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The Process Behind Successful Tax Reform

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Comment

THE PROCESS BEHIND SUCCESSFUL TAX REFORM*

I. INTRODUCTION

Congress’ recent proposal to overhaul the income tax system was a necessary response to the growing dissatisfaction with the income tax system. Until a decade ago, the federal income tax system, although not popular, was at least viewed as fair. However, in recent years, polls have uniformly shown that the public views the federal income tax as being the least fair, least popular tax in the country. Ultimately, this change of attitude can be attributed to the public’s growing perception that the income tax, as it is presently applied, is arbitrary and unfair. In addition, the increasing complexity and incoherency of the current Internal Revenue Code (Code) necessitates tax reform. True tax reform will not be achieved unless there is significant simplification of code provisions. This paper will focus on the reasons that tax reform is deemed necessary and the goals that the legislation is attempting to achieve. The paper will also consider the two primary tax reform proposals: the Treasury Department’s original proposal, Treasury I, and the Administration’s proposal. Finally, this paper will discuss the House’s attempt to reconcile these plans in enacting the House bill, H.R. 3838.

* EDITOR’S NOTE: This Comment is based on remarks made by David Brockway, Chief of Staff, Congressional Joint Taxation Committee. Wayne Dillahey, Associate Editor, wrote substantial portions of this Comment. This Comment was written to show the progress of the tax reform movement as of February 22, 1986, the date of the Villanova Law Review Tax Reform Symposium. The postscript reflects, briefly, some of the major changes introduced by the Tax Reform Act of 1986 since that date.

1. See The President’s Tax Proposals to the Congress for Fairness, Growth, and Simplicity, 1985: Hearings Before the House Comm. on Ways and Means, 99th Cong., 1st Sess. 8 (1985) [hereinafter cited as Hearings on President’s Proposals] (recent Internal Revenue Service survey reports that 80% of all taxpayers believe present tax system is unfair). Public hearings held by the House Ways and Means Committee also revealed increasing disrespect for, and dissatisfaction with, the federal income tax system. H.R. REP. No. 426, 99th Cong., 1st Sess. 54 (1985); see also President’s Tax Proposals to the Congress for Fairness, Growth and Simplicity I (May 1985) [hereinafter cited as President’s Proposals] (“The overwhelming majority of Americans are dissatisfied with the current tax system.”). Because the federal income tax system is based on voluntary tax compliance, it was thought that if the public’s perception of the fairness of the system continued to decline, taxpayers would become less willing to pay taxes and the viability of the tax system would be threatened.

(1803)
II. THE NEED FOR TAX REFORM

A. Closing the Tax Loopholes

As the economy becomes more sophisticated, the tax law necessarily becomes more complex. As the economic structure changes, Congress is faced with the task of enacting comprehensive legislation that will maximize revenue by ensuring that those who gain the most financial benefit from such changes bear the tax burden. However, after laws have "been on the books" for a period of time, taxpayers against whom the laws are directed devise "loopholes" or plans to get around them. Congress in turn is forced to come up with increasingly complex rules to close loopholes—the result being a Code that is several volumes thick and difficult to use.2

2. See TREASURY DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 6 (1984) [hereinafter cited as TREASURY I]. In its original tax reform proposal to the President, the Treasury Department made note of the recent boom in the tax shelter industry. Id. The Treasury Department stated:

Some shelters involve little more than thinly veiled, if sophisticated, tax fraud. But even perfectly legal tax shelters distort the allocation of scarce capital because they produce highly visible inequities in taxation. Perhaps most importantly of all, they undermine taxpayer confidence in the integrity and fairness of the tax system. Tax shelter losses typically result from a combination of current deductions for future expenses, deferral of taxable income, and conversion of ordinary income to preferentially taxed long-term capital gains. Thus, shelters allow taxpayers to defer tax liability far into the future. Tax deferral is equivalent to an interest-free loan from the Federal Government. Id. at 6-7.

3. For most taxpayers, the income tax was simpler following the enactment of the 1954 Internal Revenue Code, in part because incomes were lower and the financial affairs of most families were simpler. Id. at 3. Most taxpayers did not need to engage the services of a tax professional to file an individual income tax return and tax planning was the concern of only a few. Id.

However, as loopholes and inconsistencies in the tax laws have been discovered or created, exploited, and then plugged, techniques of tax avoidance have become increasingly sophisticated and the complexity of the income tax has grown, in a never-ending cycle. Id. at 1. The Treasury Department noted that:

Today, the proliferation and expansion of exclusions, adjustments to income, deductions, and credits create a major burden of paperwork and make part-time bookkeepers of many Americans. At present, about 100 different Federal tax forms are used by individuals. Many decisions—for example, whether and how to make a charitable contribution, whether to participate in insurance plans offered by an employer, and whether to contribute to a political party—all have tax consequences. Ordinary citizens are confronted with the alternatives of using a professional tax preparer, becoming knowledgeable in arcane tax law, running afoul of the tax administration, or possibly passing up available tax benefits. Today, over 40 percent of all individual income tax returns—and some 60 percent of all long forms (form 1040s)—are prepared by paid professionals. So-called tax shelters, once known only to the wealthy, are now attracting increasing numbers of middle-income Americans, many of whom do not have access to sophisticated tax advice and are misled by the misrepresentations of unscrupulous
Another reason that tax law has become increasingly complex is that Congress has attempted to accomplish a variety of non-tax policy goals that have started to produce a muddle of different provisions, working at cross-purposes. The result is an inefficient system whereby there is a radically different effective tax rate for different lines of business. It is as if there is an incoherent, unplanned industrial policy running through the Code, which is arbitrarily giving some industries a high effective rate and others a low effective rate. Many analysts have suggested that there would be a more efficient economy if all of the various business activities were taxed at a more comparable level, rather than at

promoters of illegal shelters, often with disastrous effects. Legislative response to the tax shelter problem over the last 15 years has involved a patchwork of solutions that has generally increased the complexity of the tax systems without correcting the underlying causes of tax shelters. Id. at 3-4.

In addition to the administrative burden imposed on taxpayers, the Code's complexity may be responsible for the public's perception that the tax system is unfair. President's Proposals, supra note 1, at 1. Taxpayers perceive "that complexity is the means by which some benefit while others do not." Id. Thus, some taxpayers feel that they have to pay more than their fair share of tax because complexities in the system give unwarranted benefits to others. See Hearings on President's Proposals, supra note 1, at 8 (statement of James A. Baker III, Secretary of Treasury).

4. Many tax incentives, which were individually designed to promote desired objectives such as encouraging investment and increasing productivity, collectively have caused significant economic distortions and have increased the tax burden on other sectors of the economy. H.R. REP. No. 426, supra note 1, at 54. These incentives have often caused the unintended result of diverting capital from productive investments to less productive, but tax-favored, investments. Id. For example, excessive tax incentives have encouraged the construction of office buildings in communities with already record high office vacancy rates. Tax incentives designed to aid farmers have shifted the ownership of farm property from family farmers to investors with higher marginal rates, since the latter obtain greater benefits from the tax deductions provided.

Id. Due to such tax incentives, many "investments are made only because they produce large deductions and credits that may be used to offset other income, and, importantly, not because there is a market demand for the services provided by these investments." Id. Such "tax-induced distortions in the use of labor and capital and in consumer choices have severe costs in terms of lower productivity, lost production, and reduced consumer satisfaction." Treasury I, supra note 2, at 4. Consequently, the federal tax code has become overloaded with tax incentive provisions "that fail to accomplish the objectives for which they were originally intended." H.R. REP. No. 426, supra note 1, at 54.

5. The existing taxation of capital and business income "favors capital-intensive industries over others, such as services." Treasury I, supra note 2, at 5. Existing tax laws also favor: "industries that are usually dependent on equipment over those—such as wholesale and retail trade—that rely more heavily on other forms of capital, including inventories and structures." Id.

Other industries that currently benefit from special tax subsidies or preferences include banking, insurance, mining, timber and oil and gas. See President's Proposals, supra note 1, at 6.
the radically diverse levels that exist under current law.\footnote{By not taxing all business activities similarly, the tax system reduces the efficiency of the economy. H.R. Rep. No. 426, supra note 1, at 59. Excessive tax preferences for certain industries result in too much investment in those industries and force other industries to shoulder an increased tax burden. Id. If investments were equally taxed in all business sectors, the tax system would no longer interfere with the efficient allocation of resources in the economy. Id. at 58. When the market, rather than the tax laws, governs capital allocation, "the total output obtainable from the economy's stock of capital is maximized." Id. at 59; see also Hearings on President's Proposals, supra note 1, at 534 (statement of Alan Greenspan, President, Townsend-Greenspan & Co.: sounder economy likely to result as consequence of shift away from tax subsidies).
}

Another reason that enactment of non-tax policy goals leads to disenchattment, is that the goals are accomplished by reducing the taxes of those who make a desired investment, thereby defeating the major goal of the income tax system, which is to insure that those taxpayers who make the same amount of income pay the same amount of tax. The result is that Congress is forced, through public pressure, to enact anti-abuse rules designed to prevent people from decreasing their income tax by taking advantage of incentives originally in the Code. This phenomenon of creating incentives and then indirectly eliminating them, further contributes to the incoherency and instability of the Code. Many experts argue that if Congress enacts a system with the sole goal of raising revenue, the result will be a more coherent, stable Code.\footnote{See, e.g., Hearings on President's Proposals, supra note 1, at 1806 (statement of K. Martin Worthy, Chairman, American College of Tax Counsel: sole purpose of Code should be to raise revenue).}

B. Unfairness of the Current System

Because the general public feels it is being taken advantage of, it perceives the current system as unfair. A common complaint of average taxpayers is that while they are paying a substantial amount of taxes, a majority of those taxpayers earning a higher income, as well as many businesses, are paying little or no tax.\footnote{See Treasury I, supra note 2, at 9; President's Proposals, supra note 1, at 1. For a further discussion of the public's view of the unfairness of the tax system, see supra note 1 and accompanying text.}

In fact, this is a partial misconception, because the current system is a progressive one with upper-income people, on the average, paying a significantly higher tax rate than middle- and lower-income people.\footnote{See I.R.C. § 1 (West Supp. 1986). The present personal income tax law provides for 14 brackets of tax rates ranging from 11% to 50%. Id.}

Furthermore, corporations, even though their contributions to federal revenue have decreased over the last thirty years,\footnote{See H.R. Rep. No. 426, supra note 1, at 55. Between 1955 and 1985, the percentage of total budget receipts attributable to corporate income taxes declined from 27% to 8%. Id. Over the same period, the corporate income tax as a percentage of total income tax receipts declined from 38% to 16%. Id. at 56.} still pay a substantial amount of taxes.

A 1983 study of effective corporate tax rates does lend some
credence to the public's view that corporations are not meeting their share of the tax burden. The study established that eighty of the 200 largest corporations had an effective tax rate of less than 10%, measured by the amount of tax paid as a percentage of book income reported to shareholders.\textsuperscript{11} At the present time, the conclusion is inescapable that there are numerous highly successful businesses paying very little revenue to the federal government. On the individual side, a 1983 study of United States taxpayers earning over $250,000 revealed that a number did pay a substantial amount of tax.\textsuperscript{12} However, about 11% of those high-income taxpayers had effective tax rates of less than 5% and more than half had effective tax rates of less than 20%.\textsuperscript{13} Among taxpayers with the very highest incomes—those with incomes greater than $2 million in 1983—63% paid an effective tax rate of less than 20%.\textsuperscript{14} In light of these figures, the general view as to the unfairness of the system seems justified. This is best typified by noting that most people in the entry-level bracket have income and social security tax imposed on the first dollar of their income which results in an effective rate of 14% (the income tax alone at this level is 11%). Thus, at the present time, there are a significant number of taxpayers with income levels below the poverty line paying more taxes than approximately 15% of the richest individuals in the United States.

Perhaps the primary reason for this disparity in tax payments is the substantial amount of tax sheltering tolerated by the system thereby allowing high-income taxpayers to avoid the payment of a significant amount of tax.\textsuperscript{15} Tax reform must address the public's concern that

\textsuperscript{11} See Hearings on President's Proposals, supra note 1, at 351 (statement of Robert S. McIntyre, Director of Federal Tax Policy, Citizens for Tax Justice: median tax rate was 8.7% for large corporations). The Joint Committee on Taxation and Citizens for Tax Justice conducted studies on the nation's largest corporations which found that the average effective corporate rate has fallen to between 14% and 16%. \textit{Id.} In the Citizens for Tax Justice's October 1984 report, it was disclosed that the median tax rate for "250 large, profitable companies" was only 8.7%. \textit{Id.} Between 1981 and 1983, more than half of the 250 companies studied enjoyed at least one year in which they either paid no federal income taxes or received tax refunds. \textit{Id.} A quarter of the companies paid no federal income taxes at all over the three-year period, including such giant firms as General Electric, Boeing, Dow Chemical and Tenneco. \textit{Id.}

\textsuperscript{12} \textit{Id.} at 20 (statement of James A. Baker, III, Secretary of the Treasury). The Treasury Department studied taxpayers who, ranked by income, represented approximately the top one-fourth of one percent of all households in the United States. \textit{Id.} The study ranked these taxpayers on the basis of their positive sources of income only, that is, income before deducting any offsetting losses. \textit{Id.}

\textsuperscript{13} \textit{Id.}

\textsuperscript{14} \textit{Id.} Eleven percent of those taxpayers with incomes in excess of $2 million paid an effective tax rate that was less than 5%. \textit{Id.}

\textsuperscript{15} See \textit{TREASURY I}, supra note 2, at 6-9. In its original tax reform proposal to the President, the Treasury Department illustrated the recent abuses of tax shelters by citing a sample of 88 taxpayers who held interests in certain tax shelters. \textit{Id.} at 7. The Treasury Department explained that tax shelter accounting
many taxpayers are making investments that allow them to avoid paying any current tax to the federal government. In summation, in order to achieve tax reform which will be acceptable to the general public, Congress must enact a statutory scheme which fairly distributes the tax burden. 16

C. Who Should Bear the Burden of Tax Reform

In the past, taxpayers have resisted any attempts to “broaden the tax base” and “lower rates” because they believed that such suggestions were in actuality simply attempts to change the distribution of the tax law or raise revenue. Consequently, the tax reform legislation which has recently been proposed is designed to avoid those issues by being neutral as to revenue raising and tax distribution. 17

Despite the fact that one of the congressional goals to be furthered by the tax reform legislation is to lower tax rates across the board, some individual’s and corporation’s taxes are necessarily going to increase. 18

losses and other business and investment-related losses are used to offset gross income and, thereby, reduce the taxpayer’s income tax liability. Id. at 9. The Treasury Department study concluded:

Of the 88 returns sampled, 19 returns, with an average gross income before loss (positive income) of $243,710, reported a total income tax payment of $500 or less; 37 returns, with an average gross income before loss of $172,113 reported a total tax payment of $6,000 or less. By comparison, a typical family of four, with positive income of $45,000, but no tax shelter losses, would pay $6,272 in taxes. The extent to which tax shelter losses can be used to dramatically reduce tax liabilities is further documented by estimates from the 1983 Treasury tax model which show that 9,000 taxpayers with gross incomes before losses of $250,000 or more paid no tax as a direct result of partnership losses, while 59,000 taxpayers with that much positive income were able to reduce their tax payments by at least one-half.

Id.

16. In fact, it was because of massive tax distribution problems that the Treasury Department, in its original tax reform proposal, recommended not adopting a flat tax. Id. at 21-23. The Treasury Department noted that some of the advantages of a pure flat tax, as compared to the present graduated system of tax rates, included the loss of taxpayers incentive to shift and defer income to take advantage of lower rates. Id. at 21. However, the Treasury Department concluded that, despite these important advantages, the redistribution of the tax burden from high-income taxpayers to low or middle-income taxpayers was unacceptable. Id. Thus, the Treasury Department recommended against the enactment of a pure flat tax. Id. at 23.

17. See H.R. Rep. No. 426, supra note 1, at 62, 84-85. It is estimated that the bill passed by the House of Representatives, H.R. 3838, will raise 99.9% of the revenue which would have been raised under current law over the five-year period from 1986 to 1990. Id. at 62. In addition to being revenue neutral, H.R. 3838 attempts to distribute individual tax reductions equitably among the vast majority of individuals who bear the tax burden, thereby avoiding tax redistribution problems. Id. at 84.

18. The total amount of tax revenue generated is basically a function of two variables, the tax rate and the tax base. If the tax reform legislation is to be revenue neutral as planned, the proposed reductions in tax rates must be offset
It is primarily those taxpayers who are not benefitting from substantial preferences under the current law who will have their aggregate tax rate reduced. 19 Perhaps the entities which will be most adversely affected by the recent tax reform proposals will be corporate taxpayers. 20 As can be expected, corporate lobbyists are actively resisting the recent tax reform proposals. It is not surprising that the taxpayers who may lose substantial preferences under the various tax reform proposals are lobbying much more actively than those members of the general public who will benefit from tax reform.

II. The Political Process Behind Enacting Comprehensive Tax Reform

A. The Treasury Department’s Proposal and the Administration’s Proposal

Despite the opposition from a strong corporate lobby, there will be tax reform, primarily because of the leadership of President Reagan, who strongly supports significant tax reform. In 1984, President Reagan directed the Treasury to design a comprehensive tax reform package. 21 by a corresponding increase in the tax base. The proposed legislation broadens the tax base by eliminating inefficient and preferential tax provisions and curtailing abuses. Id. at 57. Consequently, individual taxpayers and corporations which formerly benefitted from these preferential tax laws may be faced with increased tax liability despite the rate reductions.

19. For example, under the Administration’s proposal, 79% of all families and individuals would have their taxes reduced or would experience no change in their income tax liability. See Hearings on President’s Proposal, supra note 1, at 27 (statement of James A. Baker, III, Secretary of the Treasury). The 21% who would face increased tax bills, are those currently enjoying special tax law benefits or concessions which are not being enjoyed by the majority. Id. This 21% would see their tax bills rise by an average of 17%. Id.

20. See H.R. REP. No. 426, supra note 1, at 55-56. Between 1950 and 1985, the income tax paid by corporations as a percentage of total income tax receipts declined from 40% to only 16%. Id. at 55. For a discussion of the reduction of the proportion of income taxes paid by corporations, see supra note 10 and accompanying text. The tax reform bill passed by the House, H.R. 3838, will greatly restrict the ability of corporations to eliminate their tax liability in an attempt to restore the traditional balance of income tax between individuals and corporations. Id. The House bill will increase the share of total taxes paid by corporations an estimated 2.9% over the next five years. Id. at 56. The House explained that “[w]hile this increase is significant relative to the present law projections, the estimated share of taxes paid by corporations is still modest in comparison to historical levels.” Id.

21. See Treasury I, supra note 2, at iii. President Reagan directed the Treasury to undertake this study in his State of the Union address in January, 1984. Id. In this address, the President stated:

To talk of meeting the present situation by increasing taxes is a Band-Aid solution which does nothing to cure an illness that has been coming on for half a century, to say nothing of the fact that it poses a real threat to economic recovery. . . .

There is a better way: Let us go forward with an historic reform for fairness, simplicity and incentives for growth. I am asking Secretary Don Regan for a plan for action to simplify the entire tax code so all
The result, *Treasury I*, was politically neutral and, from a tax expert's standpoint, an accurate measurement of income. The Reagan Administration made a number of changes to *Treasury I* in order to have this proposal comply with its policy goals. These changes solved certain political problems which were inherent in *Treasury I*. Nevertheless, the tax reform package that the Administration sent to Congress was an extremely controversial piece of legislation.

Generally, the House supported the notion of broadening the tax base. There were a number of representatives who felt this issue to be so important that they would not support a tax reform package which did not accomplish significant base broadening. In fact, one of the major difficulties in achieving tax reform legislation has been this refusal by individual members of the House to support an overall package that does not include the various elements that each feels is important to achieve comprehensive tax reform. This may be illustrated by examining the response to *Treasury I*’s proposal to eliminate the deduction for payment of state and local taxes. Although a simple majority of the taxpayers, big and small, are treated more fairly... I have asked that specific recommendations, consistent with those objectives, be presented to me by December 1984.

*Id.*

22. See *Treasury I*, supra note 2, Vols. 1, 2 and 3.

23. See *Hearings on President's Proposals*, supra note 1, at 2403-58 (statements of Harvey Galper, Senior Fellow, the Brookings Institution; Hugh Calkins, Esq., Jones, Day, Reavis & Pogue, Cleveland, Ohio; Paul McDaniel, Professor of Law, Boston College School of Law; Marshall E. Blume, Professor of Finance, the Wharton School, University of Pennsylvania; and Isabel Sawhill, Senior Fellow, the Urban Institute). The Treasury Department’s proposal noted that in order to insure a fair and neutral tax code, all income had to be subject to taxation, regardless of its source or use. *Treasury I*, supra note 2, at 73. Therefore, *Treasury I* sought to broaden the tax base by: 1) subjecting presently excluded sources of income to taxation and 2) eliminating deductions for certain preferred uses of income. *Id.* at 73-84. In the former category, *Treasury I* proposed changes to existing law in the areas of employee fringe benefits, retirement savings, wage replacements, scholarships and fellowships and treatment of capital gains. *Id.* at 73-77. In the latter category, *Treasury I* proposed eliminating some deductions for state and local taxes, charitable contributions and interest expenses. *Id.* at 78-83. For a further discussion of *Treasury I*’s proposal to eliminate the deduction for payment of state and local taxes, see infra notes 26-27 & 30 and accompanying text.


25. See *Hearings on President's Proposals*, supra note 1, at 5 (statement of Dan Rostenkowski, Chairman, Committee on Ways and Means, U.S. House of Rep.: House must broaden tax base by reducing or eliminating preferences which protect income from taxation).

26. See *Treasury I*, supra note 2, at 78. *Treasury I* justified the proposed elimination of the state and local tax deduction on a number of grounds. *Id.* First, the Treasury explained that the historical justification for the deduction was no longer relevant. *Id.* Many years ago, when top federal income tax rates near 90%, the deduction was necessary to “prevent the sum of the marginal tax rates for federal and state income taxes from exceeding 100 percent.” *Id.*
House Ways and Means Committee would have supported imposing a limitation on the deduction for state and local taxes, a working majority could not be achieved because four of five members of the committee would not support a bill including this change. Thankfully, in the end, concessions were made as members focused their attention on enacting a bill that the public would perceive as reflecting its objectives rather than one that would reflect the objectives of a committee composed of tax experts.27

B. Comparison of the Administration’s Proposal and H.R. 3838

The basic features of the Administration’s proposal and H.R. 3838 are the same. The substantial rate reductions, both on the corporate and individual side, particularly in the upper rate bracket, are present in both H.R. 3838 and the Administration’s proposal.28 Furthermore, each version funds the rate reductions by broadening the tax base. In the aggregate, H.R. 3838 probably broadens the base slightly more than the Administration’s proposal. Profiles of the “winners” and “losers” are substantially the same as each proposes to shift the tax burden from the individual to the corporate sector.29

The greatest difference between the Administration’s proposal and H.R. 3838 is that the former would repeal the deduction given for state

The Treasury concluded that given the present levels of tax rates, such a possibility did not exist and, therefore, the deduction was no longer needed. Id.

In addition, the Treasury explained that because the deduction for state and local taxes leads to higher federal tax rates for everyone, there is a net benefit only for those states that levy above-average taxes. Id. at 80. Residents of states with below-average taxes are worse off than if there was no deduction. Id. Therefore, the Treasury noted that these low-tax states were indirectly subsidizing the high-tax states. Id. at 81.

27. The House passed H.R. 3838 which retains the full deduction for payment of state and local taxes. See H.R. Rep. No. 426, supra note 1, at 60.

28. Compare H.R. 3838, 99th Cong., 1st Sess. §§ 101, 301 (1985) with President’s Proposals, supra note 1, at 3, 118. The Administration proposed that the current 14 tax rates should be replaced by three rates—15%, 25% and 35%—and that the applicable tax rate brackets should be indexed to adjust for inflation as under existing law. President’s Proposals, supra note 1, at 3. The House Bill, H.R. 3838, provides for four marginal tax rates, 15%, 25%, 35% and 38%. H.R. 3838, 99th Cong., 1st Sess. § 101 (1985). The Administration would reduce the maximum rate for corporations from 46% to 33%. President’s Proposals, supra note 1, at 118-19. H.R. 3838 decreases the maximum corporate rate to 36%. H.R. 3838, 99th Cong., 1st Sess. § 301 (1985).

29. See President’s Proposals, supra note 1, at 461; H.R. Rep. No. 426, supra note 1, at 56. The President’s proposal would increase the yearly income tax liability of corporations by approximately $20 billion over current law while the income tax liability of individuals would decrease approximately $25 billion. President’s Proposals, supra note 1, at 461. H.R. 3838 calls for the share of total taxes paid by corporations to increase from 15.6% in 1985 to 22.3% in 1990. H.R. Rep. No. 426, supra note 1, at 56. For a discussion of how the share of the corporate income tax as a percentage of total income tax receipts has declined over the last 30 years, see supra note 10.
and local taxes. By eliminating this deduction, the Administration's proposal would raise approximately $150 billion in revenue during a five-year period.\textsuperscript{30} However, H.R. 3838 retained the deduction.\textsuperscript{31} Theoret-

\textsuperscript{30} See President's Proposals, supra note 1, at 62-64, 453. Under current law, individuals who itemize deductions are permitted to deduct state and local property taxes, income taxes and general sales taxes without regard to whether they were incurred in carrying on a trade or business or an income-producing activity. \textit{Id.} at 62. Other state and local taxes are deductible by individuals only if they are incurred in carrying on a trade or business or income-producing activity. \textit{Id.} The President's Proposals noted that this deduction has created one of the most serious omissions from the federal income tax base and claimed that unless this omission is corrected, a substantial reduction in marginal rates will not be possible. \textit{Id.} at 63. Consequently, the Administration proposes the repeal of the itemized deduction for state and local income taxes and for other state and local taxes which are not incurred in the carrying on of a trade or business or income-producing activity. \textit{Id.} at 64. State and local taxes (other than income taxes) which currently are deductible only by itemizers, but which were incurred in carrying on an income-producing activity, will be aggregated with employee business expenses and will be deductible subject to a threshold. \textit{See id.} at 104-05.

\textsuperscript{31} See H.R. REP. No. 426, supra note 1, at 60. The House Committee on Ways and Means noted that the proposal to eliminate the deduction for state and local taxes stimulated more broad-based concern than any other provision of the President's package. \textit{See Hearings on President's Proposals, supra note 1, at 5449. In recognition of this, the Committee scheduled a full-day's hearing on the impact of the President's proposal on state and local governments. \textit{See id.} at 5449-888. The majority of speakers at the hearing strongly opposed eliminating the deduction for a variety of reasons. \textit{See id.} at 5450 (statement of Jacob K. Javits, former Senator from New York: eliminating deductions runs counter to reality, to U.S. Federal system, to comity between states and to equal treatment of their citizens): \textit{id.} at 5455 (statement of Howard Wolpe, member of Congress from Michigan: proposed elimination of deduction would violate reciprocal immunity whereby states do not tax federal property and federal government does not tax state and local activities); \textit{id.} at 5479 (statement of Bill Green, member of Congress from New York: deduction does not subsidize high tax states because such states assume greater social responsibility than other states); \textit{id.} at 5485 (statement of John Carlin, Governor, State of Kansas: state and local tax deduction contributing disproportionate share of base broadening compared to other deductions); \textit{id.} at 5502 (statement of Mario M. Cuomo, Governor, State of New York: deduction must be retained because it is part of overall subsidy structure built into Code and because it helps states meet their needs); \textit{id.} at 5609 (statement of Andrew P. O'Rourke, County Executive, Westchester County, New York: deductibility of taxes preserves ability of state and local governments to raise revenues and provide services, promotes equity in federal tax system, avoids excessive cumulative tax rates and helps preserve independence of state and local governments); \textit{id.} at 5597 (statement of Don Bailey, Auditor General, Commonwealth of Pennsylvania: elimination of deduction would have devastating impact upon both state and local governments); \textit{id.} at 5600 (statement of Patrick G. Halpin, Assemblyman, Lindenhurst, New York: eliminating deduction of local taxes would reduce local government investment in public education); \textit{id.} at 5603 (statement of John Bragg, Deputy Speaker, Legislature of Tennessee, President, National Conference of State Legislatures: deduction should be retained to avoid increasing financial pressure on state and local governments, to maintain balance in the federal system of government, to avoid skewing priorities, to avoid greater tax competition and to avoid double taxa-
cally, the deduction may not be justifiable from a tax policy standpoint,\textsuperscript{32} but as a political matter, it was simply not realistic for the

\textsuperscript{32} The deduction for payment of state and local taxes is often defended on the grounds that income used to pay taxes to other levels of government should not be counted in determining an individual’s ability to pay taxes at the federal level. \textit{Hearings on President’s Proposals}, supra note 1, at 5617 (statement of Al Bilik, Executive Director, State and Local Division, Public Employee Department, AFL-CIO). To subject the income used to make state and local tax payments to a federal tax amounts to double taxation which is fundamentally unfair. \textit{See id.} at 5618 (statement of John Bragg, President, National Conference of State Legislatures).

However, in recommending that the deduction be eliminated, the President’s proposal dismissed this rationale as fallacious. \textit{President’s Proposals}, supra note 1, at 63-64. In reaching this conclusion, the President’s proposal explained:

Some argue that the deductibility of State and local taxes is appropriate because individuals should not be “taxed on a tax.” The argument is deficient for a number of reasons. First, it ignores the effect of State and local tax deductibility on the Federal income tax base. Deductibility not only reduces aggregate Federal income tax revenues, it shifts the burden of collecting those revenues from high-tax to low-tax States. High-tax States effectively shield a disproportionate share of their income from Federal taxation, leaving a relatively greater share of revenues to be collected from low-tax States. Absent the ability to impose Federal income tax on amounts paid in State and local taxes, the Federal government loses the ability to control its own tax base and to insist that the burden of Federal income taxes be distributed evenly among the States.

Second, the “tax on a tax” argument suggests that amounts paid in State or local taxes should be exempt from Federal taxation because they are involuntary and State or local taxpayers receive nothing in return for their payments. Neither suggestion is correct. State and local taxpayers have ultimate control over the taxes they pay through the electoral process and through their ability to locate in jurisdictions with amenable tax and fiscal policies. Moreover, State and local taxpayers receive important personal benefits in return for their taxes, such as public education, water and sewer services, and municipal garbage removal. In this respect, the determination by State and local taxpayers of their levels of taxation and public service benefits is analogous to their individual decisions over how much to spend for the purchase of private goods.

It is, of course, true that not all benefits provided by State and local governments are directly analogous to privately purchased goods or services. Examples include police and fire protection, judicial and administrative services and public welfare. These services nevertheless provide substantial personal benefits to State and local taxpayers, whether directly or by enhancing the general quality of life in State and local communities.

Finally, the “tax on a tax” argument is contradicted by the practice of most States with respect to their own tax systems, including many of
Administration to expect Congress to repeal this deduction. As far as H.R. 3838 was concerned, it was not even a regional issue—there was not much support from any area of the country to repeal this deduction. As far as H.R. 3838 was concerned, it was not even a regional issue—there was not much support from any area of the country to repeal this deduction. 

Retaining this deduction was an example of Congress' attempt to meet the public's objectives: the general public does not believe that the deduction it receives for paying taxes is the abuse in the system which causes basic unfairness. Rather, the general perception is that payment of taxes is a cost that should justifiably result in a deduction. By not eliminating the deduction for state and local taxes, the largest revenue raising aspect of the Administration's proposal, H.R. 3838 necessarily had to contain fewer rate cuts than the Administration's proposal necessarily had to contain fewer rate cuts than the Administration's proposal.

Federal income taxes are allowable as a deduction from State individual income taxes in only 16 States and from State corporate income taxes in only seven States. New York and California, States with very high tax rates, are among the States that deny a deduction for Federal income taxes.

In addition, the President's proposal supported its recommendation to eliminate the deduction by noting that the deduction disproportionately benefits high-income taxpayers residing in high-tax states. The Treasury Department, in its tax reform proposal to the President, set forth a similar argument to support its recommendation to repeal the deduction. See Treasury I, supra note 2, at 78-81. For a discussion of the Treasury Department's argument in support of its recommendation to eliminate the deduction for state and local taxes, see supra note 26. However, advocates of the deduction dispute this argument as well. See Hearings on President's Proposals, supra note 1, at 5606 (statement of John Bragg, President, National Conference of State Legislatures). These advocates argue that the deduction is of genuine benefit to the middle class, not merely to high-income taxpayers. As for "high tax states," they argue that the deduction is only one of many federal provisions which does not treat states even-handedly.

The average citizen in the thirty-four lower-tax states ends up subsidizing high-income taxpayers in higher-tax states. Governor Thornburgh concluded that "the choice is simple: either to continue a tax break which benefits only one-third of all taxpayers, and those in the high brackets in high-tax States at that, or to provide lower tax rates for all taxpayers in all States, as the President has proposed." In calling for the repeal of the deduction, Governor Thornburgh claimed that the two-thirds of Americans who do not itemize get no benefit from the deduction, and end up subsidizing those who do. In calling for the repeal of the deduction, Governor Thornburgh claimed that the two-thirds of Americans who do not itemize get no benefit from the deduction, and end up subsidizing those who do. In calling for the repeal of the deduction, Governor Thornburgh claimed that the two-thirds of Americans who do not itemize get no benefit from the deduction, and end up subsidizing those who do. Id. at 5509. The Governor stated that the average citizen in the thirty-four lower-tax states ends up subsidizing high-income taxpayers in higher-tax states. Id. Governor Thornburgh concluded that "the choice is simple: either to continue a tax break which benefits only one-third of all taxpayers, and those in the high brackets in high-tax States at that, or to provide lower tax rates for all taxpayers in all States, as the President has proposed." Id. at 5509. The Governor stated that the average citizen in the thirty-four lower-tax states ends up subsidizing high-income taxpayers in higher-tax states. Id. Governor Thornburgh concluded that "the choice is simple: either to continue a tax break which benefits only one-third of all taxpayers, and those in the high brackets in high-tax States at that, or to provide lower tax rates for all taxpayers in all States, as the President has proposed." Id. at 5509. The Governor stated that the average citizen in the thirty-four lower-tax states ends up subsidizing high-income taxpayers in higher-tax states. Id. Governor Thornburgh concluded that "the choice is simple: either to continue a tax break which benefits only one-third of all taxpayers, and those in the high brackets in high-tax States at that, or to provide lower tax rates for all taxpayers in all States, as the President has proposed." Id. at 5509. The Governor stated that the average citizen in the thirty-four lower-tax states ends up subsidizing high-income taxpayers in higher-tax states. Id. Governor Thornburgh concluded that "the choice is simple: either to continue a tax break which benefits only one-third of all taxpayers, and those in the high brackets in high-tax States at that, or to provide lower tax rates for all taxpayers in all States, as the President has proposed." Id.
posal. The result is that taxpayers in the middle-rate brackets, which apply to lower-middle income taxpayers, will not realize any substantial rate cuts.\textsuperscript{35} Tax cuts in H.R. 3838 come primarily through increases in the standard deduction and the personal exemption.\textsuperscript{36} The effect is to increase the tax entry point above the poverty line and cut taxes for individuals across the board.\textsuperscript{37}

One other significant difference between the Administration's pro-

\begin{table}
\begin{tabular}{|c|c|c|}
\hline
Marginal Tax Rate (percent) & Taxable Income ($) & President's Proposal & H.R. 3838 \\
\hline
15 & 4,000 to 29,000 & 0 - 22,500 \\
25 & 29,000 to 70,000 & 22,500 - 43,000 \\
35 & 70,000 or more & 43,000 - 100,000 \\
38 & N/A & 100,000 or more \\
\hline
\end{tabular}
\end{table}

See President's Proposals, supra note 1, at 3; H.R. Rep. No. 426, supra note 1, at 90.

\textsuperscript{36} See H.R. Rep. No. 426, supra note 1, at 90-91. H.R. 3838 called for re-instituting the standard deduction in place of the current zero bracket amount (ZBA). Id. at 87. The House explained that:

many individuals find the ZBA to be confusing and do not view it as a device that simplifies calculation of income tax liability. Under the committee bill, taxpayers will deduct certain expenses (the standard deduction or a total of separately itemized amounts) in order to determine taxable income. Unlike the ZBA, the standard deduction enables the taxpayer to know directly how much income is subject to tax and to understand more clearly that taxable income is the base for determining tax liability.

Id. at 88. The bill calls for the standard deduction to increase from $3,540 to $4,900 for joint returns, from $2,990 to $4,200 for heads of households and from $2,990 to $2,950 for single taxpayers. Id. at 91. In addition to these increases, the standard deduction will be increased an additional $600 for each taxpayer who is age 65 or older, or who is blind. Id.

In addition, H.R. 3838 calls for an increase in the personal exemption amount to $2,000. Id. Indexing of this amount to adjust for inflation will continue, beginning in 1987. Id. The additional exemption under present law for the elderly and for the blind will be repealed because such taxpayers will be entitled to a larger standard deduction. Id.

Id. at 82. An overriding goal of the House bill is to relieve millions of poverty-level individuals from federal income tax liability. Id. Accordingly, H.R. 3838 increases the amounts of both the personal exemption and the standard deduction, as well as the earned income credit, thereby, raising the income level at which individuals begin to have tax liability (tax threshold). Id. The committee estimates that as a result of these changes, 6.5 million poverty-level taxpayers will be relieved from the tax roles. Id. In addition, the benefit of these increases will not be confined to the poor because they will reduce the tax burden for all families by raising the tax threshold for everyone. Id. at 83.
posal and H.R. 3838 is that the distribution of tax cuts in H.R. 3838 is substantially more even-handed. There is a reasonably uniform consensus among the members of the Administration that the distribution scheme in the Administration's bill was inequitable.\textsuperscript{38} H.R. 3838, on the other hand proposes to redistribute the tax cuts in what is perceived to be a much fairer manner.\textsuperscript{39}

On the corporate side, H.R. 3838 proposes to increase corporate tax rates over the Administration's proposal, while maintaining other

\textsuperscript{38} One of the most common criticisms of the distribution scheme in the Administration's proposal is that the proposal grants its largest tax reductions to the wealthiest Americans, while the burden distributed among the broad middle-income bracket remains largely unchanged. \textit{See Hearings on President's Proposals, supra} note 1, at 355 (statement of Robert S. McIntyre, Director of Federal Tax Policy, Citizens for Tax Justice); \textit{id.} at 558 (statement of Richard A. Musgrave, Professor of Economics, Harvard University and University of California, Santa Cruz). Critics argue that under the Administration’s plan, the average individual earning more than $200,000 will save $10,000 a year in taxes. \textit{id.} at 355. This proposed distribution of the tax cuts is particularly troubling to critics of the Administration’s plan:

The rich already got their share and more of tax reduction as a result of the President’s 1981 tax legislation. Individuals earning more than $200,000 received an average of $30,000 a year or more in tax reductions from the 1981 rate reductions and expanded tax avoidance devices. There is nothing even-handed about giving the rich additional large tax cuts, while short-changing the middle class and, for the poor, merely rolling back the tax increases that occurred during the President’s first term.

\textit{id.}

\textsuperscript{39} \textit{See H.R. REP. No. 426, supra} note 1, at 84. Under the House bill, individuals with less than $75,000 of income (95\% of all income tax filers) will receive 72\% of the total tax reduction for individuals. \textit{id.} at 85. Taxpayers with incomes above $75,000 will receive the remaining 28\% of the total tax reduction. \textit{id.} The percentage change in income tax liability and after tax income for each income class due to H.R. 3838 for 1987 is illustrated by the following table:

\begin{center}
\begin{tabular}{lccc}

\hline
Income class (thousands of 1986 dollars) & Percentage & Percentage & Percentage \\
 & change in & change in social & change in after-

| Income class (thousands of 1986 dollars) | Percentage change in income tax liability | Percentage change in social security and income tax liability | Percentage change in after-tax income |
|------------------------------------------|------------------------------------------|------------------------------------------------------------|
| Less than $10                            | -76.0                                    | -18.5                                                     | 1.0 |
| 10-20                                    | -23.4                                    | -12.8                                                     | 1.5 |
| 20-30                                    | -9.9                                     | -6.1                                                      | 1.0 |
| 30-40                                    | -9.0                                     | -5.7                                                      | 1.0 |
| 40-50                                    | -8.7                                     | -5.8                                                      | 1.2 |
| 50-75                                    | -7.4                                     | -5.4                                                      | 1.2 |
| 75-100                                   | -5.7                                     | -4.7                                                      | 1.2 |
| 100-200                                  | -7.3                                     | -6.5                                                      | 1.9 |
| 200 and above                            | -5.9                                     | -5.7                                                      | 1.9 |

\hline
Total                                      | -9.0                                     | -6.6                                                      | 1.3 |
\end{tabular}
\end{center}

\textit{id.}
preferences which have historically favored corporations. With regard to specific industries, H.R. 3838 and the Administration's proposal assign the brunt of the tax increase to capital intensive industries, banking and insurance. Over the first five years, the aggregate revenues from corporations under H.R. 3838 are similar to those suggested in the Administration's proposal.

Despite the aforementioned similarities with the Administration's bill, H.R. 3838 actually contains significant differences. Perhaps the most important difference between the two is that the Administration's proposal did not include any transition rules. H.R. 3838, on the other

40. See id. at 232. The following chart offers a comparison of the corporate tax rates proposed in the Administration's plan and under H.R. 3838.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate %</th>
<th>Taxable Income</th>
<th>Tax Rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $25,000</td>
<td>15</td>
<td>Not over $50,000</td>
<td>15</td>
</tr>
<tr>
<td>25,000 - 50,000</td>
<td>18</td>
<td>50,000 - 75,000</td>
<td>25</td>
</tr>
<tr>
<td>50,000 - 75,000</td>
<td>25</td>
<td>Over 75,000</td>
<td>36</td>
</tr>
<tr>
<td>Over 75,000</td>
<td>33</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

See id.; President's Proposals, supra note 1, at 119. Both proposals called for the phase out of the benefit of graduated rates for corporations which earn above a certain taxable income. The Administration's proposal calls for the imposition of a flat tax of 33% for a corporation with taxable income over $360,000 while H.R. 3838 provides for a flat tax of 3% for a corporation with taxable income in excess of $365,000. See H.R. Rep. No. 426, supra note 1, at 233; President's Proposals, supra note 1, at 119.

41. See H.R. Rep. No. 426, supra note 1, at 55-56. The committee explained that many tax provisions that have been used by these industries to substantially reduce their tax liabilities will be eliminated or restricted by the bill. Id. For example, the committee noted that defense contractors and large construction firms will no longer be permitted to defer income to the future while they take current deductions for expenses. Id. Under the bill, large commercial banks would no longer be allowed to take deductions for bad debts before the underlying loan is determined to be wholly or partially worthless. Id. Finally, the committee noted that the insurance industry will also be subject to greater income tax due to rules designed to more accurately measure income. Id. at 56. For a discussion of other industries which currently benefit from preferential tax provisions, see supra note 5.

42. Compare H.R. Rep. No. 426, supra note 1, at 65 with President's Proposals, supra note 1, at 461. The projected corporate tax revenue under the House bill for the years 1986 to 1990, respectively, will be (in billions of dollars) 15.6, 22.9, 27.1, 32.0 and 41.2. H.R. Rep. No. 426, supra note 1, at 65. In comparison, the President's proposal will generate corporate revenues of (in billions of dollars) 18.9, 26.1, 24.3, 23.9 and 25.2. President's Proposals, supra note 1, at 461.

43. See President's Proposals, supra note 1, at 435. The President's proposal invited the congressional tax writing committees to design appropriate transition rules to minimize the unfairness and disruption which would result if the changes were immediately implemented. Id.
hand, introduces approximately $25 billion worth of transition rules.44 Another difference is that the Administration’s proposal introduced a windfall recapture tax, which increased the tax for accelerated depreciation claimed on property put in service before the legislation goes into effect.45 Although this proposal would have generated about $55 billion,46 there was never really support in any stage of the political process for adopting such a change. A tax reform plan which contains a windfall tax and which did not provide any transition rules had no chance of making it through Congress intact.

Following the correction of these shortcomings, the Administration sent the revised version of its proposal to Congress. However, this revised version was essentially $75 billion short of its goal to remain revenue-neutral. Consistent with the goal to enact legislation that the general public would perceive as fair, Congress necessarily has to raise this revenue by increasing the taxes paid by the business sector. Obviously, this means that the House bill is much less attractive to corporate taxpayers than the Administration’s version.

Despite the differences between the two bills, the Administration

45. See President’s PROPOSALS, supra note 1, at 193. The President’s proposal noted that the substantial rate reductions in the plan made recapture of accelerated depreciation deductions appropriate. Id. In explaining the need for the windfall recapture tax, the proposal noted that:
[most taxpayers with substantial accelerated cost recovery deductions taken over the period 1980-85 will have been able to reduce tax at rates of 46 or 50 percent (48 or 70 percent for 1980-81). These taxpayers generally expected to repay their deferred tax liabilities attributable to accelerated depreciation at the currently applicable 46 to 50 percent rate. However, because of the proposed reduction in tax rates after July 1, 1986, the deferred tax liabilities of such taxpayers would generally be repaid at a 33-percent rate instead of a 46-percent rate for corporations (at a 35-percent rate instead of a 50-percent rate for top-bracket individuals). In the absence of a rule designed to recapture the unexpected benefit of the reduction in rates, part of the deferred tax liabilities attributable to accelerated depreciation deductions would effectively be forgiven. Taxpayers with deferred tax liabilities on July 1, 1986, would obtain an unintended windfall benefit, which had not been anticipated when investment decisions were made.
Id.
In order to prevent taxpayers from obtaining such a windfall benefit, the proposal provided for 40% of a taxpayer’s “excess depreciation” taken between January 1, 1980, and July 1, 1986, to be included in income over a three year period. Id. “Excess depreciation” was defined as the “excess of cumulative depreciation or amortization deductions over [the] cumulative depreciation deductions that would have been allowed during such period using the straight-line method” specified under current law at section 312(k) of the Code. Id. For calendar year taxpayers, 12% of the excess depreciation would be included in income for the 1986 taxable year, 12% in 1987, and 16% in 1988. Id.
46. See id. at 455. The President’s proposal estimated that the windfall recapture tax would yield $7.6 billion in 1986, $19.7 billion in 1987, $20.7 billion in 1988, and $9.6 billion in 1989. Id.
has taken the position that it will generally support H.R. 3838 if, prior to final enactment, three basic changes are made. First, the Administration favors a lowering of the effective tax rate paid by upper income taxpayers from 38% to the Administration's original proposal of 35%. Since the Administration favors maintaining the existing capital gains rate, the loss of revenue resulting from lowering the highest effective tax rate from 38% to 35% will have to be replaced by broadening the tax base by approximately $25 billion dollars. If this change is to occur, it will have to be done in the Senate, because the House has gone as far as it is willing to go in terms of base broadening. At this time, it is unclear whether the Senate can go into areas not touched by H.R. 3838 to raise the $25 billion. An even more difficult problem to solve than the aggregate dollar amount is what to do about the fact that the change will favor upper-income taxpayers—those with earnings above $100,000, and particularly for those with earnings over $200,000. It is very difficult to find any type of base broadening which will raise taxes in higher-income classes; and if the revenue does not come from these classes, then the result will be a much larger tax cut for upper-income people. The general public will view such a result as unfair. In order to enact legislation with a 35% top rate which the general public will perceive as being equitable, Congress will have to increase the tax cut realized by middle- and lower-income taxpayers. To do this, Congress will have to dramatically increase the taxes paid by corporations, thereby further widening the shift of tax liability from individuals to the corporate sector. Considering the strength of the corporate lobby, this will be difficult to achieve.

Second, the Administration favors a $2,000 personal exemption across the board, which means that Congress will have to find a way to raise an additional $40 billion in revenue. Again, this change will give the greatest benefit to the middle- and upper-income taxpayers. Since

47. See id. at 1.

48. See H.R. 3838, 99th Cong., 1st Sess. § 101 (1985). Under the House bill, the top 38% marginal tax rate becomes effective at taxable incomes of $100,000 for a married couple filing jointly, $60,000 for an unmarried taxpayer, $75,000 for the head of a household, and $50,000 for a married taxpayer filing separately. See H.R. REP. NO. 426, supra note 1, at 90. For a comparison of the taxable income brackets under the Administration's proposal and the House bill, see supra note 35.

49. It has been suggested that eliminating the 60% deduction for net capital gains is one method of broadening the tax base of high-income taxpayers. Hearings on President's Proposals, supra note 1, at 510 (statement of Fred Wertheimer, President of Common Cause). This is because the capital gains tax preference primarily benefits such taxpayers. For example, IRS data indicates that nearly 70% of the capital gains from sales of corporate stock is attributable to taxpayers with incomes over $100,000. Id. Therefore, by eliminating the deduction, the taxable income of such taxpayers is increased. The original Treasury proposal called for the repeal of the capital gains deduction, however, neither the Administration's proposal nor the House bill adopted this reform.

50. See id. at 544 (statement of Martin Feldstein, Professor of Economics, Harvard University: proposed increase in personal exemption from $1,080 to
H.R. 3838 proposes to give the full $2,000 exemption to all non-itemizers, Congress must face the major problem of raising revenue to pay for this exemption.\textsuperscript{51}

Third, and most important to the Administration, the House bill presents a major fundamental policy shift on the issue of the cost of capital. The House bill provides for the repeal of the regular investment tax credit (ITC), replacement of the existing Accelerated Cost Recovery System (ACRS) with a new "Incentive Depreciation System" and indexing to increase depreciation deductions to reflect inflation.\textsuperscript{52} The Treasury has strongly advocated the indexing of depreciation as a way of lowering the effective rate of tax on capital investment.\textsuperscript{53} The problem

\textdoublespace

\$2,000 would cause $40 billion annual revenue loss and would disproportionately benefit higher-income groups). The increase in the personal exemption, although accomplishing the commendable purpose of removing many low-income families from the tax rolls, would be of primary benefit to higher-income taxpayers. \textit{Id.} This would occur because the value of the additional exemption increases with the taxpayer's marginal rate. \textit{Id.} About 38\% of the $40 billion tax cut due to the increase in the personal exemption would go to taxpayers with incomes over $40,000. \textit{Id.}

\textsuperscript{51} Some economic experts have argued that the bill could provide the desired assistance to low-income taxpayers without the tremendous loss of revenue by targeting the tax relief. \textit{See id.} at 544 (statement of Martin Feldstein, Professor of Economics, Harvard University); \textit{id.} at 552 (statement of Henry J. Aaron, Senior Fellow, Brookings Institution). Martin Feldstein has suggested that perhaps the simplest method of targeting the tax relief to low-income families is to increase the personal exemption to $2,000 only for taxpayers in the 15\% tax bracket—that is, for couples and families with taxable income up to $29,000. \textit{Id.} at 544. Those in the 25\% tax bracket—with incomes between $29,000 and $70,000—could be given a more modest increase to $1,200. \textit{Id.} But those with incomes over $70,000 would continue to receive the $1,080 exemption provided under current law. \textit{Id.}

Targeting the increased exemption in this way would cut the revenue cost in half—to $20 billion a year instead of the $40 billion implied by the President's proposal. \textit{Id.} According to Feldstein, "the targeted exemption increase would nevertheless provide as much relief to low income families and individuals and could take as many people off the tax rolls as the President's plan." \textit{Id.}

\textsuperscript{52} \textit{See H.R. REP. No. 426, supra} note 1, at 147-60. The Incentive Depreciation System (IDS) groups assets into ten different cost-recovery classes according to present class lives, in contrast to the six classes prescribed under the existing ACRS system. \textit{Id.} Recovery deductions are determined through prescribed depreciation methods. \textit{Id.} The cost of most personal property is recoverable using the double declining balance method over periods ranging from 3 to 30 years. \textit{Id.} at 150-52. The cost of real property generally is recoverable using the straight-line method over 30 years. \textit{Id.} at 152.

Under current law, the basis of depreciable property is not adjusted for inflation. \textit{Id.} at 154. Under the House bill, beginning in 1988, IDS deductions are to be increased half the annual inflation rate in excess of 5\% after the second year an asset is placed in service. \textit{Id.} at 154-55.

\textsuperscript{53} \textit{See TREASURY I, supra} note 2, at 105-09. The Treasury noted that the existing capital cost recovery provisions do not adjust the basis of depreciable assets for inflation. \textit{Id.} at 105. Therefore, in order to prevent the confiscatory taxation of income from capital which inflation causes, the ITC and the ACRS were introduced, thereby allowing businesses to front-load their cost-recovery
with that view is that the business community does not support indexing since it prefers to have its depreciation front-loaded, a method available under existing law. 54 Another difficulty with indexing is that if the present cost of capital is maintained, while at the same time a substantial tax cut which favors the individual taxpayer is enacted, there is a real possibility that in the long run the result will be a revenue loss. For this reason, the Senate Finance Committee ("Finance Committee") shares the Administration's concern over the House bill. Because the Finance Committee favors improving the treatment of capital investment, 55 it is more than likely that something close to the Administration's proposal will be enacted in this area.

In summation, it appears that the President and his Administration will continue to push strongly for tax reform, and thus, one way or another, before the end of the year, there will be a fairly significant change in the tax law. Whether it is a fundamental tax reform is open to debate.

deductions. Id. In justifying the need to replace these provisions, the Treasury Department explained:

At the lower rates of inflation prevailing today, the ITC and ACRS allow investment in depreciable assets to be recovered far more rapidly than under a neutral system of income taxation. As a result, the tax system favors industries that invest heavily in depreciable assets such as equipment over others such as high technology industries, service industries, and the trade sector that invests more heavily in inventories.

Because the advantages of the ITC and ACRS are "front-loaded," these provisions are of relatively little value to new and rapidly growing firms or to ailing industries, neither of which can fully utilize their benefits. New firms are penalized and there are incentives for tax-motivated mergers. The result is reduced competitiveness and less incentive for innovation. The front-loading of tax benefits also leads to the proliferation of tax shelters, many of which are abusive and create severe administrative burdens for the Internal Revenue Service.

To assure that capital consumption allowances will be more nearly appropriate, regardless of the rate of inflation, the Treasury Department proposes that the investment tax credit be repealed, that the basis of depreciable assets be indexed for inflation, and that depreciation allowances for tax purposes be set to approximate economic depreciation.

Id. at xiii.

54. See, e.g., Hearings on President's Proposals, supra note 1, at 3399 (statement of David M. Roderick, Chairman and Chief Executive Officer, United States Steel Corp.: elimination of ITC coupled with slower depreciation will lead to less capital investment); id. at 3402 (statement of Charles W. Parry, Chairman and Chief Executive Officer, Aluminum Company of America: opposes repeal of ITC and worries about tax system which removes critical incentives for capital intensive industries); id. at 3406 (statement of Richard Briggs, Executive Vice President, Association of American Railroads: proposal places unduly heavy burden on capital-intensive industries; opposes repeal of ITC and ACRS). For a discussion of the benefits of the existing capital recovery provisions enjoyed by corporations, see supra note 53.

55. See S. REP. No. 313, 99th Cong., 2d Sess. 96 (1986) (committee believes efficient capital cost recovery system is essential to maintain economic growth).
but if what has been proposed comes to pass, it certainly will be a major change in the way the tax system operates.

IV. POSTSCRIPT

On October 22, 1986, President Reagan signed the Tax Reform Act of 1986 (1986 Act) thereby enacting what has been hailed as the most comprehensive tax legislation in over thirty years.56 The scope and significance of the new law are evidenced by the redesignation of the 1954 Code as the Internal Revenue Code of 1986.57 The progression of the legislation from the House Ways and Means Committee to the Senate Finance Committee and ultimately through the Conference Committee, resulted in numerous concessions and changes being made to the House-passed version of H.R. 3838 (House bill). Some of the more important changes include: 1) imposition of a two-bracket tax rate schedule for individuals; 2) repeal of the 60% deduction for net capital gain; 3) modifications to the personal exemption and standard deduction amounts and 4) adjustments to the capital cost provisions.58

A. Tax Rate Schedules

The changes in the tax rate schedules are some of the most fundamental reforms in the new legislation. With respect to individuals, the 1986 Act rejected the four-bracket system set forth in H.R. 3838 and adopted instead the tax rate structure proposed under the Senate amendment.59 Beginning in 1988,60 an individual’s income will be sub-

57. Id. § 2. The 1986 Act contains approximately 1,850 separate amendments to the Internal Revenue Code, an unprecedented number for a single tax law. See id. § 1(b).
58. See id. §§ 101(a), 301(a), 103, 102(a), 211, 201(a). For a discussion of the two-bracket tax rate, see infra notes 59-65 and accompanying text. For a discussion of the repeal of the net capital gain deduction, see infra notes 71-78 and accompanying text. For a discussion of the personal exemption and standard deduction, see infra notes 79-87 and accompanying text. For a discussion of the adjustments to capital cost provision, see infra notes 88-96 and accompanying text.
ject to one of two tax rates, 15% and 28%. The top rate of 28% will apply to taxable income in excess of $29,750 for married individuals filing jointly; $23,900 for heads of households; $17,850 for single individuals and $14,875 for married individuals filing separately. Beginning in 1989, the taxable income levels to which the 28% rate applies will be adjusted for inflation. Although the maximum tax rate for all individual taxpayers is 28%, taxpayers with higher incomes are subject to a rate adjustment which will phase out the benefit of the lower 15% tax rate. Thus, a taxpayer with income above a specified level will in effect be taxed at the 28% rate on all of his taxable income, rather than only on that amount of taxable income which is above the "breakpoint."

With respect to the corporate tax rate schedules, the 1986 Act adopts the provisions of H.R. 3838 and replaces the prior five-bracket graduated rate structure with a three-bracket system. As to the maxi-

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Married, Filing Joint Returns</th>
<th>Heads of Household</th>
<th>Singles</th>
</tr>
</thead>
<tbody>
<tr>
<td>11%</td>
<td>0-$3,000</td>
<td>0-$2,500</td>
<td>0-$1,800</td>
</tr>
<tr>
<td>15%</td>
<td>3,000-28,000</td>
<td>2,500-23,000</td>
<td>1,800-16,800</td>
</tr>
<tr>
<td>28%</td>
<td>28,000-45,000</td>
<td>23,000-38,000</td>
<td>16,800-27,000</td>
</tr>
<tr>
<td>35%</td>
<td>45,000-90,000</td>
<td>38,000-80,000</td>
<td>27,000-54,000</td>
</tr>
<tr>
<td>38.5%</td>
<td>Above 90,000</td>
<td>Above 80,000</td>
<td>Above 54,000</td>
</tr>
</tbody>
</table>

Id.

61. *Id.* The two brackets and tax rates will begin at zero taxable income due to the replacement of the ZBA with the standard deduction. See *Conf. Rep. No. 841, supra* note 59, at II-4. For a further discussion of the standard deduction, see *supra* note 36 and infra notes 84-87 and accompanying text.


63. *Id.* The 1986 Act directs the Secretary to prescribe tables which will increase the minimum and maximum dollar amounts for each bracket by a yearly cost-of-living adjustment. *Id.* The yearly cost-of-living adjustment is to be based upon the average of the consumer price index as of the close of the twelve month period ending August 31 of the calendar year. *Id.*

64. *Id.* Those higher-income taxpayers who are subject to this rate adjustment will have their income tax liability increased by 5% of their taxable income within specified ranges. *Conf. Rep. No. 841, supra* note 59, at II-4. The Conference Committee explained that the: rate adjustment occurs between $71,900 and $149,250 of taxable income for married individuals filing jointly; between $61,650 and $123,790 of taxable income for heads of household; between $43,150 and $89,560 of taxable income for single individuals; and between $35,950 and $113,300 of taxable income for married individuals filing separately. These amounts will be adjusted for inflation beginning in 1989.

*Id.*


mum corporate rate, the 1986 Act reflects a compromise between the House bill and the Senate amendment. The new law imposes a maximum corporate tax rate of 34%, thereby splitting the maximum rates set forth in the House bill (36%) and the Senate amendment (33%). The maximum 34% rate applies to taxable income in excess of $75,000. Taxable income between $50,000 and $75,000 is taxed at a 25% rate, and a corporation's initial $50,000 of taxable income is subject to a tax rate of 15%. The benefit of the lower rates is phased out for high income corporate taxpayers by means of a rate adjustment similar to the adjustment applied to high-income individuals.

B. Capital Gains

The most radical change in the 1986 Act from the House bill and prior law is its treatment of capital gains. The new law eliminates the 60% deduction for individuals for net capital gains (i.e. the excess of net long-term capital gain over net short-term capital loss). However, the statutory provisions for determining the character of gain as ordinary or capital, and as long-term or short-term are “retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase.” The 1986 Act retains the deduction for capital losses to the full extent of capital gains. In addition, the 1986 Act allows individuals to apply capital losses against up to $3,000 of ordinary income.

Although H.R. 3838 had proposed reducing the capital gains deduction from 60% to 42%, the House did not call for the complete

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69. Id.
70. Id. The conference report explains that “[t]he phase-out of the benefit of graduated rates occurs through the imposition of an additional five-percent tax” on taxable income between $100,000 and $335,000. Conf. Rep. No. 841, supra note 59, at II-159.
71. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 1986 U.S. Code Cong. & Ad. News (100 Stat.) 132-33. In addition, the new law provides that corporate net capital gain will be taxed at regular corporate rates and is not eligible for the lower alternative tax rate of 28% which existed under prior law. Id. § 311.
73. Id.
74. Id. As under prior law, unused capital losses may be carried forward.
75. See H.R. Rep. No. 426, supra note 1, at 196. Under prior law, an individual could deduct 60% of any net capital gain from gross income. Id. Since the maximum individual income tax rate was 50%, the deduction meant that net capital gain was taxed at a maximum rate of 20% (the 50% maximum individual tax rate times the 40% of net capital gain included in adjusted gross income). Id. The House Ways and Means Committee felt that it was appropriate to maintain the maximum tax rate for net capital gains at approximately the same level.
elimination of the deduction. The Senate Finance Committee, however, viewed the deduction as an unwarranted preference in light of the substantial overall rate reductions and determined that eliminating the deduction was one of the few ways to broaden the tax base among high-income taxpayers. The Conference Committee agreed and adopted the Senate amendment.

C. Personal Exemption and Standard Deduction

Another means of broadening the tax base among high-income taxpayers was accomplished through manipulation of the personal exemption. The new law increases the personal exemption amount for an individual, an individual’s spouse and each dependent to $2,000 beginning in 1989. The benefit of the increased personal exemption, however, is phased out for taxpayers having taxable income exceeding specified levels. This phasing out of the increased personal exemption corresponds to the same taxable income levels at which the phase out of the 15% tax rate begins. Thus, the increased personal exemp-

Id. Because the House Bill provided for a reduction of the maximum individual tax rate from 50% to 38%, the House Ways and Means Committee proposed to limit the net capital gain deduction to 42%. This would yield an effective maximum tax rate of 22.04% on net capital gains for an individual with a maximum tax rate of 38% on the 58% of net capital gains included in adjusted gross income. Id.

76. Id. The House Ways and Means Committee explained that the deduction was warranted because the reduced rates on long-term capital gains of individuals alleviated “the impact of high individual tax rates on dispositions of assets that have appreciated in value over time.” Id. Therefore, the Committee concluded that these reduced rates “contribute to the efficient allocation of capital by minimizing the possible ‘lock-in’ effect of higher regular rates, and may also serve as an incentive to investment.” Id.

77. See S. REP. No. 313, supra note 55, at 169-70. For a discussion of why the elimination of the deduction is one of the few ways to broaden the tax base among high income taxpayers, see supra note 49 and accompanying text.

78. CONF. REP. No. 841, supra note 59, at 11-106.

79. For a discussion of why the personal exemption is of primary benefit to taxpayers with high incomes, see supra note 51 and accompanying text.

80. Tax Reform Act of 1986, Pub. L. No. 99-514, § 103(a), 1986 U.S. CODE CONG. & AD. NEWS (100 Stat.) 18-19. The $2,000 amount is to be adjusted for inflation annually after 1989. Id. The new law follows the House bill and the Senate amendment in repealing the additional exemption for an elderly or blind individual and, instead, provides an additional standard deduction amount for such individuals. CONF. REP. No. 841, supra note 59, at II-9. For a discussion of the additional standard deduction amount for elderly or blind individuals, see infra note 86 and accompanying text.


82. See id. For a discussion of the phase out of the benefit of the 15% individual income tax rate for high-income taxpayers, see supra note 64 and accompanying text.
tion amount achieves its avowed purpose of raising the tax threshold and thereby eliminating the tax liability of the very lowest-income families. At the same time, the 1986 Act also precludes high-income taxpayers from using the exemption to shelter income.

Additionally, the 1986 Act follows the House bill in replacing the zero bracket amount with the previously utilized standard deduction. Beginning in 1988, the standard deduction amounts will be increased to $5,000 for joint returns and surviving spouses; $4,400 for heads of households; $3,000 for single individuals and $2,500 for married individuals filing separately. In 1987, an additional standard deduction amount will be allowed for elderly individuals. Beginning in 1989, these increased standard deduction amounts will be adjusted for inflation.

D. Capital Cost Provisions

In the area of capital investment, the Conference Committee was confronted with a House bill and a Senate amendment which substantially agreed on some provisions, but which differed markedly on others. For instance, both the House bill and the Senate amendment called for the repeal of the regular ITC. In accord with this bicameral agreement, the 1986 Act repeals the ITC, subject to certain exceptions, for property placed in service after December 31, 1985.

In contrast, the House and Senate provisions dealing with accelerated depreciation forced the Conference Committee to reconcile conflicting congressional views. In this area, the new law does not adopt the Incentive Depreciation System set forth in the House bill, but instead severely modifies the existing ACRS rules. Under the 1986 Act, resi...
idential real property is depreciated over 27.5 years, while non-residential real property is depreciated over 31.5 years. Tangible personal property is classified as three-year, five-year, seven-year, ten-year, fifteen-year or twenty-year property based upon the depreciable life of the property. The appropriate depreciation category for personal property is based upon the mid-point life of the asset as determined by the asset depreciation range system (ADR) that was in effect prior to the adoption of ACRS.

accelerated depreciation for the revised three-year, five-year, and ten-year classes; 2) reclassifying certain assets according to their present class life as determined by the asset depreciation range system and 3) creating a 7-year class, a 20-year class, a 27.5-year class, and a 31.5-year class. CONF. REP. No. 841, supra note 59, at II-39.

In addition, the new law prescribes depreciation methods for each ACRS class in lieu of providing statutory tables. Id. The Conference Report explains that:

[the] depreciation method applicable to property included in the three-year, five-year, seven-year, and 10-year classes is the double declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. For property in the 15-year and 20-year class, the conference agreement applies the 150-percent declining balance method switching to the straight-line method at a time to maximize the depreciation allowance. The cost of section 1250 real property generally is recovered over 27.5 years for residential rental property and 31.5 years for nonresidential property, using the straight-line method.

Id.


92. Id.

93. CONF. REP. No. 841, supra note 59, at II-39. The Conference Report describes the depreciation categories as follows:

Three-year class.—ADR midpoints of 4 years or less, except automobiles and light trucks, and adding horses which are assigned to the three-year class under present law.

Five-year class.—ADR midpoints of more than 4 years and less than 10 years, and adding automobiles, light trucks, qualified technological equipment, computer-based telephone central office switching equipment, research and experimentation property, and geothermal, ocean thermal, solar, and wind energy properties, and biomass properties that constitute qualifying small power production facilities (within the meaning of section 3(17)(c) of the Federal Power Act).

Seven-year class.—ADR midpoints of 10 years and less than 16 years, and adding single-purpose agricultural or horticultural structures and property with no ADR midpoint that is not classified elsewhere. 10-year class.—ADR midpoints of 16 years and less than 20 years.

15-year class.—ADR midpoints of 20 years and less than 25 years, and adding municipal wastewater treatment plants, and telephone distribution plant and comparable equipment used for the two-way exchange of voice and data communications.

20-year class.—ADR midpoints of 25 years and more, other than section 1250 real property with an ADR midpoint of 27.5 years and more, and adding municipal sewers.

27.5-year class.—Residential rental property (including manufactured
Another issue on which the House bill and Senate amendment were in conflict was the indexing of the depreciation deduction for inflation. On this issue, the House bill provided that for the second year an asset had been in service and those years which followed, the depreciation deductions would be increased by half the annual inflation rate in excess of 5%. The Senate amendment proposed to retain the prior law which did not provide for basis adjustments of depreciable property to reflect inflation. The 1986 Act follows the Senate amendment and retains the prior law.

homes that are residential rental property and elevators and escalators).

31.5-year class.—Nonresidential real property (section 1250 real property that is not residential rental property and that either does not have an ADR midpoint or whose ADR midpoint is 27.5 years or more, including elevators and escalators).

Id. at II-39 to II-40.

94. See H.R. Rep. No. 426, supra note 1, at 154. Under the House proposal, an inflation adjustment would have been computed for a taxable year only if inflation for that year exceeded 5%. Id. If the inflation rate for the year exceeded 5% as measured by reference to the Consumer Price Index, the inflation adjustment would have been the sum of: 1) one plus 2) one-half of the inflation rate in excess of 5%. Id. A taxpayer's indexed depreciation deduction would have been computed by multiplying the normal depreciation deduction times the inflation adjustment. Id. For a discussion of IDS, see supra note 52 and accompanying text.
