax as the only tax capable of producing this vast amount of revenue.\(^{40}\) Its capacity to generate large amounts of revenue is attested to by the fact that in fiscal year 1981 the income tax generated 67% of total federal tax revenues.\(^{41}\)

The fact that in fiscal year 1981 the federal government spent $.41 per $100 of revenue raised on administration of the tax system adequately attests to its ability to raise vast sums of money with only minor amounts spent on administration.\(^{42}\) Although this figure includes federal government revenue from all sources, since the income tax comprises 67% of all federal government revenue, it is fair to conclude that it is a very efficient tax to administer.\(^{43}\) Unfortunately, there is no reliable data on the cost to taxpayers of complying with the federal income tax.\(^{44}\) Development of such data is rather difficult since it requires not only some determination of actual out-of-pocket disbursements by taxpayers in preparing tax returns, but also some estimate of the amount of taxpayer time spent in preparing returns and an assumption of the value of that time. Although this is an issue which has been largely ignored in the designing of our Internal Revenue Code (Code), in recent years some attention has been paid to this mat-

\(^{39}\) See S. Ratner, Taxation and Democracy in America 57-99 (1967).

\(^{40}\) Id. at 168-92, 298-336.


\(^{42}\) Id. at 55.

\(^{43}\) Even if one were to assess the full cost of administering the Internal Revenue Service to the income tax, an erroneous assumption, it would only cost $.62 per $100 of revenue raised to administer the tax.

\(^{44}\) The paucity of scholarship in this area is demonstrated by the fact that the most thorough bibliography on compliance costs of which this author is aware is found in C. Sandford, M. Godwin, P. Hardwick & M. Butterworth, Costs and Benefits of VAT 170-75 (1981). The bibliography lists only 20 studies covering a wide variety of taxes including excise taxes, retail sales taxes, value-added taxes and both corporate and individual income taxes. The low quality of a number of these studies further illustrates the dearth of knowledge in this area.
PERSONAL DEDUCTIONS

For example, the zero bracket amount (recently relabeled as the standard deduction) was introduced at a fairly high level, and was significantly enlarged by the Tax Reform Act of 1986 for the purpose of removing vast numbers of taxpayers as itemizers. In concluding discussion of this issue, it is safe to say that the income tax was embraced because of its ability to raise vast sums of money in a relatively efficient fashion and that concern has increasingly focused in recent years on the issue of the cost of complying with a complicated tax system, as well as the cost of administering that tax system. It is therefore obvious that one of the principal reasons why our society adopts and maintains an income tax system is because of its ability to generate vast sums of money in a relatively efficient fashion.

3. **Countercyclical Tool**

Although the income tax system, which was first adopted during the Civil War, briefly embraced at the end of the 19th century and subsequently reintroduced in the early 20th century, was surely not adopted because of its countercyclical capacity, it is safe to conclude that since the birth of Keynesian economics the income tax has been assigned a significant countercyclical role in the management of the nation’s economy. Because of the progressive rate structure and a number of built-in fixed deductions, such as personal exemptions and deductions and the standard deduction or the zero bracket amount, the income tax functions as an automatic economic stabilization device. During times of

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(d) Zero bracket amount

For purposes of this subtitle, the term “zero bracket amount” means—

(1) in the case of an individual to whom subsection (a), (b),
(c), or (d) of section 1 applies, the maximum amount of taxable income on which no tax is imposed by the applicable subsection of section 1, or

(2) zero in any other case.


47. The discretionary use of the income tax for countercyclical purposes is quite well-known and understood. During periods of economic contraction, tax cuts are employed to effect economic stimulation. See J. PECHMAN, FEDERAL TAX POLICY 8-14 (3d ed. 1977). Similarly, during periods of inflation, Congress theoretically should increase taxes to remove money from the economy. Unfortunately this step is seldom undertaken.

The automatic economic stabilization feature of the income tax is not as well known. Because economic contractions decrease governmental revenue more rapidly than spending programs can be cut, and because spending pro-
economic contraction, taxpayers who lose their jobs or otherwise face diminished amounts of income see their tax bills geometrically reduced. Moreover, in times of economic expansion, these same features of the Code act to increase geometrically the tax burden of an individual with rising income, thereby stemming inflation as proportionately greater amounts of money are removed from the economy.

It must be conceded that in recent years there has been a waning of interest in using the income tax to manage the economy. Proposals to reduce substantially the progressive rate structure are adequate testimony to the fact that Congress is assigning decreasing importance to this role of the income tax in managing the nation's economy. Moreover, although this is still an important role which is assigned by our society to the income tax, it has only minor bearing on the issue of whether particular items should be continued as personal deductions, and consequently, warrants only limited discussion.

4. Examples of Application

In order to allow a tax system to make adjustment for varying levels of ability to pay of taxpayers with the same basic income, it will be necessary to allow a deduction for some consumption expenditures which are involuntary in nature. Concededly, a vast array of expenditures to finance the basic costs of living, such as food, shelter and clothing, are involuntary to some degree or another. These expenditures, however, also involve a significant amount of discretionary spending. The standard deduction and the personal exemption and deduction provision of the Code together can be viewed as an efficient device for sorting out the
truly involuntary consumption activities for food, shelter, clothing and the like, and those other expenditures for these items which reflect not involuntary expenditures necessary to sustain life but expenditures which involve a basic upgrading of the standard of living of the spender. An additional problem that exists if one attempts to provide a deduction for all involuntary expenditures is the fact that individuals may sometimes be able to arrange with an employer, or another individual with whom a contractual relationship exists, to compel the taxpayer to make certain expenditures which would be of great benefit to the taxpayer. Clearly, no deduction should be allowed for such expenditures. It is this author's opinion that in making an accommodation to ability to pay, a deduction should be allowed for only two types of involuntary expenditures: 1) those which are necessary for the survival and basic well-being of the taxpayer and his or her dependents and 2) those expenditures which do not provide the taxpayer with a personal benefit roughly commensurate with the amount of the expenditure. As previously mentioned, expenditures for food, shelter, clothing and the like would be within the first category and would be adequately provided for by the standard deduction and personal exemptions and deductions. An additional item which would be within the first category, but would not be covered by the personal deduction or the standard deduction, would be expenditures for medical service and treatment since these items are for services which are necessary to sustain life, and consequently, can be viewed as de facto involuntary. With respect to the second category, it should be noted that although items such as contributions to pension plans and social security taxes represent basically involuntary expenditures, since the taxpayer will be provided with a benefit which is roughly commensurate with the value of what is being contributed, no deduction should be allowed.49 On the other hand, since economists are in wide agreement that payments of state income taxes do not provide taxpayers with benefits which are in any way commensurate with the amount of the tax paid,50 a good case could be made for including state and local income taxes in the second category.

49. The benefits thus acquired typically become part of the reserve of wealth of the taxpayer and do not diminish his or her ability to pay. For example, because of enhanced economic security, the taxpayer who builds up social security or pension benefits is more able to pay his or her income tax than is one with equal net take-home pay who is not amassing any such benefits.

For the purpose of illustrating the application of the ability to pay standard to personal deductions, we will examine the deduction for medical expenses. A medical expense is basically a consumption expenditure, since it represents a destruction of goods and services for the purpose of obtaining a personal benefit for the taxpayer. Consequently, it is not warranted as a deduction necessary to cause receipts to equal income under the Haig-Simons definition. Since such expenses are assumedly for services and goods which are necessary for survival or maintenance of well-being and are largely involuntary, a deduction is appropriate based on the ability to pay rationale. For example, if we assume that taxpayers A and B both earn $50,000 a year, while taxpayer C earns $40,000 a year and that taxpayer B breaks his leg and spends $10,000 in having it repaired, it is safe to conclude that B has the same ability to pay as C and that A's ability to pay significantly exceeds that of B and C. Any tax system which was going to attempt to achieve some degree of horizontal equity would have to allow B a deduction for the $10,000 involuntarily spent on medical services. In this regard it is worth calling attention to an article written by Professor Kelman in which he attacks the medical expense deduction in part, not because of disparities in ability to pay between A, B and C, but rather because of the disparity in the ability to pay between B and D who earns, for example, only $10,000 a year. By focusing on concerns of vertical equity, he attempts to make a case that the tax deduction for medical expenses should not be allowed.

The impact which concerns about the ability of the income tax to raise money efficiently will have on our decision with respect to personal deductions can be illustrated by the medical expense deduction and the deduction for state income taxes. Dealing first with the deduction for state income taxes, we discover that it imposes very little burden on the taxpayer to determine the amount of this deduction. He simply need go no further than consulting his W-2 forms to see how much money was withheld from him during the prior year and additionally consulting his record of estimated tax payments, as well as his prior year's tax return to see how much additional money he either paid the state or received as a refund on his tax. This is a task which can

52. See Kelman, Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World, 31 STAN. L. REV. 831 (1979).
be carried out in several minutes. Moreover, since the records of the amounts paid by individuals to state and local governments as income taxes are readily available to the IRS from the states and since withholding statements provide substantial back up for much of this information, it is relatively simple for the Service to verify these amounts. The medical expense deduction, however, provides us with indeed a more complicated situation. Although we might be inclined to adopt a medical expense deduction as a valid deduction because of concern with ability to pay, the multiplicity of qualifying expenses for sick taxpayers calls for some restraint in this area. Medical expenses are typically incurred with respect to a vast variety of payees. Moreover, they are spread out over a long period of time and often involve offsetting reimbursements for a portion of the expenditures from insurance companies, thereby placing a substantial burden on taxpayers who wish to calculate the exact amount which is deductible. In addition, the government when it seeks to verify such claims on audit is similarly confronted with a vast array of bills and receipts and limited knowledge of the amount which has been reimbursed by insurance: Consequently, it is not surprising that we discover that there have been substantial limitations imposed upon the deductibility of medical expenses. For example, only prescription drugs are deductible and many items which are only tangentially involved with the treatment of a disease or disorder are not allowed as deductions, despite the fact that they may have some actual impact on the well-being of the taxpayer. 53 In addition, by employing a significant deductible amount, we insure that only expenses for items which are great in the aggregate provide an opportunity for deduction, thereby substantially limiting the class of taxpayers who qualify for the medical expense deduction. 54

53. See, e.g., Ochs v. Commissioner, 195 F.2d 692 (2d Cir.) (additional housekeeping and child custodial care expenses to allow for recovery from cancer surgery not deductible), cert. denied, 344 U.S. 827 (1952); I.R.C. § 213(b) (West Supp. 1986) (only prescription drugs are deductible); id. § 213(d) (lodging expenses incurred to secure medical services limited to $50 per day).

54. The medical expense deduction is occasionally criticized on the ground that since a portion of the cost of medical services of an ill taxpayer is being satisfied with non-taxpayer funds, the ill taxpayer becomes a profligate consumer and drives up the cost of medical services. Repeal of the deduction is sometimes suggested as a means of reducing escalating medical expenses. Havighurst, Controlling Health Care Costs: Strengthening the Private Sector's Hand, 1 J. Health Pol., Pol'y & L. 471, 475-78 (1977).

There are three basic non-consumer sources for the direct or indirect payment of medical expenses: 1) insurance; 2) governmental programs and 3) tax deductibility. It is submitted that the market impact of the last source on the price of medical services is inconsequential when compared with the impact of
The automatic countercyclical function of the income tax is largely the result of the progressive rate structure coupled with fixed deductibles such as the zero bracket amount or standard deduction, personal exemptions and dependent deductions, which neither rise nor fall as income rises or falls. This point is illustrated by considering the case of a married taxpayer who earns $30,000 a year and has two dependents. If we assume a standard deduction or zero bracket amount of $3,500 and a $1,000 personal deductions and exemptions, he would report a net taxable income of $22,500. If he lost his job after six months of employment, given the $15,000 salary, and the same zero bracket amount and dependent deduction status, while his gross salary plunged by 50%, his net taxable income would plunge by 66 2/3% to $7,500. When this is coupled with a progressive rate structure, the diminution in the tax burden becomes even greater. Only fixed, non-discretionary personal deductions such as real property taxes and the interest on mortgages or consumer durable items could in any way be asserted to contribute to this function of the income tax. Their impact on, and contribution to, the automatic countercyclical role of the progressive income tax is too slight to enable one to make a plausible case for deduction on this ground. Thus, while the countercyclical feature of the income tax is one of its principal functions, it has little impact, if any, on a decision to continue any item as a personal deduction.

C. Coordination with Fundamental Social, Economic and Political Values

Although it is important to a tax theoretician to design an income tax system which taxes income and is consistent with other important roles assigned to an income tax, such as taxation predicated on ability to pay, one must, nonetheless, readily concede that society might have some more important values which must be served, and that our concerns with a pure income tax must be made subservient to these more fundamental concerns. Here we are concerned with the need for the income tax to be

the other two sources. To seek to control medical expenses through repeal of § 213 is to hunt for a gnat with the shotgun which you should be using on the two grizzly bears. For example, in 1983, patients provided only 27.2% of all payments for medical services with third parties (insurance, government, philanthropy, etc.) providing the balance. For a discussion of percentage of patient direct payments of all medical service payments, see infra note 153. Moreover, because of the § 213 deductible and the deductible provisions of most insurance policies, it is fair to conclude that a disproportionate share of patient-paid medical services are paid for with non-deductible dollars.
consistent with the basic principles that underlie our social covenant. Assuredly, any tax system must be constitutional. What we must consider, however, is that there may be other extremely fundamental societal goals which are implicit in our Constitution and which, in a system of a hierarchy of values, are superior to the goal of creating a fairly comprehensive income tax. This is a bit of a difficult step for a tax theoretician to make, because he must here accept the veil of humility and concede that there may be a few other things which are more important to a society than a tax system which he considers ideal. Before proceeding any further with this discussion, the author notes that since the fundamental values which are to be accorded consideration should have some strong constitutional underpinnings, this does not become the camel's nose whereby every favorite deduction of various powerful political constituencies can be let into the tent of deductibility. Although there are a number of values which underlie our Constitution and which can be considered basic underpinnings for our social compact, and consequently which are worthy of some consideration on this ground, this author can discern only two such values which impact on the issues under discussion. These values are a desire to create and preserve a federal system and to encourage diversity of beliefs and views in a pluralistic society.

Concerns with respect to accommodation of a tax system with fundamental societal goals could also, on occasion, be satisfied with the allowance of a credit rather than a deduction. On other occasions, use of a deduction might be more appropriate. Where one is dealing with an item for which a good case for deductibility can be made under either of the first two prongs of the three-pronged test proposed in this article, consideration of fundamental societal values provides us with a reinforcement of the decision which has been tentatively reached with respect to accord deductibility for a particular item. For example, since we might already have tentatively concluded that allowance of the charitable contribution deduction is consistent with the Haig-Simons definition of income, if we reach a conclusion that allowance of the deduction is also supportive of fundamental societal goals, we can then rest more easily in our decision to accord charitable contributions deductible status. Moreover, consideration of deductible status is also appropriate where one reaches a decision that a particular item should be deductible on either of the two prongs of the three-pronged test, and one then discerns that a decision not to allow a deduction for another related item would
produce conflict with fundamental societal values. For example, if one concludes that a deduction for state and local income taxes is warranted under the Haig-Simons definition of income and reaches no such conclusion with respect to the other principal sources of state and local revenue, in order to preserve a neutral environment in which states can reach decisions with respect to the funding of their activities, and thereby promote the healthy state of fiscal federalism, one might reach the conclusion that it would be appropriate to extend deductibility to all of the major sources of state and local revenue. In closing, it should be noted that the approach suggested here will not always be expansive of the list of items accorded deductible status. For example, in the case of state and local taxes, neutrality in a fiscal system of the state could be equally well preserved by removal of deductible status from all state taxes, just as well as it could be promoted by according deductibility to all major state taxes. Moreover, having reached the conclusion that the deductibility of charitable contributions is mandated under the Haig-Simons definition of income, we can also conclude that because of deeply felt beliefs regarding due process and equal protection, section 170 should have been drafted to preclude a deduction for contributions to charities which practice racial or other forms of discrimination.55

Where no compelling considerations which require us to make a decision with respect to deductibility are present, and we, nonetheless, wish to cause the tax system to accommodate itself to fundamental societal goals, it is undeniable that a credit would provide a more equitable means whereby this goal could be realized. The deduction for charitable contributions provides us with a convenient vehicle by which this point can be illustrated. If, for example, we had not concluded that the Haig-Simons definition of income mandated allowance of a charitable contribution deduction and we, nonetheless, wished to establish a tax-assisted program to enhance the pluralism of our social services, establishment of a credit for charitable contributions would be in order and would be preferable to allowance of a deduction. In the case of the charitable contribution deduction, however, the compelling conclusion reached with respect to deductibility based on Haig-Simons does in fact preclude consideration of the credit alterna-

55. This requirement was read into §§ 170 and 501(c)(3) of the Code by the Supreme Court. See Bob Jones Univ. v. United States, 461 U.S. 574 (1983) (non-profit private schools prescribing discriminatory admissions policy do not qualify as tax exempt institutions under Code).
Having concluded that continuation of deductible status for charitable gifts is warranted under the Haig-Simons definition of income, we now should turn our attention to the impact of concerns about fundamental societal values on a decision to continue deductible status for such gifts.

The charitable contribution deduction has long been defended on the ground that it enhances the diversity of our pluralistic society. In an indirect fashion, the charitable contribution deduction, or a credit substitute, ensures that there is substantial support for a great number of non-governmental institutions providing for education, supporting the arts, and furnishing a variety of social services, many of which the government would not support by direct grants.

If one looks back over the past twenty-five years, and assumes that in lieu of the charitable contribution deduction the government had established a program of making direct grants to charities, one can speculate that the charities which would have been the beneficiaries would have come from a substantially narrower class than those supported by the general public. Moreover, due to changing political winds, there would have been considerable shifting among the favored charities. During the early 1960's, education, historical restorations, and fine arts may have been in a favored category. In the mid- to late 1960's there may have been a dramatic movement away from these charities toward programs which affected the poor, as well as other community oriented and social service programs. This would most likely have been followed by a contraction of governmental support for such organizations and a possible shifting toward parks and recreation programs, as well as programs which benefitted veterans and refugees of war. In the 1980's we may have seen a further dramatic contraction in public support for such programs, coupled with a shift toward drug education and rehabilitation programs. The charitable contribution deduction, or a credit alternative, by resting on the choices made by millions of Americans of very diverse backgrounds, facilitates support for organizations which may not otherwise be on a favored governmental list, and also insures against radical contractions of support to charitable activities. It is obvious that the deduction, or a credit alternative, can play a significant role in enhancing the plurality of our society.

Having concluded that a direct government spending program would not provide the same accommodation to the desire to preserve a diverse society that a deduction or a credit system
would provide, we must next choose between adoption of a deduction or a credit. The best case for the credit is predicated on the fact that there are significant differences between the types of charities which are supported by the poor and the wealthy, and neutrality can be achieved between different economic classes of taxpayers by use of a credit rather than a deduction. Acceptance of the credit, of course, would undermine the case for deductibility of charitable contributions based on the Haig-Simons definition of income. Since that concern could also only be accommodated by according charitable contributions deductible status, it would seem fair to conclude that the best way of satisfying our two principal concerns with respect to charitable contributions would be to retain their deductible status.

In closing our discussion of this area, it should be reiterated that the above mode of analysis is not a mechanical one which will readily produce an easy answer for any given deduction. A sensible and cogent decision can only be made by considering all such factors, as they affect a given deduction, and balancing them and weighing them as a means of reaching a sensible overall decision.

II. APPLICATION TO EXISTING LAW

Because the proposed test is not a mechanical test but requires a balancing and weighing of the various factors which make up the test, it will be fruitful to illustrate the application of the test to the various existing personal deductions: 1) charitable contributions;\textsuperscript{56} 2) medical expenses;\textsuperscript{57} 3) interest;\textsuperscript{58} 4) state and local taxes;\textsuperscript{59} 5) alimony\textsuperscript{60} and 6) casualty losses.\textsuperscript{61}

\begin{itemize}
  \item \textsuperscript{56} I.R.C. § 170 (West Supp. 1986). For the text of § 170, see supra note 15.
  \item \textsuperscript{57} I.R.C. § 213 (West Supp. 1986). For the text of § 213, see supra note 13.
  \item \textsuperscript{58} I.R.C. § 163 (West Supp. 1986).
  \item \textsuperscript{59} I.R.C. § 164 (West Supp. 1986). Section 164 states: Sec. 164. Taxes.
  \begin{itemize}
    \item (a) General Rule.—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
      \begin{itemize}
        \item (1) State and local, and foreign, real property taxes.
        \item (2) State and local personal property taxes.
        \item (3) State and local, and foreign, income, war profits, and excess profits taxes.
        \item (4) The windfall profit tax imposed by section 4986.
        \item (5) The GST tax imposed on income distributions.
        \item (6) The environmental tax imposed by section 59A.
      \end{itemize}
      In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are
  \end{itemize}
\end{itemize}
Prior to discussing the impact of the proposed test on various items individually, it will be useful to deal first in an abbreviated fashion with the minimal impact of the countercyclical nature of the income tax on our decision. Only fixed deductible amounts over which the taxpayer can exercise no discretion with respect to making expenditures are supportive of the countercyclical role of the income tax. Consequently, only the interest deduction, with respect to substantial consumer durable items, the real property tax and alimony payments, fall into the category of making some contribution to the countercyclical role. With respect to the alimony deduction, one can note that once a taxpayer loses his job, he probably seldom views his alimony payments as necessary payments and also can petition a court for a reduction in payments based on his changed economic circumstances. Consequently, they basically fall into the category of discretionary expenditures for individuals experiencing economic distress. To a lesser extent, the same may be said for home mortgage payments and property tax payments. Moreover, given the infrequency with which home owners suffer the slings of economic downturns,
scant attention should be paid to the contribution of these deductions to the countercyclical role of the income tax. Consequently, throughout the discussion which follows, it will not be necessary to make reference to this feature when analyzing the validity of each of the various deductions. In addition, since concern with fundamental values only impacts on our decisions with respect to charitable contributions and state and local taxes, it will only be discussed when dealing with those deductions.

A. Charitable Contributions

A fairly strong case can be made for the continuation of the charitable contribution deduction on the ground that it is necessary to produce a tax base which is consistent with the Haig-Simons definition of income. If, as assumed for purposes of this article, one accepts the definition of consumption which incorporates the concept of destruction of property or services for a personal benefit, it is fairly easy to conclude that the donor of property is not the consumer of that property. Consequently, if one, starting from receipts, wishes to develop a tax base which only taxes income, one will have to allow a charitable contribution deduction. It is conceded that the consumers of the donated property are the charity or, more appropriately, the beneficiaries of the charity. Theoretically, as the consumers of goods and services, the beneficiaries of a charity should be taxed on the amount of their benefit as if it were income.\footnote{62} This is, of course, an administrative impracticality. Moreover, given the low tax rates of many beneficiaries of charities, such a procedure, even if practical, would not produce an amount of revenue in any way commensurate with the revenue loss generated by a deduction. Nonetheless, if one's goal is to tax only income, a charitable contribution deduction does seem to be in order. In closing discussion of this topic, one must concede that there is no justification for allowing an individual to take a deduction on the unrealized gain inherent in a piece of property donated to a charity.\footnote{63} Although the realization principle is perhaps a necessary administrative concession to a tax base, it is inconsistent with the Haig-Simons definition of income to allow a deduction for unrealized gain. Since we have not included in income the increase in net worth with respect to

\footnote{62. For a discussion of the consumption of charitable contributions as income for the donee, see Bittker, \textit{supra} note 16.}

\footnote{63. \textit{See} I.R.C. § 170(e) (1986). Section 170(e), in general, only allows this benefit to donors of long-term capital assets. \textit{Id}.}
unrealized gain, it is entirely inappropriate to allow a deduction of that amount when it is given to a charity. 64

It is relatively easy to evaluate the legitimacy of the claim to deductibility of the charitable contribution predicated upon its consistency with the reasons why we have adopted and maintained an income tax system. Considering first the issue of ability to pay, since the donor is involved in making a totally voluntary decision as to whether he or she should part with the donated funds, there is no element of involuntariness involved. Consequently, not only is it possible to conclude that no case can be made for the charitable contribution deduction predicated upon ability to pay, but also is it possible to conclude that concerns with ability to pay might perhaps cause one to have second thoughts about whether or not a deduction is warranted with respect to charitable contributions.

Considering next the impact of the charitable contribution deduction on the ability of the income tax to be an efficient, significant revenue producer, we must consider not only the loss of revenue created by the deduction, but also the burden placed upon the taxpayer and the Internal Revenue Service in complying with, and administering, this particular deduction. The 1984 Statistics of Income indicate that approximately 34.7 million returns were filed in which a charitable contribution deduction was claimed. 65 Moreover, the tax expenditure budget for fiscal year 1987 estimates that the charitable contribution deduction will cost the Treasury approximately $12 to $14 billion. 66 Although in itself this sum seems rather large, when compared with total federal revenue costs of items such as the deduction for state and local taxes 67 and the interest deduction on home mortgages, 68 it

64. See Andrews, supra note 10, at 371-72.
66. The tax expenditure budget for fiscal year 1987 indicated that the deduction for charitable contributions (education) cost the Treasury $1.1 billion, charitable contributions (health) cost the Treasury $1.6 billion and charitable contributions, other than education and health, will cost the Treasury $11.4 billion. See Executive Office of the President Office of Management and Budget, Special Analysis, Budget of the United States Government, Fiscal Year 1987, at G-39, G-40 (1986) [hereinafter cited as O.M.B.]. Since the tax expenditure budget is developed with the cost of each item estimated on a “but for” basis, addition of individual components to reach a total cost is highly inaccurate.
67. The tax expenditure budget for fiscal year 1987 indicated that the deduction for non-business state and local taxes other than on owner-occupied homes cost the Treasury $25.2 billion and that for owner-occupied homes will
is indeed of less consequence. In attempting to evaluate the impact of the deduction on the efficient administration and compliance issue, one should note that, given the continuously increasing use of negotiable instruments in our society, it is a relatively easy task for the taxpayer to compute the amount of most cash gifts at the end of the year by reviewing cancelled checks. Moreover, it is a relatively simple task for him to substantiate this issue on audit when requested to do so by the Service. Principal opportunities for abuse would seem to arise in the area of gifts of property to charities. Here, the recent tightening up on appraisals and reporting could be expected to have some favorable impact. Moreover, if the deduction with respect to property was limited to the donor’s adjusted basis, as it should be, many of the abuses in this area would vanish. Taxpayers who donated appreciated property would no longer have to obtain precise appraisals, and on audit the IRS would confront the relatively more simple task of determining a taxpayer’s adjusted basis on a donated item.

The last issue to be considered is the impact which the charitable contribution deduction has on fundamental societal values. As mentioned previously, the charitable contribution deduction, or an alternative credit, is an excellent means whereby we can enhance the plurality of our society. Continuation of some preferential treatment, either as a credit or a deduction, is certainly supportive of basic concerns which we have to promote diversity of views which are implicit in the first amendment to the Constitution. Some concern might be raised as to whether allowance of a cost the government an estimated $10.9 billion. O.M.B., supra note 66, at G-38, G-40.

68. The tax expenditure budget for fiscal year 1987 indicated that the deduction for mortgage interest on owner-occupied homes cost the Treasury $29.8 billion. Id. at G-38.

69. See I.R.C. §§ 6050L, 6652(a)(1)(ix), 6659 & 6678(a)(1) (West Supp. 1986); Temp. Reg. § 1.170A-13T (1986). Some of the recent improvements regarding reporting, compliance and appraisals with respect to charitable contributions are to be found in these provisions.

70. Where depreciated property is given to a charity, a different approach would be called for. If the donated property was property on which a loss would be allowed as a deduction on sale, it would be necessary to preclude the taxpayer who donated a capital asset from swapping what should be a capital loss for an ordinary deduction. This could be done by treating the donation as a sale and limiting the deduction to fair market value. If the donated property is ordinary income property, no such abuse would be present. This constructive sale approach and limitation of deduction to fair market value would incorporate the basic § 165(c) limitation of individual losses approach, thereby avoiding abuses with respect to gifts of personal use property (e.g., used household items). For the text of § 165(c), see supra note 11.
deduction or a credit for gifts to religiously-oriented organizations might be viewed as a violation of the Establishment Clause of the Constitution. If, on the other hand, one views the Freedom of Religion and Establishment Clauses combined as expressions of a deeply felt societal concern to establish an exceedingly diverse society, one can perhaps rest more easily with preferential treatment for charitable contributions being accorded to a wide variety of organizations including organized religions.

As mentioned previously, use of a credit rather than a deduction might be considered as a means whereby pluralism can be promoted. Given the strong theoretical justification for the charitable contribution deduction predicated on the Haig-Simons rationale, however, one is strongly inclined to opt for the deduction.

In summing up the discussion with respect to charitable contributions, one should consider a variety of factors. The deduction has an exceedingly strong theoretical claim based on the Haig-Simons definition of income. Not to allow the deduction would be to cause the donor to be taxed on the income which is being realized by the beneficiaries. Although this would have the benefit of preventing any diminution in the aggregate national tax base, given the de facto need to exclude charitable benefits from income, it would be achieving this result by substituting one individual’s tax liability for another’s tax liability, hardly a desirable result in an individual income tax system. Given the significant support which the deduction renders to promotion of diversity and pluralism in our society, one feels additionally comfortable with continuing the charitable contribution deduction. The principal concern which must exist with respect to the charitable contribution is the fact that it, to some degree, detracts from the efficient administration of the income tax. By not allowing a deduction for gifts of appreciated property, the proper result under the Haig-Simons definition of income, we could further enhance the efficiency of the income tax. Moreover, by use of a deductible amount such as the two percent which was proposed by the Treasury, we could achieve several desirable results. First, we would substantially diminish the number of tax returns claiming a charitable deduction, if we exclude from consideration those donors who made gifts which total less than two percent of adjusted gross income. This would also be a useful device for separating out basically consumptive charity from non-consumptive charity.

71. See Warren, supra note 22, at 1083-90.
For example, it can easily be asserted that a certain portion of all charitable donations, such as contributions to UNICEF, and to membership organizations such as scout troops and churches which we, or members of our family, attend basically amounts to consumption for which a deduction is not warranted. Moreover, such a step would also enhance the revenue-raising capacity of the Code with virtually little negative impact on other important considerations.

B. Medical Expenses

Medical expenses reflect expenditures to finance consumption of goods and services by the taxpayer to attain a personal benefit, namely the alleviation of a disease or the repair of an injury. Since the payor is consuming society's scarce resources for the purpose of attaining a personal benefit, deduction is not warranted on the ground that it is necessary to adjust receipts to equal income under the Haig-Simons definition. By focusing principally on the involuntary nature of these expenditures, Professor Andrews concluded that a deduction for medical expenses is necessary under Haig-Simons. This author disagrees with that conclusion. Regardless of the use to which consumed assets are put, whether it be for treatment of a physical disorder or the attainment of pleasure, their destruction results in consumption and, consequently, income to the consumer. The author, nonetheless, is in accord with the suggestion that the medical expense deduction is warranted because of the impact which it has on ability to pay. Because of the significant involuntary nature of medical expenses, as mentioned, continuation of the deduction indeed is of great significance if one wishes to design an income tax system predicated upon ability to pay.

Addressing the issue of the impact of the medical expense deduction on the ability of the tax system to raise a significant amount of money in an efficient fashion, one discovers that in 1984 the medical expense deduction was claimed by about 10.6 million taxpayers. Moreover, the tax expenditure budget for 1987 indicates that the medical expense deduction would have

72. See Andrews, supra note 10. Andrews posited a state of well-being as a basic natural state and classified all involuntary expenses for medical assistance necessary to attain that state as non-consumptive diminutions in net worth.

73. See Statistics of Income, supra note 65, at 5. Statistics are kept based on returns filed. Since many filed returns are joint returns, it is impossible to know whether a single return reflects one or two taxpayers. For the sake of editorial ease, the terms taxpayers and return filers are used interchangeably.
resulted in a diminution in revenue of about $4 billion\textsuperscript{74} or 13\% of the amount represented by interest on personal residences\textsuperscript{75} or 16\% or the amount represented by state and local taxes other than the real property tax on owner-occupied residences.\textsuperscript{76} Because of the relatively small amount of the revenue loss resulting from the medical expense deduction, our concern in this area should perhaps focus somewhat more on the impact which maintenance of this deduction has on the efficient administration of the tax system. Because of the scattered nature of bills for medical services and the problem of coordination with insurance reimbursements, both of which have been previously mentioned, significant compliance and administrative burdens are present. Steps such as the 1982 changes limiting the medical expense deduction to prescription drugs and the increase in the deductible amount to five percent\textsuperscript{77} are probably adequate means for meeting these concerns and coordinating with concerns regarding ability to pay.

In concluding our examination of the medical expense deduction, we can note that if adequate steps are taken to protect the efficiency and integrity of the tax system, the direct relationship of medical expenses with the ability to pay of individual taxpayers indicates that the medical expense deduction should have a fairly high claim to continuation of its deductible status.

C. Interest

If one excludes from consideration all interest used for generation of income, which would qualify for a deduction either under Section 162 or 212 of the Internal Revenue Code, most

\textsuperscript{74} See O.M.B., supra note 66, at G-39. The Tax Reform Act of 1986 replaces the 5\% deductible with a 7.5\% deductible with the result that the actual relative impact of the medical expense deduction will be even less than projected by the 1987 tax expenditure budget.

\textsuperscript{75} The tax expenditure budget for fiscal year 1987 indicated that the deduction for mortgage interest on owner-occupied homes cost the Treasury $29.8 billion while the deduction for medical expenses cost only $3.9 billion or 13\% of the amount represented by mortgage interest on owner-occupied homes. See O.M.B., supra note 66, at G-38, G-39.

\textsuperscript{76} The tax expenditure budget for fiscal year 1987 indicated that the deduction for non-business state and local taxes other than on owner-occupied homes will cost the Treasury $25.2 billion, while the deduction for medical expenses will cost $3.9 billion or 16\% of the amount represented by non-business state and local taxes other than real property on owner-occupied homes. See O.M.B., supra note 66, at G-39, G-40.

remaining interest represents a consumption of the time value of a storehouse of goods for the purpose of financing personal consumption, and as such no case can be made for its deductibility as being necessary to adjust receipts so as to result in only income being subject to tax.\textsuperscript{78} If the debt with respect to which the interest is being paid is incurred with respect to items such as a home or an automobile, the consumption of which should be included in the tax base, then it is clear that the interest deduction is not justified on the ground that it is necessary to adjust receipts so that income alone is taxed. For purposes of simplicity, this discussion will leave aside the issue of the fungibility of borrowed money and will assume that the debt in question can be readily classified as being incurred either for the purpose of financing consumption or for the purpose of financing income producing activities.\textsuperscript{79} Suffice it to say, however, that some device such as several of the proposals which were under consideration in the recent round of tax reforms will be necessary in order to achieve this result.

Let us next consider the issue of the bearing that the fundamental reasons why our society has adopted and maintained an income tax system has on the issue of deductibility of interest. Since the incurring of indebtedness is typically a discretionary act, no claim can be made for the deductibility of interest based on considerations of ability to pay.\textsuperscript{80} In considering the issue of the deductibility of interest and its impact on the ability of the income tax system to raise vast sums of money in a relatively efficient fashion, it should be noted that in 1984 approximately 34.6 million returns claimed a deduction for interest paid.\textsuperscript{81} Moreover, the tax expenditure budget for fiscal year 1987 indicated that the interest deduction with respect to personal residences alone will

\textsuperscript{78} But see Gunn, \textit{Is an Interest Deduction for Personal Debt a Tax Expenditure?}, 1 Canadian Tax 46 (1979). For a discussion of the concept of income, see supra note 6.


\textsuperscript{80} Theoretically, if a debt were incurred with respect to the need to finance the acquisition of bare essentials or to pay for necessary medical expenses because the taxpayer lacked the resources necessary to obtain medical services, one might be able to sustain a claim for deductibility of interest based on its involuntary nature in this particular fact setting. Since, however, lenders are seldom willing to lend money to debtors without any resources for the purpose of financing the acquisition of bare essentials or medical services, this issue need not be dealt with further.

\textsuperscript{81} See Statistics of Income, supra note 65, at 5.
cost the government approximately $30 billion,\textsuperscript{82} and the interest deduction with respect to other items of consumption will cost the government approximately $19 billion.\textsuperscript{83} This widespread use of the deduction, as well as the impact that it has on the revenue, warrants that it be given considerable attention because of its capacity to erode the base, without being able to make any other claim to legitimacy as a deduction. About the only thing which can be said for the interest deduction on this score, is that it is often relatively easy for the taxpayer to determine the amount of interest paid by contacting the lender at the end of the year, and the Service typically has little trouble verifying the taxpayers' claims.

In concluding our discussion of the interest deduction, one can say that virtually no plausible theoretical case can be made for the continued allowance of the deduction for non-business and non-investment interest. The only significant problem which would seem to remain in this area is the means by which Congress should devise a system for separating interest which should be appropriately allowable as a deduction under Sections 162 and 212 from other interest which has been incurred for the purpose of financing consumption. The actual structure of the device selected, however, has little bearing on the question of whether we should allow an interest deduction for debt incurred to finance personal consumption.

\section*{D. State and Local Taxes}

In analyzing the deductibility of state and local taxes, we must separately examine the deductibility of each of these principal taxes. First, analyzing the impact of the Haig-Simons definition of income on the state and local income tax, we find that a strong case can be made for deductibility because the individual taxpayer is not the consumer of the funds paid to his state or local government. Much like charitable contributions, the consumer of these taxes are the beneficiaries of the programs funded by state and local governments. Moreover, there is widespread agreement that there is no relationship between the payment of such taxes and the obtaining of benefits from state and local governments.\textsuperscript{84} It was for such reasons that the Treasury in its \textit{Blueprints}

\textsuperscript{82} See O.M.B., \textit{supra} note 66, at G-38.

\textsuperscript{83} Id.

\textsuperscript{84} For a discussion of economists' view on this subject, see \textit{supra} note 50 and accompanying text.
for Basic Tax Reform in 1977 concluded that preservation of the deduction for state and local income taxes was fully warranted.\textsuperscript{85}

Before we consider the deductibility of property and sales taxes, it is worthwhile to note that the now repealed deduction for state gasoline taxes is an example of a deduction which never should have been allowed. Because of the relationship between the consumption of gasoline and the weight of an automobile and the number of miles driven, the gasoline tax was basically a user fee which imposed tax burdens on the users of the public roads in proportion to the benefits which they derived from the public roadways. Consequently, allowing a deduction for this tax was basically allowing a deduction for an item of consumption, something which was totally inconsistent with the Haig-Simons definition of income.\textsuperscript{86} The deductions for state and local property and sales taxes present us with a slightly different situation. Although the taxpayer does not consume the public benefits which his sales and property taxes finance,\textsuperscript{87} because these taxes arise in conjunction with decisions to consume, they are basically facets of consumption and hence the legitimacy of their claim to deductibility is considerably less than that of the state and local income tax.

Considering next the impact of the reasons for adoption and maintenance of an income tax on the decision to allow a deduction, we first address the issue of ability to pay. With respect to the state income tax, it is safe to conclude that this tax is an involuntary diminution in net worth which does not provide the taxpayer with a benefit commensurate with its cost. Consequently, it can be viewed as a tax which should be allowed as a deduction based on the ability to pay rationale. It has been suggested, somewhat feebly, that, since we are members of a democracy, taxes imposed by state and local governments are voluntary pay-

\textsuperscript{85} See U.S. Treasury Dep't, supra note 50, at 92-93.

\textsuperscript{86} See H.R. Rep. No. 1445, 95th Cong. 2d Sess. 41, reprinted in 1978-3 C.B. 215 (1979). The following statement is contained in the report:

The committee believes that State-local gasoline taxes essentially constitute charges for the use of highways, comparable to the non-deductible Federal gasoline tax. Therefore, these taxes are more like personal expenses for automobile travel (as are highway tolls or the cost of gasoline itself) than like income or other general State-local taxes. To allow deduction of the gasoline tax is inconsistent with the user-charge nature of the tax, in that deductibility serves to shift part of the cost from the highway user to the general taxpayer.

\textit{Id.}

\textsuperscript{87} For a further discussion of the public benefits financed by state and local taxes, see supra note 50 and accompanying text.
ments and that consequently no deduction is warranted because of concerns with respect to ability to pay. Such a suggestion should be rejected out of hand. On the basis of that sort of reasoning, one can conclude that military conscription in a democracy results in an all volunteer army or that the victims of capital punishment in a democracy have committed suicide.

State and local sales and property taxes present us with a somewhat different result. Since these taxes are largely the consequence of voluntary decisions to consume, one cannot make a very good case that they reflect involuntary payments except insofar as they are incurred for the purpose of providing for the minimal essentials in food and housing necessary to sustain life. The standard deduction or the zero bracket amount and personal exemptions and deductions provide an adequate basis for accounting for such taxes.

Considering the impact of the deduction of state and local taxes on the ability of the income tax to raise vast sums of money in an efficient fashion, we discover that almost 38 million tax returns claimed a deduction for state and local taxes in 1984, and that the tax expenditure budget for 1987 estimated that this deduction would cost the federal government approximately $11 billion with respect to real property taxes on personal residences and $25.2 billion with respect to all other taxes. This deduction is the second most costly of all of the personal deductions according to the 1987 tax expenditure budget. Although a very costly deduction, its administrative and compliance burdens are relatively light. Withholding statements, tax returns and bank statements make it relatively easy to determine state income and property taxes. Moreover, when one realizes that most taxpayers

88. See Joint Committee on Taxation, Tax Reform Proposals: Rate Structure and Other Individual Income Tax Issues 146 (1985) [hereinafter cited as JT. COMM.].
89. See Statistics of Income, supra note 65, at 5.
91. Although it is highly inaccurate to add deduction costs, when one considers that the deduction for home mortgage interest cost about $30 billion and that for all other consumer interest cost $19 billion, it is safe to conclude that § 163 is more costly than § 164. For example, the deduction for real estate taxes on residences cost $11 billion and all other taxes cost $25 billion. Compare notes 67, 68 & 81 and accompanying text. For a discussion of § 163, see supra note 13. For a discussion of § 164, see supra note 59 and accompanying text.
used the sales tax tables provided with the instructions to the return, it is fair to conclude that this deduction places an inconsequential burden on the efficient operation of our tax system. In closing discussion of this issue, however, one should note that because only five of the less populous states do not impose the sales tax, and because it, when compared with other personal deductions, constitutes a relatively small amount for most taxpayers, removal of this deduction could be effected by factoring the results into the tax rates.

With respect to the countercyclical role of an income tax we should observe that since state and local income taxes and spending for items subject to the sales tax rise and fall geometrically in proportion to income, neither sales taxes nor state and local income taxes represent fixed deductible amounts and consequently continued deductibility of either of these taxes cannot be sustained on the basis of their contribution to the countercyclical role of the income tax. The property tax, on the other hand, because of its fixed nature does offer a modest support to this feature of the income tax. Nonetheless, as previously mentioned, because of the relatively low status of the impact of this particular consideration on the issue of the deductibility, continuation of the deduction for the property tax on this ground does not seem to be warranted.

With respect to the impact of the deduction for state and local taxes on fundamental societal values, one can make the case that the deduction for state and local taxes promotes a healthy federal system. There are two factors which one could point to on this ground. First, since the deduction for state and local taxes facilitates state revenue raising, its repeal could further diminish the states' ability to fund necessary programs, leaving the federal government with little choice but to pick up the slack in the area of terminated programs, thereby enhancing the role of the federal government vis-a-vis that of the states. If one assumes that states

92. Only the sparsely populated states of Alaska, Delaware, Montana, New Hampshire and Oregon do not impose a sales tax. See STATE TAX HANDBOOK (CCH) 662-63 (1985).
93. Cf. Turnier, supra note 5, at 267 & n.25.
94. This fact is attributable to two basic factors. In the case of the income tax, progressivity personal exemption dependent deductions and standard deductions account for this phenomenon. In the case of the sales tax, exemption for most basic essential expenditures such as food, housing and medical expenses is the reason for the phenomenon.
95. For a fuller discussion of the impact of the state and local tax deduction on fundamental societal values, see Turnier, supra note 5, at 286-93.
design their tax programs to take advantage of deductibility, any suggestion that only some of the principal sources of state revenue should be deductible would result in imposing a pressure on state governments to design their tax programs favoring deductible taxes, hardly a desirable result if one wishes to promote a healthy federal system.\footnote{See, e.g., id.; Feldstein, Tax Reform: Harmful if Passed, Wall St. J., Feb. 14, 1986, at 18, col. 4.}

In concluding our discussion of the deductibility of state and local taxes, it seems fair to state that an extremely strong case can be made for the continued deductibility of the state income tax and that a far weaker, but plausible case, largely predicated on the issue of concerns with respect to federalism, can be made for continued deductibility of property and sales taxes.

E. Alimony

In determining whether the alimony deduction\footnote{See I.R.C. § 215 (West Supp. 1986). For a discussion of § 215, see supra note 60 and accompanying text.} is necessary in order to adjust receipts so as to tax only income, we should observe that because the payee, and not the payor, is the ultimate consumer of the alimony, deduction is consistent with the Haig-Simons definition of income. Similarly, inclusion of alimony in the income of the payee is a result which is also called for by Haig-Simons. Because any amount taken as an alimony deduction should be included in income by the payee spouse, the loss to the Treasury represented by this deduction is nothing more than the relative difference in rates between the payor and payee spouse, which should be further diminished as we move toward a flattening of marginal rates.

In considering the impact of the issue of ability to pay on the continued allowance of the alimony deduction, we should note that because of the largely involuntary nature of alimony and the non-benefit to the payor, allowance of a deduction is appropriate to reflect the payor’s diminished ability to pay. Basically, concerns with this issue caused the Congress to provide for the deduction for alimony in 1942.\footnote{See H.R. 2333, 77th Cong., 2d Sess. 46 (1942).} Prior to that time, alimony was neither deductible by the payor nor taxable to the payee.\footnote{See Gould v. Gould, 245 U.S. 151 (1917) (alimony paid monthly to divorced wife under decree of court is not income).} This, on occasion, produced the outrageous result that for some individuals the total of alimony payments and federal income taxes...
exceeded their receipts for a given year.\textsuperscript{100} Congress responded by including the alimony deduction in the Code and at the same time required payees to include alimony in income. Another way to view the alimony deduction would be to do as Professor Chirelstein has done and characterize it not as an exclusion or a deduction from income, but rather as a choice of taxable person.\textsuperscript{101} In either case, the same result is reached.

The deductibility of alimony has only minimal negative impact upon the ability of the income tax to raise significant revenue in an efficient fashion. This author is unaware of any generally available data which indicates the number of taxpayers who claim the alimony deduction or the cost to the government of the deduction. In 1984 only $2.5 billion was reported as alimony income.\textsuperscript{102} Even if one assumes substantial underreporting of this item of income, it is fair to extrapolate from this figure and conclude that the alimony deduction probably generates something less than $5 billion in claimed deductions. Moreover, given the consideration that the revenue loss represented by this provision is only the rate differential between payor and payee, the revenue impact of this deduction is somewhat less than it might appear at first blush, probably amounting to something less than $1 to $2 billion. The presence of the deduction has very little negative impact on the administration of, and compliance with, the income tax. The small number of payments involved, all of which assumedly would be made by negotiable instruments, insures that the amount of the deduction can be quickly determined by the taxpayer and easily verified on audit. The Service's burden in administering the deduction and the accompanying inclusion in income have been recently alleviated by the improved reporting requirements with respect to taxpayers claiming the deduction.\textsuperscript{103}

In concluding our discussion of alimony, we can feel fairly comfortable in accepting the continued deductibility of alimony. The deduction has a strong justification based on the Haig-

\textsuperscript{100} Two factors accounted for this phenomenon. First, state courts were often unaware of the status of the tax law and erroneously awarded alimony assuming the payee would be obligated to pay tax on the award and that the payor would get to exclude the sum from income. Moreover, when rates escalated during World War II, a number of payors found that their alimony payments and federal income tax obligations exceeded their total income. Congress acted in 1942 in response to both of these factors.

\textsuperscript{101} See M. CHIRELSTEIN, FEDERAL INCOME TAXATION 197 (1985).

\textsuperscript{102} See STATISTICS OF INCOME, supra note 65, at 2.

\textsuperscript{103} See I.R.C. § 215(c) (West Supp. 1986); Temp. Reg. § 1.215-1T (1986) (payor claiming deduction must provide payee's social security number).
Simons definition of income, as well as the ability to pay rationale and the concern about maintaining an efficient, effective tax system.

F. Casualty Losses

As previously mentioned, the casualty loss has a significant claim to continued deductibility based on the Haig-Simons definition of income. Undeniably, it is necessary to make some distinction between the casualty loss in which the taxpayer is definitely not the consumer of the goods which have been lost or destroyed, and the casualty loss which is in essence nothing other than the mere consequence of consumption activities. In the case of thefts, we have a theoretical substitute consumer who has income, which is never reported, and the model is theoretically similar to the alimony model. In the case of “acts of god,” we do not have the same model present and aggregate individual income does not equal societal income in these cases. One might suggest that this would be a convenient place to draw the line between casualties which are consumptive and those which clearly are not. The undesirable result of doing this, however, is to reach the conclusion that the taxpayer is the consumer of goods which are destroyed, and consequently not used for his benefit. One might counter this by asserting that the destruction of the goods is merely one of the consequences of the decision to consume and as such a deduction is not in order. An alternative approach is to employ a deductible amount as a means whereby casualty losses which constitute consumption are separated from those which do not. This would seem to be a preferable approach.

In considering the impact of the casualty loss on the taxpayer’s ability to pay, it becomes immediately evident that this has been significantly negatively impacted by the involuntary act which has resulted in the casualty loss and which brings no benefit to the taxpayer. Continuation of the deduction for the casualty loss is thus also supported by the ability to pay rationale.

Both concerns about preserving the tax system as an efficient

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104. For a discussion of the Haig-Simons definition of income, see supra note 6 and accompanying text.

105. Given the virtual certainty that theft income will not be reported, creation of a distinction between various types of casualty losses on this ground would be allowing the theoretical hair on the tip of the tail of the dog to do all the wagging. The example also exposes a difficulty in allowing tax policy to be fully controlled by a model which insists that aggregate individual income must equal societal income in all cases.
raiser of significant amounts of revenue as well as the preservation of the countercyclical role of the tax system mildly militate against preservation of the casualty loss deduction. In 1984, only 245,000 returns showed a deduction for casualty losses, and the amount claimed equaled $798 million, thereby presenting no substantial revenue consideration. The principal negative impact which the casualty loss deduction has on the maintenance of a significant effective tax is the result of the fact that there is substantial difficulty in verifying the extent of the casualty loss, thereby imposing substantial compliance and administrative burdens on the system.

In summary, once procedures are established to exclude the non-consumptive component of the casualty loss and to protect concerns about compliance and administrative efficiency, both the Haig-Simons definition of income and the ability to pay rationales warrant continuation of the casualty loss deduction. As has been mentioned, these concerns can be satisfied by the use of a significant deductible amount. Unfortunately, the move to a 10% deductible amount which was enacted in 1982 represents significant overkill in this area. Rather than constituting a step in the right direction, it amounted to a leap beyond the pale.

III. THE PRESENT REFORM PROPOSALS

In this section of the article, the author will employ the foregoing discussion and analysis of personal deductions for the purpose of evaluating the major proposals which have been put forth in the present round of tax reforms. Although each of the major reform proposals must be dealt with separately insofar as they impact upon the six principal personal deductions, a general observation should be made with respect to one of the principal reform proposals. The so-called Bradley-Gephardt Bill proposed three gradations in the rate structure. It did this by first imposing

107. The imposition of the 10% deductible amount is largely responsible for this. For example, in 1982, the last year before the 10% deductible was imposed, 2.2 million returns claimed a casualty loss, almost ten times more than the number of returns claiming such a loss in 1984. Compare Internal Revenue Service, Department of the Treasury, Statistics of Income—1982 Individual Income Tax Returns, at 61 (1984) (2,238,197 returns, $2,291,330 in casualty or theft deductions) Publ. No. 79 with Statistics of Income, supra note 65, at 22.
a flat income tax of 14% on all income and then two special surtaxes of 12% and 16% on various portions of income in excess of certain base amounts.\footnote{110} Deductions were to be allowed against only the income subject to the 14% tax and not against income subject to the surtaxes. This was nothing other than a bit of political huxtering in which a credit was to be substituted for a deduction, thus completely subverting any legitimate role which deductions can play in an income tax system. For reasons of political expediency, it was obviously decided to create the income and surtax scheme so as to permit proponents of this tax to be able to claim that they were still in favor of maintaining most of the principal personal deductions. Insofar as one concludes that a deduction rather than a credit is called for in the income tax system for reasons such as those outlined in this article, it will be necessary to reject this approach which is proposed under the Bradley-Gephardt Bill.

The Bradley-Gephardt approach, or an easier-to-administer credit approach, would, however, be a sensible provision when an item for which an allowance is to be made has no relationship to the proper tax base or the reasons why we employ an income tax, but rather represents a decision by government to encourage or support certain conduct through the tax system. Here, concerns regarding equity warrant use of the credit or the Bradley-Gephardt variation of the credit.

A. Charitable Contribution Deduction

Under current law, taxpayers who itemize deductions, subject to certain percentage limitations, claim a personal deduction for gifts to qualifying charities.\footnote{111} This has been construed as allowing a taxpayer to take a deduction for the full fair market value of certain types of appreciated property, part of the value of which reflects unrealized gain.\footnote{112} Moreover, until 1987, non-itemizers were allowed to take a deduction for all or part of their contributions to charities.\footnote{113} The original Treasury proposals with respect to the charitable contribution deduction reflected an extremely sensible approach to this issue. They proposed that charitable contributions in excess of 2% of adjusted gross income

\footnote{110} Id. § 1.
\footnote{112} See I.R.C. § 170(e) (West Supp. 1986).
\footnote{113} See id. § 170(i). For a discussion of § 170(i)(4), see infra note 118 and accompanying text.
would continue to be deductible and that no deduction should be allowed for unrealized gains on contributed property.114 This was an extremely positive approach to the problem of the role of charitable contributions in an income tax. As has been demonstrated, the charitable contribution deduction rests on fairly strong theoretical grounds.115 On the other hand, as noted, the allowance of the deduction with respect to the fair market value of unrealized gain is totally uncalled for and represents a perversion of the tax system.116 The use of a deductible amount such as 1% or 2% is also well advised. Undeniably, some of the gift giving in our society reflects nothing other than the cost of a lifestyle and personal choices with respect to consumption activities. Minor contributions to one's church, tickets for benefit performances and gifts to UNICEF at Halloween are all examples of giving which basically constitutes consumption activities of the taxpayer. The 2% deductible amount can be viewed as covering this type of giving. Moreover, it serves two other laudable functions. First, much of the giving which is below a low deductible amount, such as 1% or 2%, is most likely not tax-motivated. Since much giving above that amount probably has a significant tax motivation, the use of the deductible amount will not significantly impair tax motivated giving. Second, since the deductible amount will obviously preclude a number of taxpayers from claiming charitable contribution deductions on their returns, it will substantially assist in enhancing the efficiency of compliance and administration activities insofar as the charitable contribution is concerned. Another significant feature of Treasury I is the elimination of the deduction with respect to non-itemizers.117 Because the zero bracket amount adequately provides for these taxpayers and because the giving which is covered by the current provision with respect to non-itemizers is typically not tax-motivated giving which largely reflects basic consumption activities, this is a deduction which is totally unwarranted.

Both the President's Proposals and the Ways and Means Committee proposed to continue the present basic treatment of chari-

114. See DEPARTMENT OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH vol. 1, 81-83 (1984) [hereinafter cited as TREASURY I].

115. For a general discussion of charitable deductions, see supra notes 62-71 and accompanying text.

116. For a further discussion of allowance of the deduction with respect to the fair market value of unrealized gain, see supra notes 63-64 and accompanying text.

117. See TREASURY I, supra note 114.
table contributions, with the Ways and Means Committee slightly tightening up on the gifts of appreciated properties under the minimum tax and the President’s Proposals eliminating non-itemizers from the category of deductors. Ways and Means also proposed allowing a deduction for non-itemizers only with respect to contributions in excess of $100.\textsuperscript{118} The Senate Finance Committee proposed the outright repeal of the deduction for non-itemizers.\textsuperscript{119} The Tax Reform Act of 1986 reflected some of the best of both the House and Senate bills by eliminating the deduction for charitable gifts by non-itemizers and making the difference between the fair market value and the adjusted basis of a gift of appreciated property an item of tax preference under a beefed-up alternative minimum tax.\textsuperscript{120} Perhaps in future years Congress will see its way to eliminating completely the old abuse of allowing charitable contribution deductions with respect to gifts of appreciated capital assets and, as Treasury I suggested, providing a deductible amount with respect to charitable contributions.

\section*{B. Medical Expenses}

Prior to passage of the Tax Reform Act of 1986, the Code allowed a deduction for medical expenses in excess of 5\% of adjusted gross income.\textsuperscript{121} Moreover, all employer contributions to health insurance plans on behalf of employees were excluded from the employees’ gross income. Treasury I, the President’s Proposals and the Ways and Means Committee all proposed retaining the 5\% deductible provision.\textsuperscript{122} Treasury I and the President’s Proposals would have made some attempt to include in income a portion of employer-provided health insurance which would have been deductible subject to the 5\% provision.\textsuperscript{123} The Ways and

\textsuperscript{118} Section 170(i)(4) of the 1954 Code provided that the deduction for non-itemizers was a temporary measure with an expiration date of December 31, 1986. Repeal of the deduction was ultimately effected by not amending that provision. See The President’s Tax Proposals to the Congress for Fairness, Growth, and Simplicity, 70-21 (1985) [hereinafter cited as President’s Proposals]; H.R. 3838, 99th Cong., 1st Sess. §§ 133, 501 (1985).

\textsuperscript{119} See Treasury I, supra note 114.


\textsuperscript{122} See Treasury I, supra note 114, vol. 1, at vi; President’s Proposals, supra note 118, at 61.

\textsuperscript{123} See Treasury I, supra note 114, vol. 1, at 73-74; President’s Proposals, supra note 118, at 24-29.
Means Committee proposed applying a new comprehensive non-discrimination test with respect to health benefits provided under employer plans. The Senate Finance Committee chose not to include employer-provided health insurance benefits in income, proposed imposition of a new nondiscrimination test on plan benefits, provided a business deduction for half of the health insurance costs of self-employed individuals and taking a lead from Bradley-Gephardt and Kemp-Kasten, decided to raise the deductible amount to 10% of adjusted gross income. The Tax Reform Act of 1986 provides new nondiscrimination rules for health and other employee benefits, provides a business deduction for 20% of the cost of health insurance for self-employed individuals and raises the deductible amount for medical expenses from 5% to 7.5% of adjusted gross income.

All of the tax reform proposals are to be severely criticized for failing fully to take into income the value of employer-provided health benefits. There is no reason why we should distinguish between employer- and employee-provided benefits in the tax system. All such expenditures constitute consumption regardless of whether the employer or the employee is the source of the funds. There is no reason why an employee who earns $20,000 and receives $2,000 worth of employer-provided group health insurance benefits should be taxed more favorably than an employee who receives a salary of $22,000 from which he must use $2,000 to acquire health insurance. In large part because of such favored treatment of fringe benefits, there has been a remarkable shift toward their use. For example, in 1964, fringe benefits constituted 22% of total employee compensation, while in 1981 such benefits constituted 37% of total private sector employee compensation. Undeniably, after such items were included in income, a deduction should be allowed for them as medical expenses.

124. See H.R. 3838, supra note 118, at § 1151.
127. The present state of affairs is even worse than it appears at first blush. Because group policies typically provide greater coverage than do individual policies, the beneficiary of an employee-provided group policy will actually receive greater value for the $2,000 spent by his employer than will the uncovered individual who uses $2,000 to purchase insurance coverage.
Obviously, there is good reason to justify imposition of a modest deductible for medical expenses. The Canadians who are not overly generous with personal deductions, for example, use a 3% deductible.\footnote{129. For a discussion of Canadian deductions, see supra note 2 and accompanying text.} The dramatic increase in the deductible amount to 10% proposed by the Senate Finance Committee or the 7.5% provided by the Tax Reform Act of 1986 is obviously something which is far in excess of that which is called for because of concerns with either efficiency or the need to tax those medical expenses which constitute routine costs of living (e.g., annual dental examinations) and, as such, represents a substantial abandonment of the ability to pay criteria. As will be developed later in the paper, this is most likely the result of a crass political decision.

C. \textit{Deduction for Non-Business Interest}

Under the Code, prior to passage of the 1986 Tax Reform Act, all mortgage interest was deductible and, in general, all other interest both personal and investment was deductible subject to the limitation that it cannot exceed $10,000 plus investment income.\footnote{130. See I.R.C. § 163 (West Supp. 1986). For the text of § 163, see supra note 14.} Both \textit{Treasury I} and the \textit{President's Proposals} proposed retaining the deduction with respect to mortgage interest on a principal residence and the Ways and Means Committee also proposed granting mortgage interest on a second residence preferred status. All three proposals contained limitations with respect to the deductibility of other interest tied into deductible amounts and limitations imposed by virtue of certain types of investment activities.\footnote{131. \textit{See Treasury I}, supra note 114, at 83, 140-41; \textit{President's Proposals}, supra note 118, at 322-24; H.R. 3838 at 402.} Both the Tax Reform Bill of 1986 and the Senate Finance Committee, like the Ways and Means Committee, allowed a deduction with respect to a principal residence and a second home, and included a provision which would allow interest, and other deductions which largely spring from tax shelters, only to the extent they do not exceed investment income and a deductible amount which declines as income rises.\footnote{132. \textit{See H.R. Rep. No. 841}, supra note 125, at 151-57.} All of these proposals can be faulted insofar as they allow a deduction for interest incurred to finance personal consumption. As such, this type of interest represents a cost of consumption, which ought
not be allowed as a deduction under the Haig-Simons definition of income. Undeniably, the theoretically correct result is to disallow an interest deduction on debt incurred to finance consumption and to allow a deduction for business and investment interest. In order to accomplish this result and avoid the imposition of an ineffective tracing test, such as that employed in section 265 of the Code, it may be necessary to develop some sort of safe harbor which considers the taxpayer’s investment income and includes an additional safe harbor factor, such as a flat dollar amount or a percentage of adjusted gross income. That, however, is merely a decision as to the desired form of a restrictive provision of the Code and in no way negates our basic conclusion as to the nondeductibility of interest on debts incurred to finance consumption.

D. Deduction for State and Local Taxes

Under the Code, prior to passage of the 1986 Tax Reform Act, itemizers were permitted to claim a personal deduction for state and local income taxes, real and personal property taxes and general sales taxes that are not incurred in a trade or business or in investment activity.

In general, both Treasury I and the President’s Proposals would not have allowed for the deduction of state and local income taxes and would have limited individuals in deducting other state and local taxes only to the extent that they were incurred in income producing activities.133 The Ways and Means Committee chose to preserve the treatment available under present law.134 The Senate proposed to leave the deduction for income and property taxes untouched and to limit the deduction for sales taxes to 60% of the excess of such taxes over state and local income taxes. The Tax Reform Act of 1986 took a partial leaf from the pages of Bradley-Gephardt and chose to allow a personal deduction for all state and local taxes other than sales taxes.135

In evaluating the various reform proposals we can conclude that neither Treasury I nor the President’s Proposals took proper account of the ability to pay issue or the definition of income. Both were most likely the result of anxious attempts to generate reve-

133. See Treasury I, supra note 114 at 78-81; President’s Proposals, supra note 118, at 62-64.
nue consistent with political commitments which had been made as to what the basic features of a reformed income tax should be. Both the Ways and Means and Senate Finance Committees and Congress as a whole can be praised for retaining the deductibility of state and local income taxes. The decision to retain deductibility of the real property tax is most likely the result of some legitimate concerns with respect to fiscal federalism and the political power of the state and local governments, as well as the real estate lobby. Nonetheless, it seems to be an acceptable theoretical result. The Senate Finance Committee’s decision to limit the deductibility of the sales tax, while undeniably motivated in part by concerns about enhancing the administrative efficiency of the income tax, was most likely the result of a need to generate revenue for the tax package and effect a compromise between the interests of states who placed varying reliance on the sales and income taxes. Obviously, the Tax Reform Act’s elimination of the sales tax deduction reflected a consensus that this latter factor need not be accorded significant weight. Given the widespread use of the sales tax, it is fair to conclude that this decision will have a fairly inconsequential negative impact upon concerns with respect to the need to preserve the deductibility of the three major sources of state tax revenue due to concerns with fiscal federalism. In closing discussion of this area, the author notes that if budgetary pressures necessitate that Congress look for additional means of enhancing revenue with an eye cast toward the deduction for state and local taxes, the deduction for property tax, like the now repealed deduction for sales tax, is based on a less sound theoretical justification than is the deduction for state and local income taxes. Consequently, if a choice must be made in this area, we should first look to the liquidation of the property tax which, like the sales tax, is a facet of decisions to consume prior to considering repeal of the deductibility of state income tax.

Moreover, the loss of deductibility of the state income tax has another very significant undesirable result. Most of the concern in the present round of tax reforms has focused on the desirability of lowering effective marginal rates. Removal of the deductibility of state income taxes would have been partially counterproductive with respect to this concern, owing to the fact that loss of deductibility would result in a modest raising of the effective marginal state and local rate. For example, if one assumes a 50% federal tax rate and a combined state and local rate

136. For a list of states not using a sales tax, see supra note 92.
of 20%, in a federal tax scheme which allows for deductibility of
state income taxes, we find that the taxpayer has an effective mar-
ginal rate of 60%. If the maximum effective federal marginal rate
is then dropped all the way to 33% (as it will be in 1988), but the
deduction for state and local income taxes is entirely repealed,
the 20% state and local rate when combined with the 33% federal
rate results in a 53% effective marginal tax rate for the taxpayer.
Unfortunately, while they were trumpeting the importance of re-
ducing marginal tax rates at the federal level, both Treasury I
and the President's Proposals failed to observe that the removal of
deductibility of state and local income taxes would, in states and
cities with combined high tax rates, produce only insubstantial re-
ductions in combined effective marginal tax rates.

E. Alimony and Adoption Expenses

None of the tax reform proposals considered the issue of the
appropriateness of retaining the alimony deduction. Apparently,
all of the reform proponents presumed the correctness of this de-
duction. This is indeed as it should be. Unfortunately, political
considerations obviously beclouded their ability to realize that the
very same factors which form the theoretical justification for the
alimony deduction, namely the ability to pay and the Haig-Simons
definition of income, equally justify retention of other deductions,
in particular the deduction for state and local income taxes. The
only significant difference between the two is the fact that all
items which are deducted as alimony are both theoretically and
administratively includable in income to the payee spouse,
whereas although all benefits provided to citizens in the state with
state income taxes are also theoretically includable in income of
the recipients, political and administrative practicality prevents
including them in the tax base. If our true motivating concerns
are ability to pay as well as taxation of income, we should be un-
concerned with the fact that allowance of a deduction practicably
works a reduction in aggregate societal taxable income. We
ought not unfairly increase the tax burden of the individuals who
are the payors of state and local income taxes because of an ad-
ministrative or political inability to increase the tax burdens of
individuals who are the recipients of state services.

An additional item of concern in the present round of tax
reforms was the rather foolish deduction which was provided to

137. See Treasury I, supra note 114, vol. 2, at 13-14; President's Propo-
sals, supra note 118, at 1-3.
itemizers with respect to expenses relating to adoption of children with special needs which the Senate Finance Committee suggested be retained.\textsuperscript{138} The House Ways and Means Committee advocated repeal of this deduction and substitution of some form of federal support program for adopting parents\textsuperscript{139} and the Tax Reform Act of 1986 incorporated the House proposals.\textsuperscript{140} This is indeed an appropriate step. These expenses represent items of consumption which, because of the voluntariness of the decision to adopt, do not reflect limitations in ability to pay of various taxpayers, and consequently, no theoretically plausible case can be made for allowance of a deduction in these circumstances. The public policy concerns which motivated this deduction can be responded to more appropriately by a credit or a direct spending program.

\textsuperscript{138} See I.R.C. § 222 (West Supp. 1986); JT. COMM., SUMMARY OF TAX REFORM PROVISIONS IN H.R. 3838, 99th Cong., 2d Sess. 5 (1986). The text of § 222, prior to its repeal by the Tax Reform Act of 1986, read:

\begin{itemize}
  \item[(a)] Allowance of deduction
  In the case of an individual, there shall be allowed as a deduction for the taxable year the amount of the qualified adoption expenses paid or incurred by the taxpayer during such taxable year.
  \item[(b)] Limitations
    \begin{itemize}
      \item[(1)] Maximum dollar amount
        The aggregate amount of adoption expenses which may be taken into account under subsection (a) with respect to the adoption of a child shall not exceed $1,500.
      \item[(2)] Denial of double benefit
        \begin{itemize}
          \item[(A)] In general
            No deduction shall be allowable under subsection (a) for any expense for which a deduction or credit is allowable under any other provision of this chapter.
          \item[(B)] Grants
            No deduction shall be allowable under subsection (a) for any expenses paid from any funds received under any Federal, State, or local program.
        \end{itemize}
    \end{itemize}
  \item[(c)] Definitions
    \begin{itemize}
      \item[(1)] Qualified adoption expenses
        The term "qualified adoption expenses" means reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to the legal adoption of a child with special needs by the taxpayer and which are not incurred in violation of State or Federal law.
      \item[(2)] Child with special needs
        The term "child with special needs" means any child determined by the State to be a child described in paragraphs (1) and (2) of section 473(c) of the Social Security Act.
    \end{itemize}
\end{itemize}


\textsuperscript{139} See H.R. 3838, supra note 118, at §§ 134, 1407.

\textsuperscript{140} See H.R. REP. No. 99-841, supra note 125, at 22-23.
F. Casualty Losses

Under present law taxpayers are allowed to consider only individual casualty losses to the extent they exceed $100 and are allowed to claim a deduction for all such amounts to the extent that they in aggregate exceed 10% of adjusted gross income.\(^\text{141}\) All the principal reform proposals intend to leave the present law unchanged. If the goal of the deductible amount is to separate consumptive casualty losses, such as fender benders and torn trousers from non-consumptive casualties, then the 10% deductible amount is indeed excessive. Moreover, it is far in excess of a sensible deductible amount which is necessary to screen out relatively small casualty losses for the purpose of preserving the efficiency of the Code. A case can be made for distinguishing between theft losses and "acts of god," as has previously been suggested, with theft losses being accorded more favorable treatment.\(^\text{142}\) In addition to suffering from a significant theoretical defect,\(^\text{143}\) this would probably inject too much complexity into the Code. A more sensible casualty loss provision would be one very similar to the provision which exists under current law with a substantially lower deductible amount such as 2% or 3% of adjusted gross income. As will be developed later in the article, present law with its 10% deductible amount is more than likely less a result of legitimate policy considerations than it is a reflection of concern with respect to definition of income and ability to pay tempered by a substantial dash of political cynicism.

IV. Personal Deductions and the Politics of Tax Reform

To confine our discussion of personal deductions to their ideal theoretical role while ignoring the reality of the political context would be to consider only a portion of the picture. In this part of the paper, we shall first set forth those three factors which experience shows are essential in order for personal deductions to have significant political staying power. This will then be followed by an application of the theory set forth to the six principal personal deductions allowed by the Code.

\(^{141}\) See I.R.C. § 165(c)(3) (West Supp. 1986). For the text of § 165(c)(3), see supra note 11.

\(^{142}\) For a discussion of the casualty loss deduction, see supra notes 106-07 and accompanying text.

\(^{143}\) Id. Because, as mentioned previously, the taxpayer who is the victim of a casualty loss is not the consumer of the lost funds, under Haig-Simons, it is inappropriate to tax him or her on that sum.
The experience which we have had over the last several decades indicates that three significant factors must be present in order for personal deductions to be characterized as having significant political staying power. First, there must be a great mass of taxpayers who benefit from the deduction, and who can predictably recognize the financial benefit which they will derive from continuation of the deduction. Second, we find that there is a symbiotic economic relationship between this great mass of taxpayers who claim the deduction and others who are politically powerful and who also benefit from the deduction claimed by the masses. Typically, the powerful beneficiaries enjoy only an indirect advantage from the deduction being accorded to the masses. On other occasions, the benefit enjoyed by the politically powerful group is a direct one. The existence of such a group is important since the masses are often too poorly organized for effective political activity and rely on the powerful group to carry out lobbying activities which make use of the masses and of the political contacts enjoyed by the powerful group. Finally, because we seem incapable of engaging in thoroughly crass political grabs for economic benefit, it is necessary that some lofty platitude be conjured up which serves as an altruistic fig leaf to cover over the self-interest of the masses and the politically powerful lobbying forces. It should be noted that this last requirement is the least consequential; past experience seems to indicate that virtually any sort of altruistic fig leaf, no matter how ill-fitting, seems to do the job.

A. Charitable Contributions

The charitable contribution deduction provides an ideal opportunity for illustrating the application of the above theory. In 1984 almost 34.7 million of the approximately 99.6 million total individual tax returns filed, or approximately 35% of the tax returns filed, claimed a deduction for charitable contributions. The politically powerful indirect beneficiaries who are in a symbiotic relationship with this mass of taxpayers are the charities (churches, universities, museums, etc.) who in themselves are

144. For a recent discussion of the role of these interest groups in the legislative process, see Macey, Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model, 86 COLUM. L. REV. 223, 227-233 (1986).
146. See STATISTICS OF INCOME, supra note 65, at 2, 5.
147. See REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS (1975), reprinted in 3A S. WEITHORN, TAX TECHNIQUES FOR FOUNDATIONS
well organized political pressure groups able to represent effectively themselves and the masses in the political process. The political power of charities is multiplied by virtue of the fact that most of them have boards of directors which consist of the politically and economically most powerful members of the community. It is the power of these individuals, as well as the power of the charities themselves, which are the principal determinants of the continued appeal to Congress of the charitable contribution deduction. The altruistic value which justifies the continuation of the deduction varies from time to time and spokesman to spokesman. Most often, one will hear claims that the deduction induces giving, enhances the pluralism of the society or provides a convenient means whereby social services can be privatized, thereby avoiding the entanglement of government in the rendition of social services.148

In light of the substantial political power of the charities which are virtually direct beneficiaries of this deduction, it is safe to conclude that a successful frontal attack on it will be unlikely. Further diminution of the deduction would most likely be confined to proposals which impose a minor deductible amount,149 thereby absorbing much of the giving which is not tax-motivated. Because charities would have only marginal interest in preserving this sort of gift giving, this seems to be the most likely successful line of attack for those interested in further diminishing the deduction. Undeniably, a highly significant reform would be to deprive donors of appreciated capital assets of the opportunity to obtain a full deduction while not including the appreciation in income.150 Given the importance of this to large and powerful charities such as universities, one cannot be sanguine about the prospects for such a reform. The singling out of appreciated gifts as an item of tax preference under the beefed up preference tax

148. See, e.g., FILER COMM., supra note 147, at 129-132; JT. COMM., supra note 88, at 171; M. Timberlake & M. McCauley, Charities Heat up Fight Against Tax Reform Proposals, 26 Tax Notes 398 (1985); N.Y. Times, Sept. 12, 1986, at A26, Col. 3 (letters of W.G. Bowen, Princeton University President and John G. Simon, Professor, Yale University Law School). Simon’s letter represents perhaps the highest level that public debate has reached and is recommended as an excellent, succinct defense of the deduction.

149. JT. COMM., supra note 88, at 170, 172-74.

150. For a discussion of the donor’s right to obtain a full deduction, see supra notes 63 & 64 and accompanying text.
of the recent Tax Reform Act\textsuperscript{151} might, however, be a harbinger of better things to come.

\section*{B. Medical Expenses}

The medical expense deduction provides a nice contrast with the deduction for charitable contributions. In 1984, approximately 10.6 million of the 99.3 million tax returns, or approximately 11\% of all tax returns claimed a deduction for medical expenses.\textsuperscript{152} When we couple this with the fact that over the last several decades the medical profession and the health industry as a whole have tended to look less to individuals for the purpose of meeting substantial medical expenses and have increasingly turned their attention to government and to insurance for payment of major medical expenses, we see that this deduction lacks the same strong symbiotic relationship with a mass of taxpayers that exists with the charitable contribution deduction.\textsuperscript{153} Undeniably, the medical establishment does have some self-interest in the maintenance of the medical expense deduction, however, this interest has grown increasingly less intense and indeed is substantially less intense than the self-interest of the charities in maintenance of the charitable contribution deduction.

In further assessing the political viability of the medical expense deduction, let us also consider the fact that the sick who take advantage of the deduction have two characteristics which do not make them effective allies for the medical establishment. First, since disease is random and arbitrary in nature, except in the case of the chronically ill, this deduction lacks the predictability which gives many taxpayers an interest in its continuation. Second, those who are sick enough to exceed the present deductible amounts are often individuals who suffer from a serious, life-threatening illness which dramatically detracts from their ability to become successful spokesmen for their interests.

Because of the relatively small number of benefitting taxpayers, the lack of predictability (except for the chronically ill who are ineffective spokesmen) and the weakening symbiotic relation-

\footnotesize
\begin{itemize}
  \item \textsuperscript{152} See Statistics of Income, supra note 65, at 2, 5.
  \item \textsuperscript{153} In 1950, patient direct payments constituted 65.5\% of all payments for medical services with third-party payments (insurance, government, etc.) constituting the balance. By 1983, patient direct payments had fallen to 27.2\% of the total and the third-party payments constituted 72.8\% of the total. See 6 Health Care Rev. 15 (1984).
\end{itemize}
ship between the masses and the politically powerful who have an interest in continuation of the deduction, it is not at all surprising to find that in recent years the deduction has been the subject of substantial successful limitations in the political arena. For example, the $150 unrestricted insurance deduction has been removed, non-prescription drugs have lost their deductibility and the deductible rate was raised from the old 1% to 3% amount to 5%. In the Reagan administration, interest was focused on raising the deductible amount to 7%, the Senate Finance Committee proposed a 10% deductible amount and the Tax Reform Act of 1986 settled on a 7.5% deductible amount. The long-term prognosis for the medical expense deduction is indeed poor. It is quite possible, however, that Congress may decide that having reduced the deduction to the point of virtual insignificance through the use of an extraordinary deductible like 7.5%, its retention is necessary as part of a cosmetic effort to retain concerns with respect to ability to pay and for the nation's sick.

If one looks for the fig leaf which is used in this area, one will discover concerns articulated with respect to ability to pay and alleviation of the plight of sick individuals, as well as the general attitude of sympathy which surrounds the sick bed. Perhaps these concerns will be sufficient to preserve the little bit that remains of the deduction after imposition of a 7.5% deductible amount. Since it will then cost so little to preserve a vestige of appearance of compassion, it is quite possible that the medical expense will have significant viability in its reduced form.

In closing out our discussion of this topic we should note that although the medical expense deduction has a significantly higher claim to preservation of its status than does the interest deduction with respect to a first, to say nothing of a second, home, the callous political environment in which legislation is formulated results in some bit of an upside-down world.

C. Interest

The interest deduction with respect to indebtedness incurred to finance consumption is the most costly of all the personal deductions. Ironically enough, it has the weakest theoretical claim to continued status as a personal deduction. The principal villains in this area are the home mortgage and the mortgage on the

vacation home. In 1987, the deduction for the home mortgage alone will cost the Treasury $29.9 billion and the deduction for other interest incurred to finance consumption cost $18.8 billion.\textsuperscript{156} The interest deduction was claimed on 34.6 million of the 99.6 million returns filed in 1984.\textsuperscript{157} Like the charitable contribution deduction it was claimed on almost 35\% of all returns filed. This mass of taxpayers which personally benefits from the deduction in a predictable fashion finds itself in a symbiotic relationship with some of the most powerful economic and political forces in our society. The banks, financial institutions and the building and real estate industries all benefit from the continuation of the interest deduction. Because these organizations are not only financially powerful but also well-spread out nationally in virtually every congressional district in the country, they are not subject to any limitation of political power based on regional considerations. The disproportionate importance which we should assign to the politically powerful who benefit from continuation of the deduction can be demonstrated by the fact that although only a small percentage of all home owners own second homes, since a healthy second home market is of importance to the residential construction industry and the real estate industry, none of the principal reform packages which have worked their way through either of the houses of Congress have ever suggested limitation of the deduction to principal residences.

The altruistic fig leaf which is used to cover the self-interest of the masses and their politically powerful allies is most often the American dream of home ownership.\textsuperscript{158} The real estate industry which so gleefully grabs for this and clutches it to its bosom does not even seem to be capable of generating the slightest blush despite the fact that it is far too small to cover the second home.

In closing our discussion of the interest deduction, we should note that given the large number of people who predictably benefit from its continuation and their politically powerful allies, it is highly unlikely that we would expect to see any significant change in this area with respect to interest on home mortgages. We should here perhaps take this opportunity to make an observation

\textsuperscript{156} See O.M.B., supra note 66, at G-38.

\textsuperscript{157} See Statistics of Income, supra note 65, at 2, 5.

\textsuperscript{158} An excellent example of this is the remarks of J. Koelemij, President of the National Association of Home Builders: "No other country in the world has the home ownership of this country . . . . If we want to change housing policy objectives we should do that [but not through the backdoor of tax reform], . . . ." Homebuilders Oppose Changes in Housing Performance, 27 Tax Notes 982 (1985).
which applies not only in the area of the interest deduction but also in all other areas. The individual beneficiaries of most of the personal deductions are people who tend to be in higher-income brackets as the poor have limited discretionary income and have most of their deductions sheltered by the zero bracket amount or the standard deduction. When we couple the normal political power of the wealthy with the realization that they vote in disproportionate numbers when compared with the population as a whole, we must conclude that the political power of the individuals who are beneficiaries of these deductions is vastly out of proportion to their mere numbers. In brief, the prospects for significant changes in this area are dim.

D. State and Local Taxes

In 1984 a deduction for state and local taxes was claimed on approximately 38 million of the almost 99.5 million individual income tax returns which were filed, thus making it the most extensively used of the personal deductions. The mass of taxpayers which takes advantage of this deduction has a significant symbiotic relationship with two different groups. First, state and local governments are virtually direct beneficiaries of the existence of the deduction. Second, the real estate industry is a significant indirect beneficiary of the real property tax deduction. Both of these groups seem to be powerful enough so that they are successfully able to ward off any attempts at wholesale repeal of the deduction. The administration, as it was casting about for revenue to finance its tax cuts, cleverly sought to arouse regional hatreds and weaken the alliance of states and localities against repeal. The effort, however, seems to have failed and the deduction appears to be relatively safe for the time being. It must be conceded that the strategy devised by the administration followed the old "divide and conquer" rationale and may have proven to be a fairly clever and effective strategy. Given the virtual universality of a sales tax of modest proportions, it was not at

159. In 1983, the median income of renters was 50.8% that of homeowners. See United States Department of Commerce, Bureau of Census, Statistical Abstract of the United States 1986, 733. Moreover, in the November 1982 election, 62% of the primary family members of families with incomes over $35,000 voted, while only 46% of those from families with incomes below $35,000 voted. Bureau of the Census, Dep't of Commerce, Voting and Registration in the Election of November 1982 61 (1983).
161. See, e.g., President's Proposals, supra note 118, at 62-68; N.Y. Times, Sept. 13, 1985, at D9, col. 3.
all surprising to see the success of proposals for repeal of the deductible of the sales tax since this will have only a modest distributional impact on taxpayers in most of the states. Only taxpayers in those few non-populous states which do not employ a sales and use tax would be significant winners.\textsuperscript{162} The altruistic fig leaf which is used to cover the economic and political interests protected by this deduction is often the tax on a tax rationale, or on other occasions, the fiscal federalism rationale.\textsuperscript{163}

In closing we can predict that unless budgetary pressures produce an increased need for new revenue which is sufficient to arouse substantial regional differences thereby revitalizing the administration's "divide and conquer" strategy, it is fair to conclude that this deduction will be with us for a number of years to come. We might here note the suggestion of Senator Russell Long that a 3\% deductible be imposed with respect to the deduction for state and local taxes.\textsuperscript{164} Senator Long settled on this deductible amount since he determined that it would cover the lowest average combined state and local tax burden of the lowest taxing state. As such, this proposal amounts to nothing other than a disguised special tax increase for itemizers. Clearly, since virtually all itemizers, even those in the lowest taxing state, are subject to a combined state and local tax of approximately 3\%, disallowance of a deduction in that amount in effect results in a tax increase for itemizers which could be just as readily achieved by leaving the deduction intact and slightly increasing the rates or adjusting the bracket structure.\textsuperscript{165} The proposal does, however, have some appeal to the high tax states since it raises revenue without in any way disturbing their existing advantages over low tax states. This very fact could cause it to result in an unravelling of the coalition existing between many states with respect to non-repeal of the deduction of state and local taxes.

E. \textit{Alimony}

This deduction least complies with the model set forth in this

\textsuperscript{162} For a list of the states not employing a sales tax, see supra note 92.

\textsuperscript{163} See, e.g., U.S. Treasury Dep't, supra note 50; NYSBA Opposes Repeal of State and Local Tax Deduction, 28 Tax Notes 1404 (1985) (letter from Dale S. Collison, Chairman of the Tax Section of the New York State Bar Association to Ronald A. Pearlman, Assistant Treasury Secretary); M. Uhlfelder, Coalition Against Double Taxation Launches Ad Campaign, 28 Tax Notes 1431 (1985).


portion of the article with respect to the political vitality of personal deductions. As mentioned earlier, only a small portion of all taxpayers, probably something on the order of 5% or less take advantage of this deduction. Moreover, there is no significant powerful economic group which has a symbiotic economic relationship with the itemizers of the alimony deduction. We nonetheless may have other factors at work which account for the low level of interest in the alimony deduction during the present round of reform proposals in this deduction.

Because this deduction is basically a rate arbitrage device in which the amount which is deducted by the payor is included in income by the payee, the Treasury, except for the differential in rate between the payor and payee, has minimal financial interest in the deduction's disallowance. Consequently, as marginal rates have been flattening out over the course of the last few decades and as various steps have been undertaken to ensure greater reporting of alimony as income, the interest of the Treasury in this deduction as a producer of financial losses has been substantially diminished. Consequently, the political pressures which must exist to retain deductibility need not be as high as they need be in the case of other deductions. Here, the taxpayers themselves constitute the mass of interested parties and also must furnish much of the effective lobbying support for the deduction. In recent years there has been an obvious growth in the political power of single, divorced and remarried individuals in reshaping the Internal Revenue Code. For example, the lower single person's rate and the new Q-Tip version of the marital deduction, as well as the allowance of the alimony deduction to non-itemizers adequately testify to the increased strength of these individuals in shaping the Code. When this is added to the minimal financial interest of the Treasury in disallowance of the deduction, there seems to be little likelihood that we will see any significant change in this area.

166. For a discussion of the status of alimony as income, see supra notes 98-103 and accompanying text.

167. I.R.C. § 1(c) (West Supp. 1986). The Tax Reform Act of 1969 changed the single person rate so that the tax paid by singles was no longer equal to one-half of the tax paid by a married taxpayer on twice the income. It is not less than that amount.


F. Casualty Losses

The casualty loss deduction is the deduction which has the weakest political basis. In the first place, only a relatively small number of persons benefit from the deduction. For example, in 1984 slightly less than 250,000 taxpayers took advantage of the casualty loss deduction\(^{170}\) and prior to the addition of the 10% deductible requirement almost 2 million more taxpayers had claimed the casualty loss.\(^{171}\) Moreover, because this deduction, unlike others, such as the mortgage deduction or the deduction for state and local taxes, lacks an element of predictability with respect to its enjoyment by individual taxpayers, the political effectiveness of the benefitting individuals is less than the numbers would indicate. Moreover, in addition to there being no symbiotic indirect or direct beneficiaries who can serve as organized lobbyists to protect the deduction, one of the politically best organized industries, the insurance industry, has a direct financial interest in effective repeal of the deduction regardless of the theoretical case which can be made for it.

When payment of casualty loss premiums are not deductible, and casualty losses are deductible, taxpayers are encouraged to engage in substantial self-insurance with the help of substantially increased deductible amounts on their insurance policies. This, of course, cuts down on the opportunity for insurers to maximize premiums. Consequently, it came as no surprise that in 1982, when Congress was casting about for revenue enhancers, it was with complete ease that Congress added the 10% of adjusted gross income deductible to the already existing deductible of $100 per casualty. Since the deduction in its present form produces virtually no significant loss of revenue and since further restrictions on the deductible amount would be unlikely to produce further premium revenue for insurers, it is quite likely that the casualty loss will be preserved in its present ineffective state at least as a cosmetic gesture to good tax theory.

Another deduction which was also possessed of substantial political vulnerability was the deduction with respect to adoption expenses incurred for children with special needs. In view of the small number of taxpayer direct beneficiaries and the low level of interest of any indirect beneficiaries (public and private adoption

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\(^{170}\) See Statistics of Income, supra note 65, at 5.

\(^{171}\) For a discussion of the casualty loss deduction, see supra note 107 and accompanying text.
agencies), the surprise is not that this deduction was repealed, but rather that it ever came into existence in the first place.

V. Conclusion

In discussing and evaluating personal deductions in the context of tax reform, we are called upon to perform two distinct operations. First, we should examine the idealized role which can be assigned to personal deductions in an income tax system. Second, we should evaluate the political viability of theoretically correct or incorrect personal deductions in the context of the existing political order. This article has attempted to carry out both tasks.

In conducting a theoretical evaluation of the proper role of personal deductions in an income tax system, three appropriate roles can be assigned to these deductions. First, personal deductions can perform the function of refining the tax base so that receipts are properly adjusted, thereby producing the result that only income is subject to tax. Second, they can provide a means whereby the tax base is made consistent with the principal fiscal roles assigned to the income tax. These roles are threefold: 1) creation of a tax system predicated on ability to pay; 2) creation of a tax system which is capable of raising vast sums of revenue in an efficient fashion and 3) assistance in the process of maintenance of a stable economy. Third, personal deductions can be a means whereby our tax system is made compatible with fundamental societal values which have greater legitimacy than do the concerns of tax theoreticians with creation of a comprehensive tax base. Since none of these three factors can be assigned primacy over any of the others, a sensible decision with respect to the maintenance of individual personal deductions can be made only after considering all of these factors.

Despite the individual conclusions which we may draw with respect to the theoretical justification for the existence of various personal deductions, the decisions about these deductions will be made in the political arena where other factors will be of more importance. Here the political staying power of personal deductions is basically determined by three factors. First, we must find a substantial number of individual taxpayers who benefit from the deduction and who can predictably recognize their financial benefit. Second, we should look for the existence of a symbiotic economic relationship between this mass of taxpayers and other politically powerful individuals and institutions who will directly
or indirectly benefit from the deduction claimed by the masses and who can serve as the effective political spokesmen for the masses. Last, we should find some lofty platitude which justifies the continuation of the deduction, thus bringing us back to our starting point by making the conclusions drawn with respect to the appropriate theoretical role of individual deductions of occasional relevance in the political arena.