Simplification and Comprehensive Tax Reform

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by

Harvey Galper and Michael Kaufman*

I. Introduction

In January 1977, the Treasury Department of the Ford Administration released its view of what tax reform could accomplish in a publication entitled Blueprints for Basic Tax Reform. 1/ The purpose of that study was not to propose directly a legislative agenda but to present and discuss the basic structure of a tax system predicated on a comprehensive measure of income. The Blueprints exercise sought to determine the maximum potential for broadening the base of the tax system, thereby allowing a greatly reduced structure of tax rates. Base broadening does not involve the creation of additional income, for income is generated only as an outcome of economic transactions. Instead, base broadening results from the consistent application of rules for measuring income so that the income that is really "out there" can be made subject to tax.

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The primary objectives of comprehensive tax reform are horizontal equity and efficiency. Horizontal equity, which requires that persons in equal economic circumstances be taxed the same, presupposes an accurate measurement of income in the first place. Efficiency which calls for keeping to a minimum the distorting effects of taxes on economic decisions also requires that income as measured for tax purposes should correspond to economic reality. Under such income measurement rules, resource allocation would be determined by economic rather than tax considerations. Comprehensive income tax reform has long been advocated as necessary to achieve these two important goals.

The purpose of the present paper is not to evaluate the extent to which comprehensive tax reform as developed in Blueprints would achieve tax equity and efficiency, but rather to consider its impact on simplicity. The question to be addressed here is: can a system which comprehensively taxes income also be a simpler tax system? This paper will evaluate the proposals in Blueprints in terms of the complexity that would be likely to result from their adoption. Although the basic proposals themselves will be discussed, the underlying rationale for each will only be mentioned briefly, as the equity and efficiency objectives which motivate them have already been noted.

Some preliminary observations are in order regarding the nature of the Blueprints study. First, while no claims have been made as to the political acceptability of any of the recommendations in Blueprints, considerable effort was directed toward developing a system that would be administerable and workable in practice. Thus, it was explicitly recognized that a tax system based on readily observable data will be inherently less complex. Hence, Blueprints specifies that "transactions should be objectively observable -- as in the case of the transaction of a wage payment. . . .'Imputed' transactions, i.e., values arrived at by guesses or rules of thumb --as in the case of depreciation -- should be kept to a minimum." (P. 42) Thus, realizations rather than accruals enter into the tax base, and specifically excluded are imputations for such items as the services provided by owner-occupied housing and in-kind benefits such as medical care. This cash or realization principle may at times come into conflict with comprehensive income measurement but at some gain in simplicity.

Secondly, the Blueprints study should not be regarded as definitive in the sense that all of the decisions made are considered final decisions. In many cases, alternative recommendations are presented; for example, the optional ways of dealing with medical or charitable deductions or the two transition rules suggested for the phase-out of the

preferential tax treatment for capital gains. If considerations of simplicity are found to be compelling, other alternatives could also be developed without doing violence to the principle of a comprehensive tax base. In determining whether the specific recommendations of Blueprints are compatible with simplicity, one should be aware of the fact that modifications to better achieve this objective are possible.

Thirdly, there are some inherent limitations in examining Blueprints as a model tax system. Despite reasonably full articulation of specific proposals, many of the recommendations are spelled out only broadly and not in complete detail. Therefore, some difficulties will inevitably arise in comparing the complexities of current law resulting from sixty years of experience with income taxation to a set of more generally specified proposals for which the full array of rulings, regulations, and court cases does not exist.

Finally, one element of simplification that is often lost sight of in much of the discussion of complex forms and intricately structured transactions, is whether or not the basic structure of the tax system itself is understandable. One important virtue of Blueprints is that it greatly clarifies what an income tax system should tax.

Our discussion of Blueprints will first describe the overall tax structure proposed and then consider in detail the taxation of corporate income, capital gains, business income generally, and retirement income. The results of the base-broadening measures envisioned by Blueprints are impressive. Using data representative of the year 1976, the study finds that for all tax filing units comprehensive income, the tax base of Blueprints, would have been $1,270 billion compared to adjusted gross income of $1,055 billion under 1976 tax law -- an increase of 20 percent. 2/ Furthermore, income subject to tax, after taking into account allowable deductions and exemptions, would rise from $669 billion to $884 billion, an increase of about one-third. Thus, the potential for base broadening -- and correspondingly for rate reduction -- is large indeed. The specific proposals which would accomplish this expansion of the tax base are the main subject of this paper. First, however, it is necessary to discuss the topic of simplification itself.

II. What is Meant by Simplification?

To determine the degree of complexity inherent in comprehensive income taxation it is necessary to identify the various participants involved in the annual struggles of taxpayers with the tax system. These participants include individual taxpayers -- both those of moderate means and those with higher incomes and more complex transactions-- corporate tax and financial officers, tax practitioners, and administrators and legislators of the tax system.

The average taxpayer often experiences considerable difficulty not just in assembling information and performing the calculations for preparing his tax return but also in interpreting the instructions required to fill out the forms. For instance, many middle income taxpayers have trouble determining their eligibility for the retirement income credit, or in the case of divorced parents the dependency exemption, because of the rather complicated set of conditions governing the use of these provisions. For higher income individuals, the need to know the tax consequences of alternative investment and other transactions greatly complicates economic decision making.

As in the case of individual taxpayers, corporate officers making investment or financing decisions are faced with uncertainties about how the tax laws will apply to transactions they are considering. Since many business decisions span a considerable period of time, corporate officers also need to make forecasts of possible changes in tax policy and administration that will affect the profitability of these decisions. Tax administrators, moreover, may find it convenient to impose on corporations reporting requirements for annual statements of wages, interest, and dividends. While these statements ease the burdens of record-keeping for individuals and facilitate the monitoring of tax compliance by administrators, they, at the same time, impose additional complexity and costs on business managers.

Complexity in the tax code makes it difficult for tax practitioners to understand how the tax code applies to the problems of their clients. The disparity of tax treatments associated with alternative investments further complicates tax planning. As complexity escalates, more and more time of tax practitioners is spent in keeping abreast of tax developments and in counseling clients on the implications of these developments.

For tax administrators, tax complexity creates difficulties in providing taxpayers with intelligible tax forms, interpreting the tax code, enforcing tax compliance, and resolving legal disputes with respect to emerging tax issues. Complexity also increases the administrative costs of all these functions. Furthermore, legislators are becoming increasingly concerned about complexity, both in response to the complaints of their constituents and in their capacity as drafters of legislation designed to improve the equity and efficiency of the tax system. The concerns of these various participants in the operation of a tax system must all be considered in evaluating the complexity of a proposed new tax structure.

Complexity is not a static concept which applies to a tax system for all time, but rather it characterizes the development of a system over time. Thus, our current system not only _is_ complex, but it _has grown_ complex in response to pressures created by its basic design features. An evaluation of the complexity of a tax system based on the _Blueprints_ design should therefore consider its likely evolution as well as its current features. This broader perspective may permit a more hopeful appraisal of the compatibility of simplification and comprehensive income tax reform. Several of the _Blueprints_ reforms are very likely to lead to increased first-round complexity, but they would also greatly reduce the scope of transactions which are relatively

lightly taxed. This virtual elimination of tax preferences in combination with a structure of lower tax rates would sharply diminish incentives to design transactions in order to receive special tax treatment.

Furthermore, experience has shown that tax minimizing behavior on the part of individuals and corporations breeds further reaction by tax administrators and legislators who try to stem the tax avoidance tide by measures which specifically prohibit the latest tax maneuvers. Although the energy of tax reformers and administrators is large, the rewards for developing new tax gimmicks are likewise great. Thus, unless the underlying cause of the tension is attacked directly, the prohibition of old shelters leads to the construction of new ones and the tax system emerging from this sequence of events may be more complex by far than what one might have expected from looking at the design of the system initially.

This kind of complexity may be called dynamic complexity. Much of the complexity in our existing code seems to be of the dynamic variety. The initial tension created by preferential taxation stimulates new types of transactions as individuals seek to gain the tax benefits created by the preferences. This leads to reactions by administrators and legislators concerned with preserving the integrity of "legislative intent" and protecting tax

revenues. A portion of the complexity of current tax law can undoubtedly be attributed to the complexity of modern society and to efforts to use the tax system to serve diverse social purposes. But surely a significant share must be attributable to this dynamic process just described. This process in turn has its roots in the economic pressures created by a failure to tax all income equally in the first instance.

Probably the leading example of the process of dynamic complexity is provided by the special treatment accorded to capital gains. The preferential tax treatment of long-term capital gains has been generally recognized as one of the most significant sources of complexity in the code. 3/ However, what most observers have in mind here is the extremely complex set of statutory rules governing the taxation of capital gains and losses 4/ and the definitional requirements that must be satisfied before the statutory rules on capital gains are even applicable. Dynamic complexity does not focus on these rules and requirements, complex as they may be, but rather on the economics of the initial tension between ordinary income and capital gains. For example, as Professors Bittker and Eustice observe:

"One of the most persistent problems in the taxation of corporations and their shareholders ... is the ordinary income-capital gain dichotomy in the field of corporate distributions." 5/

The problems arise because of the relatively favorable taxation of retained earnings vis-a-vis dividends. This distinction, Bittker and Eustice go on to state,

> ". . . is a constant inducement to the accumulation of business or investment income in a corporation, where it will be shielded from a hostile tax collector. ...[T]he tax collector has in turn been armed with statutory weapons to attack undistributed corporate earnings in the more blatant cases of tax avoidance. One weapon is the accumulated earnings tax, imposed by Section 531. . . The other weapon is the personal holding tax imposed by Section 541 on the undistributed income of a "personal holding company". . ." 6/

This illustrates how attempts by taxpayers to reduce taxes by restructuring their transactions to increase corporate savings can provoke complex legislative responses. But despite these responses, "the use of the corporation as a temporary or permanent refuge from the graduated individual income tax is one of the principal landmarks of our tax landscape." 7/

Once resources have been accumulated in the corporation, pressure then is transmitted to the problem of how to get the money out. Several devices to accomplish this in a tax-minimizing way have been employed including:

- achieving income splitting and reducing corporate taxes by paying excess compensation in salary to family members of a corporation's owners. This occurs mostly in the case of closely held corporations.

- selling stock, which has appreciated in value where the appreciation is taxed at preferred rates.

- entering into transactions that enable the shareholder to realize gains on corporate earnings without paying full taxes such as redemptions of stock and partial and complete liquidations.

In each case, of course, the transactions must be carefully structured, giving rise to further complexity.

Also, at yet another stage in this dynamic process, the judicial system becomes involved. The preferential taxation of capital gains combined with the generality of the statutory definition of qualifying assets has forced the courts to decide whether various transactions qualify for capital gains treatment. Two examples where decades of decisions have failed to produce clear boundaries for capital gains treatment involve the taxation of payments for the termination of contract rights and sales of real estate by individuals. The ambiguity in the latter case stems from the fact that the capital gains asset definition excludes

property held for sale to customers in the "ordinary" course of business. Thus, preferential taxes on capital gains both in itself and in combination with corporate income taxation has been the source of a considerable amount of dynamic complexity.

Another illustration of dynamic complexity is reflected in the continuing efforts of tax legislators and administrators to control the use of tax shelters. Commissioner Kurtz of the Internal Revenue Service has aptly described this process in a recent address:

> "Congress substantially curtailed many of the known tax shelters in the Tax Reform Act of 1976. But no sooner were the apparent leaks in the dike plugged than new ones appeared. . . The fact that many of these transactions are extremely complex and present substantial administrative problems to the Service cannot be allowed to interfere with the fair administration of the tax laws. New laws may call for new responses.... We are making a concerted effort to learn of these new schemes as quickly as they develop and confront them as quickly as we can." 8/

After describing the work of the Service aimed at increasing the audits of returns showing income from tax shelters, Commisioner Kurtz discussed new revenue rulings which were about to be issued to curb the new types of tax shelter transactions that were "beginning to proliferate . . in novel areas of investment." 9/ In two cases, the rulings arose in response to taxpayers' attempts to circumvent the at-risk limitations of the 1976 Tax Reform Act which were designed to limit taxpayers' losses to the amount of the assets they had personally risked in various ventures.

The basic problem in these cases is the tax reducing possibility provided by sham transactions which overvalue assets and allow the purchaser excessive depreciation deductions. At risk rules could be rationalized as one means of preventing sham transactions. However, such rules could also prevent valid depreciation deductions from being taken for assets which were not artificially inflated in value when purchased. In practice, because accounting conventions often fail to measure income properly as it accrues, many legitimate loans might well have the appearance of sham transactions.

Apparently this tendency of overdoing reform in an effort to restrict tax reducing behavior has itself lead to further complexity in several cases. For example, Congress enacted the collapsible corporation provisions to prevent ordinary income from being taxed as capital gains in certain instances. But when it was realized that the collapsible corporation provisions had become so broad in scope that they were producing harsh and "unintended" results, Congress tried to soften them by enacting the extraordinarily complicated Section 341 (e) to provide dispensations from the collapsible corporation treatment. Finding that the relief of Section 341 (e) was insufficient, in 1964, Congress granted further relief in the form of Section 341 (f), for which final regulations have yet to be issued.

Other examples could also be cited where the failure to tax income equally has produced significant complexity. In each case, the taxpayer's initiative leads to subsequent reactions by administrators and legislators in a never ending process. Therefore, for any proposed tax change, it is necessary to distinguish between first-round simplification and subsequent-round simplification. A proposal can be quite simple initially, but if it establishes pressure points which lead to restructured transactions and patchwork legislative remedies, further complex transactions will result. We might well be better off if we initially dealt with the problem in a fairly complex way but in a way which largely eliminated the tension.

It is against this background, then, that the complexity of a comprehensive tax system must be judged. In reviewing the main elements of Blueprints, therefore, the following questions will be addressed:

Is the proposed change a simplification or not?
For whom is it a simplification?
In what ways is it a simplification?
Is it likely to be a lasting simplification?
If there is more complexity, is the complexity such that it can be regarded as avoiding even more complexity farther down the road?

Finally, it must be recognized that there are inevitable problems of equity if major tax proposals are adopted immediately. Special transition rules are generally required to deal with these problems. Since these rules would complicate tax assessment activities, although only for the period of transition, they must also be considered in this discussion of tax complexity. Thus, a final question is: Is it easy to move to the new tax system, or what are the problems of transition?

III. The Proposals in Blueprints.

This section will analyze the complexity of the tax system proposed in Blueprints for Basic Tax Reform. It will consider first the overall structure of the model comprehensive income tax and then the specific suggestions for taxing corporate income, capital gains, and deferred compensation of employees, and for improving generally various income measurement rules. Recommendations for transitional rules will be reviewed for their impact on simplicity as well.

Overview of the Structure of Blueprints: Exclusions, Deductions, and Rates

The basic structure of comprehensive taxation as presented in Blueprints implements to a far greater degree than current law the principle of taxing income from whatever source derived. Also, and perhaps as a consequence, the overall logic of the model tax system would be much easier to understand. The tax base would embrace virtually all sources of income including many items not now subject to the individual income tax such as state and local bond interest, social security benefits, public assistance benefits, fellowships and scholarships, the bonus value of food stamps,

unemployment compensation, disability and workmen's compensation, veterans' benefits, employer contributions to health and life insurance plans, earnings in pension fund reserves and corporate undistributed earnings. At the same time, the separate corporate tax would be abolished.

Taxing these currently excluded items, a decision based mainly on equity considerations, need not involve significant issues of complexity. State and local interest income would be treated the same as all other interest income. Similarly, taxation of benefits under various transfer programs such as welfare or veterans' benefits would only require the addition of a tax reporting system to the current state or Federal information system. Potential administrative problems which could arise from taxing in-kind benefits such as public housing and Medicaid are avoided by not attempting to include these items in the tax base. The bonus value of food stamps would be included because the cash equivalent value is readily determinable.

The main problem in the taxation of transfer payments is not addressed in Blueprints and that involves implementing a withholding system for such programs. If withholding is not instituted and recipients of such income have a final tax liability, they will be sorely pressed to pay at filing time. On the other hand, withholding can work a real hardship on those with very low incomes. A liberal system of filing for

exemptions from tax would be required. One possible mitigating factor is the fact that at the levels of most transfer programs, the amount withheld would be quite small due to the low tax rates at the bottom of the scale. And, of course, basic benefit levels can also be adjusted to compensate for their taxability.

The taxation of private and social security disability pay and unemployment compensation benefits gives rise to no additional complications. In these cases, Blueprints recommends that employer contributions would continue to be deductible as under current law. However, employee contributions to disability insurance would also be deductible and the benefits of such programs would be taxable.

Health and casualty insurance in contrast would be treated somewhat differently by Blueprints. In these cases, employer contributions would be treated the same way as private purchases of health insurance, with premiums paid out of after-tax dollars and proceeds not subject to tax. According to this logic, employer contributions to health and casualty insurance plans would be taken into taxable income by the employee. Similarly, payments for life insurance provided by the employer would be taken into income but not any proceeds paid under such policies. The calculations here would be straightforward and could readily be provided by the employer as part of the annual wage statement to the

employee. The only further complication occurs with respect to whole life insurance where the interest build-up in the insurance policy would also be subject to tax. A calculation of this interest could be easily made by life insurance companies which currently compute the cash surrender value of outstanding policies.

The exclusions from income under current law arising from retirement plans (including social security) and corporate retained earnings are discussed in more detail in other sections of this paper.

One implication of these proposals to tax current exclusions is that more individuals would be required to file tax returns than under current law. In fact, if simplification is measured by the number of returns filed or the number of taxable returns, comprehensive income taxation may be regarded as a step backward. Under current law, of the roughly 109 million filing units in 1976, only 87 million were required to file a tax return, and of this number, only 66 million had a positive tax liability. 10/ In contrast, the tax proposals in Blueprints would increase the number of taxable returns from 66 million to 81 million returns. On the surface, this seems like a retrogression -- on both equity and simplicity grounds. And yet Blueprints claims to replicate the current distribution of tax burdens. How can this be true?

The answer is that many returns now classified as non-taxable do in fact pay taxes but they pay them in an implicit rather than an explicit form. The best example is the corporate income tax, the burden of which may be allocated to all shareholders if not to all owners of capital assets. If this tax is allocated to either shareholders or all capital income (the latter being the assumption used in Blueprints) then many "non-taxable" and even non-filing returns are seen to be paying taxes, and often at very high rates relative to their incomes. In fact, if filing units with such implicit taxes are counted, the total number of "taxable" filing units under current law is 93 million even though 22 million of these units file no tax returns.

Thus, comprehensive income taxation in which the corporate income tax is formally abolished in favor of taxing corporate income directly to individuals may make such returns explicitly rather than implicitly taxable. This policy will not only achieve substantial gains in horizontal equity, but equally important, it will facilitate an understanding of the idea that all income flows should be directly taxed to the individuals benefitting from them. Comprehensive income taxation as defined in Blueprints is more directed to obtaining an income tax code that really

taxes income than to decreasing the number of tax returns actually filed. Of course, any increase in the number of returns filed implies greater work loads and more resources devoted to tax administration.

Blueprints also permits a limited number of deductions in the determination of taxable income. Again, there may be a conflict between the more conventional view of simplicity and the Blueprints design. The conventional view holds that simplification results from fewer taxpayers itemizing deductions rather than taking the standard deduction. The structure in Blueprints provides no such choice between itemized and standard deductions. There is no standard deduction in Blueprints, but for purposes of income measurement five deductions are allowed. These deductions are for employee business expenses, non-business interest expenses, 11/ state and local income taxes, alimony paid, and child care expenses subject to certain limitations. The child care deduction would be equal to one-half of actual child care expenses up to the lesser of $5,000 or the taxable earnings of the lesser earning spouse. In the case of employee business expenses, Blueprints also proposes a simplification option which would allow only those deductions in excess of a specified minimum amount. 12/

While these deductions would generally be available to all taxpayers, many categories of deductions allowed under current law would be disallowed such as state and local sales and gasoline taxes, property taxes for owner-occupied housing, charitable contributions, medical expenses, and casualty losses. Even moving expenses, now an "above the line" deduction, would be disallowed on the grounds that they like commuting expenses, are more in the nature of consumption outlays which reflect locational preferences than job-related expenses. 13/ Such changes would simplify individual record-keeping and tax administration. Nonetheless, given the lack of a standard deduction choice, virtually every tax return filed would be an "itemizer." Thus, Blueprints from this perspective may appear to represent a net increase in complexity.

In other respects, the recommendations in Blueprints would provide simplifcation by anyone's measure. Included here would be the abolition of the minimum tax, the maximum tax, and the whole range of credits now available under current law including the investment tax credit, the work. incentive credit, the credit for contributions to candidates for public office, the general tax credit (which in itself involves a choice between two credits), the earned income credit, the child care credit, and now the jobs tax credit.

The basic structure of rates and exemptions would also be simplified in Blueprints. As under current law, there would continue to be separate rate schedules for joint returns, single returns, and heads of households. However, the relationships among these schedules would be very much changed. For example, the "marriage penalty" which defines the excess taxes that a joint return pays over two single returns with the same income would generally, but not in every case, be reduced. The two factors contributing to this result are the structure of tax rates and the fact that a portion of the earnings of a second worker in the houehold would be excluded from the tax base. The exclusion would amount to 25 percent of the secondary worker's income up to a maximum exclusion of $2,500. Also, for secondary workers, a child care deduction as already noted would be allowed rather than the current child care credit. These measures to improve equity among various types of taxpayers do not significantly complicate the tax code.

The schedule of tax rates would also be much simpler in Blueprints. For each schedule, there would be only three tax brackets. For the joint return, taxable income of less than $4,600 would be taxed at an eight percent marginal rate, taxable income from $4,600 to $40,000 at a 25 percent marginal rate, and income over $40,000 at a 38 percent marginal rate. These rates, along with the

structure of per-return and per-taxpayer exemptions, would yield about the same distribution of tax burdens by income class as does the combination of the personal and corporate income tax under current law.

However, the simplified nature of this exemption and rate structure stands in sharp contrast to current law, and this goes well beyond the issue of tax computation. Under the proposed tax structure, most taxpayers would remain in a single marginal tax rate over most of their lives. Thus, the new rate schedule could be described as a flat rate tax of 25 percent plus a positive surtax for high-income taxpayers and a negative surtax at the very low end. That this structure of rates comes quite close to the distribution of tax burdens under current law is due to the fact that under the model income tax in Blueprints relatively more income is included at the upper end of the income distribution. For example, whereas taxable income in the aggregate would be increased by 32 percent, taxable income in classes over $50,000 would increase by almost 100 percent.

Moreover, with such a revised rate structure, calculations based on changes in marginal tax rates need not enter into individual financial planning. For example, the form in

which to hold investments in retirement years as opposed to working years or whether to realize capital gains in one year as opposed to another would not be important considerations. This in turn means that income averaging becomes less important since the effects of volatility in income would not, in general, change the marginal rates at which income would be taxed. The proposed structure of tax rates could thus make a major contribution to a reduction in dynamic complexity.

Corporate Tax Reform

General Proposal

Blueprints recommends an end to the separate taxation of corporation income for reasons of equity and efficiency. On equity grounds, the rationale given is as follows:

> "Strictly speaking, the uses concept of income -- consumption plus change in net worth -- is an attribute of individuals or families, not of business organizations. Corporations do not consume, nor do they have a standard of living. The term corporate income is shorthand for the contribution of the corporate entity to the income of its stockholders."(p. 68)

The separate corporate tax may also have the undesirable economic effects of inhibiting the flow of saving to the corporate sector and discouraging the use of equity relative to debt finance. Blueprints would deal with the problems of both equity and efficiency by a form of partnership treatment in which the income of corporate entities is directly attributed to the owners of the corporation and directly taxed under the personal income tax.

This proposal for complete integration of corporate and personal taxes consists of five basic rules. (1) The owner of each share of stock on the first day of the corportion's accounting year would be designated the shareholder of

record. (2) Each shareholder of record would add his share of the corporation's income to his own taxable income -- or deduct his share of the loss. (3) Each shareholder annually would increase his stock basis by his share of corporate income, or reduce it by his share of corporate loss. (4) The shareholder's stock basis would be reduced by the amount of dividends he received each year. Once a shareholder's stock basis had been reduced to zero, the value of any further distributions would be included in income. (5) Any difference between a shareholder's stock basis (adjusted for inflation as discussed below as well as for retained earnings) and the sales price he received for his stock would be added to his income and fully taxed when realized. The implications for simpl city of the transitional phase-in rules for integration are considered below.

While these rules address many of the technical problems inherent in integration, they are silent on others. The main advantage of these rules is that they approximate taxing to the shareholder corporate income as it accrues. Consider a shareholder who holds stock for an entire year during which time his share of corporate income is $100. Under the proposal, he would simply add the $100 to his taxable income. Dividends would have no current effect on his taxable income but would merely reduce his basis.

What about the shareholder who owns the stock less than a full year? Assume the shareholder of record sells his stock which has a basis of $1000 halfway through the year and corporate income accrues equally over the year. In this case, he will have to add the entire $100 of corporate income to his taxable income although only $50 of income accrued while he held the stock. The $50 of earnings will make the market value of his stock worth $50 more than his original basis. Under these conditions, at the middle of the year he could receive $1,050 for his stock. However, as a result of the income attributable to him, his basis will rise to $1,100. The sale, therefore, results in a $50 loss which would be fully deductible. His taxable income at the end of the year would be $100 + $1,050 - $1,100 or $50, exactly what the corporation had earned as of the date of the sale. This is the identical result that would obtain if the shareholder reported as his income the difference between his original basis and the sale price of his stock, an alternative calculation which Blueprints would also allow. In fact, this alternative treatment is probably preferable for part-year shareholders in that the corporation's income does not have to be known in order for the individual to calculate his tax. 14/

The shareholder of record designation is an important simplification of the integration proposal for public companies with large numbers of shareholders. This designation avoids the necessity of keeping records of precisely when the stock is sold during the year. Also, this designation in connection with the rules for basis adjustment accurately measure the income of part-year shareholders as indicated. The choice of the first day of the corporate year as the record date is needed to protect against trafficking in the stock of corporations which had incurred losses. If the final day of the corporate tax year were used as the record date, there would be a tendency for the stocks of corporations with losses to be transferred late in the year to higher income individuals for whom the losses would be worth more for tax purposes. Rules that encourage such behavior are undesirable in any tax system.

Integration would require corporations to report to all shareholders of record their share of corporate earnings. Shareholders would then add these earnings to their other income and would make three basis adjustments to their stock. The first is an upward adjustment for corporate income attributed to them; the second is a downward adjustment for dividends received; the third is an upward adjustment for inflation. Shareholders would thus be faced with the not inconsequential problem of keeping track of the adjusted

bases of their stocks over time. While the information for making all of these adjustments could be provided by the corporation, these calculations would be required of all taxpayers receiving dividend income.

Audit adjustments under integration would be handled the same as under current law. All dealings would occur between the coporation and the IRS. The shareholders of record for the corporation's tax year in question would not be required to make up any tax deficiency, but the higher taxable income and tax liability would be associated with the stockholders of record in the year the audit adjustments are settled. Similarly, under present law, an increase in corporate liability for any underpaid taxes affects the stock values of current stockholders. However, also as under current law, if an understatement of income is anticipated, the expected value of the tax deficiency would be reflected in the price that the affected shareholder paid for his stock in the first instance.

It might also be objected that the Blueprints system could place an undue hardship on low-income persons holding stock in companies that currently pay out few dividends. Such individuals could be forced to sell their stock to pay their taxes. This liquidity problem could be solved by imposing a withholding tax on corporations and granting a corresponding tax credit to shareholders of record for their

share of the corporate withholding tax. However, the imposition of a withholding tax would mean that a partial year shareholder would continue to have an interest in the corporation even after he sold his stock because the tax credit would not be transferable to the purchaser of the stock. In principle, the market should be able to handle this problem. While the new buyer cannot purchase the credit, the seller would be willing to sell the stock for less if he expected a tax credit to be forthcoming.

Another set of issues raised by the integration proposal is the treatment of foreign source income and taxes and foreign shareholders of domestic corporations. Concerning the taxation of international income, Blueprints would favor the residence principle under which all income wherever earned would be taxed according to the rules of the taxpayer's country of residence.

This, however, is regarded as a long-run objective. As an interim solution, Blueprints would continue to allow a foreign tax credit on foreign source income. The foreign tax credit would be computed at the corporate level and would be limited to 30 percent with the remainder of foreign taxes allowed as a deduction. Foreign source income of U.S. corporations would flow through directly to the parent corporations and their owners whether or not distributed by the subsidiary or the parent. 15/ It has been alleged that

eliminating deferral would be a major source of complexity, but the earnings and profits of foreign subsidiaries must already be calculated according to U.S. tax accounting rules in order to determine the deemed paid foreign tax credit. 16/ It may be that the most important administrative consideration would be the need for an expanded auditing and enforcement effort by the Internal Revenue Service to monitor at an acceptable level the calculation of foreign source income.

Blueprints thus deals with many problems associated with integrating the corporate and personal taxes. Other problems for which Blueprints offers no ready solutions might also be mentioned. There are, for example, income assessment problems stemming from interlocking corporate stock ownership and stock issues or redemptions after the record date. The rules enunciated by Blueprints would have to be extended to these situations before a workable integration plan could be achieved.

The problem with interlocking corporate stock ownership runs as follows. For two corporations owning stock in each other, the income of each must be determined simultaneously, because one corporation can not determine its income unless the other corporation's income is determined and vice versa. A completely accurate determination of the income of

interlocking corporations requires the solution of a set of simultaneous equations. Any possible remedy for this problem is likely to represent a compromise between accurate income measurement and administrative feasibility.

Another problem on which Blueprints is silent but which may nonetheless have a bearing on simplicity is the question of how income would be attributed to stock newly issued during the year. To attribute all of income to original record date shareholders would be unfair to them since part of the corporation's income clearly has accrued to the new shareholders. A related issue is how withholding tax credits would be divided among new and old shareholders. Additional rules for allocating corporate source income would be required with obvious implications for complexity. The rules would also have to specify how income and withholding would be allocated to stockholders in the event of redemptions of stock by corporations.

Income tax analysts have expressed concern that integration could not readily deal with the problem of allocating investment tax credits and foreign tax credits to millions of shareholders. 17/ This issue would not materialize under the Blueprints proposal. All credits except for the foreign tax credit would be eliminated, and the computation of the foreign tax credit would involve only the corporation and not its shareholders.

In general, full integration would unquestionably generate considerable complexity, although more for corporate management than for individual taxpayers. Approximately 15 million returns in the aggregate would be affected, with 55 percent in comprehensive income classes below $20,000. Even these figures do not reflect the effects of a possible increase in the ownership of corporate shares resulting from integration of corporate and personal taxes. Furthermore, some 2 million corporations would be required to change their accounting practices and procedures. Tax administrators as a consequence, would have to step up their efforts to ensure that corporate source income and basis adjustments were correctly reported. On the other hand, by generally ending the advantage of preferred capital gains treatment for corporate retained earnings, the integration proposal would greatly reduce pressures to convert corporate income into capital gains. Full integration could thus have a favorable effect on dynamic complexity.

Transition Considerations

Perhaps the major transition issue in connection with the integration proposal is the taxation of undistributed income accumulated in corporations but not paid out prior to the effective date of integration. The other major transition consideration having a bearing on integration concerns how unused losses, deductions, and credits earned in prior years but not yet utilized because of limitations of one type or another would be taxed under the integration proposal.

As an operating principle, Blueprints states that "to the maximum extent practicable, an attempt should be made to treat such items in a manner that reflects the impact of the corporate tax as in effect when the items were incurred or earned." (P.197) Rules to accomplish this objective would definitely complicate corporate taxtion during the transition period as well as decisions of managers and financial investors, since the existence and possibly changed status of the credits would alter the after-tax returns that could be expected from owning the stock of some corporations.

Capital Gains Tax Reforms

General Proposal

Blueprints. The basic recommendations for capital gains and losses are easily summarized. Gains from the sale of capital assets 19/ would be fully taxed upon realization at ordinary rates after (1) adjustments to basis for corporate stock (as explained in the integration proposal) and (2) an adjustment to basis for general price inflation. Losses, after similiar basis adjustments had been made, would be fully deductible. However losses would be limited to the adjusted basis of the shareholder. At time of death, capital gains would also be taxed as if fully realized. Blueprints would continue to allow rollover in certain situations including business reorganizations and sales of principle residences.

The adjustment for inflation would be accomplished by multiplying the original basis of the asset (or the basis at the beginning of the taxable year in the case of corporate equity) by the ratio of the consumer price index in the year of purchase (or beginning of the taxable year) to the same index in the year of sale (or the end of the taxable year).

The ratios to apply would be provided in the form of a table accompanying the capital gains tax schedule. No inflation adjustments would be provided for intra-year sales and purchases.

Blueprints recommends the above treatment on the grounds of equity, since changes in capital values which merely reflect inflation are not real income. It considers but rejects (1) the full taxation of accrued capital gains on the grounds of difficulties of valuation and (2) an interest charge on the deferral of taxes resulting from the postponement of realizations on the grounds that such an approach would engender considerable complexity with only small gains in more accurate income measurement.

Adjusting for inflation would in itself complicate the calculation of income but would not be expected to produce insuperable difficulties for tax practitioners, administrators, or accountants. Furthermore, these rules for taxing capital gains must be compared with the complexities of existing law. For example, under Blueprints there would be no need for recapture rules to prevent ordinary income created by excess depreciation deductions from being taxed as capital gains. Not only would better income measurement rules limit deferral but recapture would occur automatically since all gains would be taxed in full.

Moreover, taxpayers would be spared the need to undertake the present complicated netting procedures whereby gains and losses are divided into short- and long-term accounts, the net gain or loss in each account is determined separately, the resulting net figures in each account are netted against each other, and any net losses are subject to an income limitation but with an unlimited carryover. Also leaving the tax code would be the alternative tax of 25 percent on the first $50,000 of long-term gains, the capital gains provisions in the minimum tax and the maximum tax, and the special capital gains treatment accorded timber, livestock, coal, and iron ore. Taxing capital gains in full at death would also be far less complex than the carryover of bases rules provided in the 1976 Tax Reform Act. 20/

Removing the tendency of inflation to increase taxes on capital income would also reduce the continual pressures to effect relief through legislation -- often with uncertain or unintended side effects. This would not only contribute to a more stable tax environment for economic decision-making, but would also give investors less reason to be concerned about restructuring transactions to compensate for both inflation and a tax base defined in nominal terms. Thus, reducing the distinction between ordinary income and capital gains would abate the legislative and economic pressures toward dynamic complexity. The advantages of deferral, of course, would continue to be a factor in tax planning, but the range of

assets to which deferral would apply would be severely restricted. This would be particularly true since returns on corporate stock would be taxed largely on an accrual basis and improvements in the measurement of the income from other assets, as indicated below, would remove that source of capital gains under current law.

While the information for making inflation adjustments can be readily provided, additional computations would be required of many taxpayers. In 1976, some 7 1/2 million returns actually realized net long-term capital gains or losses but this figure presumably understates the number of taxpayers holding assets for which basis adjustments would be needed. Moreover, if the pattern of realizations is indicative of the pattern of holdings, about one-half of the tax returns affected would be in comprehensive income classes below $20,000.

Transition Considerations

As is the case with other proposals, Blueprints recommends transition rules for gains and losses that have accrued prior to the effective date of the new rules. These transition rules would deal with the equity problems which would otherwise arise from an immediate application of the new capital gains procedures.

Holders of existing capital assets would be allowed a 10-year period over which the old rules would phase out. The phase-out could take one of two forms. Under one procedure, the inclusion rates would increase over the 10-year period from 50 percent to 100 percent. An alternative transition procedure which would probably be less disruptive of capital markets would allow investors to treat realized gains or losses as accruing proportionately over the interval the asset was held, with the portion of the gain attributable to the pre-effective date period taxed according to the old rules and the remainder according to the new rules. These transition rules would lead to increased computational difficulties.

New Income Measurement Rules

General Proposals

Blueprints argues that new income measurement rules are needed to calculate more accurately income from capital, or what is more commonly termed business income. Of major importance, in this connection, is the need for allowances for depreciation and depletion to correspond more closely to the real decline in economic value of the depreciable and depletable assets. Blueprints also formulates new rules for measuring income in the case of self-constructed assets. All of these rules would significantly affect the simplicity of the proposed tax system.

Depreciation

For calculating capital consumption allowances for machinery and equipment, Blueprints advocates a system not dissimilar to the current ADR procedures. The system would involve the following elements: (1) the classification of all assets by types; (2) the mandatory maintenance of a system of vintage accounts; (3) the use of a guideline annual repair allowance for each asset; (4) the application of a specified annual depreciation rate to the undepreciated

balance in each vintage account together with a date on which any remaining balance may be deducted; (5) the computation of annual adjustments of basis in each account by a measure of the change in general price levels during the year.

Similar depreciation rules would be applied to structures except that depreciation rates could vary over the life of the structure to reflect the fact that asset values may decline less smoothly. However, in no case would total depreciation after adjustments for inflation be allowed to exceed the original basis. Gains and losses would be recognized when exchanges or demolitions occurred. Depreciation and repair allowances would always be determined by the age of the structure, not by the time in the hands of the new owner. Expenditures for structural additions and modifications beyond guidelines would be treated as new investment which would increase the asset's depreciable base.

Under the recommended procedures, all rules for estimating guideline depreciation rates and repair allowances would be "subject to continuous revision to reflect new evidence on actual experience and changing technology." (p. 65). It is imperative in this system that information be kept current while at the same time arbitrary reporting requirements are kept to a minimum. Survey techniques modeled on current procedures of the Office of Industrial

Economics of the Treasury Department may be used, but the type of information needed -- maintenance outlays and rates of depreciation in addition to asset lives -- would be more extensive.

In addition, a large educational effort would be required, at least initially, to familiarize taxpayers and practitioners with these new rules. The IRS would have the particularly important task of promulgating this information in a form that would be enforceable and understandable, particularly to small businesses. However, any rule for depreciation requires monitoring and enforcement, and once understood, the particular rules in Blueprints need not be any more onerous than existing depreciation procedures.

These rules would, moreover, have the effect of reducing the differential tax advantages of alternate investments. Since excess depreciation is perhaps the most common ingredient in tax shelters, the establishment of a system of depreciation allowances more congruent with economic reality would diminish if not eliminate the incentives of taxpayers to seek out such shelters. The tendency towards dynamic complexity, which as noted earlier is particularly important in the case of tax shelters, would be greatly abridged.

Also, as indicated in connection with capital gains taxation, the adjustment of depreciation allowances for inflation would reduce the need for legislative solutions to offset the effects of inflation on the taxation of income from capital. Legislative solutions, moreover, while often sufficient in the aggregate albeit with a lag, are seldom the apropriate correction for individual industries. As a result, the tax environment for particular investments in an inflationary world is marked by a high degree of uncertainty.

Depletion

Blueprints also restructures the rules governing the taxation of mineral deposits. The problem here is that the economic value of a mineral deposit becomes fully known only after the deposit has been completely exploited, whereas an annual depletion schedule must be estimated from the onset of production from the deposit. Uncertainty about extraction and marketing costs and mineral prices in the future as well as the extent of the discovery itself, makes the task of valuation particularly difficult.

Economic competition among suppliers of minerals tends to ensure that the costs of seeking mineral deposits at least in an expected value sense are equal to the returns from this activity. On this basis, Blueprints argues that the best

objective measurement of the market value of the mineral deposit prior to production is the total expenditures made for discovery and development of the deposit. Blueprints would, therefore, require the capitalization of all preproduction expenditures (other than for depreciable capital which would be separately depreciated under the rules already discussed). Depletion deductions for tax purposes would then be based on initial production rates combined with guideline decline rates derived from average experience. Over time -- Blueprints recommends 5 years -- these rates would be adjusted for each property to reflect individual experience. But in no case would total depletion deductions exceed cost (after adjustment for inflation).

Under these rules, tax administrators would be compelled to develop average guideline rates and workable procedures for periodically revising them in the case of particular deposits, and taxpayers would have to learn how to comply with these accounting procedures. On the other hand, investments in mineral deposits would lose their appeal as tax shelter devices with favorable implications for reducing dynamic complexity. The net result in this case would undoubtedly be an increase in complexity, but the extent of the complexity would depend upon the workability of the guideline procedures.

Self-Constructed Assets

Finally, current law accords favored treatment to capital assets constructed by a firm for its own use relative to assets purchased from other firms. For self-constructed assets, income accruing to suppliers of equity during the period of construction is not currently recognized because there is no sale of the completed structure. 21/ To equalize the tax treatment of self-constructed and other assets, Blueprints would require all costs of constructing an asset for a firm's own use (except interest paid) to be maintained in a separate account. "During the construction period a guideline rate of return would be imputed to the average value of this account and added to the tax base of the builder and also to the depreciable basis of the owner." (p. 67). The assets in service would be depreciated under the rules already discussed. Since the guideline return is imputed to the portion of the structure financed by debt as well as equity, interest costs are already included in the procedure and need not be separately added.

The rationale for this treatment is that capital tied up in such assets must pay a rate of return at least equal to what the capital could earn in alternative uses or else the investment would not have been undertaken. The imputation of

income is therefore necessary to equate the tax treatment of such assets with other assets. This imputed return is added to the depreciable basis of the property to avoid taxing capital.

These rules to reduce the favored tax treatment of self-constructed assets need not involve much additional complexity since essentially the same rules are already in use for rate-making purposes in the case of utilities, the major industry which constructs its own assets.

Transition Considerations

Blueprints recommends that assets already in place when the new income measurement rules take effect continue to enjoy the old tax treatment as long as they remain in the hands of their initial owners. The additional complexity here would be the need to follow two separate sets of accounting rules -- one for new and one for old capital assets. The transition period would continue until all existing assets had either been retired or had changed hands. A possible modification is to switch to the new rules with respect to the undepreciated or undepleted basis of existing assets at some future date, say in 10 years.

The Taxation of Retirement Income

General Proposals

Blueprints also deals with the difficult issue of the taxation of accruing rights to receive future income such as pension and social security benefits. Consistent with the concept of a comprehensive tax base, Blueprints would establish rules that would approximate accrual taxation of the value of such pension rights by combining the full taxation of pension benefits when received with the taxation of pension-fund earnings. Furthermore, neither employer nor employee contributions would be taxed when made. This method is based on the idea that accrual taxation is generally equivalent to the full taxation of realized benefits plus a deferral charge. The tax on pension-fund earnings under the Blueprints proposal represents the deferral change.

To see how the system under Blueprints would approximate accrual taxation, suppose that a taxpayer has the same marginal tax rate of 20 percent in his working years and in his retirement years. Let an employer contribute $100 to a pension fund for the last working year to be available to the taxpayer as retirement income next year. Suppose also that the money in the fund can earn 10 percent.

If a full accrual system were in effect, the taxpayer would pay a tax in year 1 of $20 on the $100 contribution at the beginning of the period leaving $80 in the fund and also an additional tax of $1.60 equal to 20 percent on the $8 of earnings of the fund during the year (10 percent of $80). At the end of the year he would have prepaid taxes of $21.60 on his retirement pension of $86.40 = $80 + 8 - 1.60 resulting from the transaction. Since taxes were prepaid on the amount in the fund, he would be allowed to receive a distribution of $86.40 from the pension fund tax free.

Under the system recommended by Blueprints, both employer and employee contributions to pension funds would be tax deductible. In this case there would be no tax liability for the taxpayer on the $100 employer contribution during his working year. However, there would be a $2 tax on his $10 of accruing interest income during this year. In addition, the distribution of $108 in the fund to the taxpayer would be fully taxed at a 20 percent rate (equals $21.60) leaving him $108 - $21.60 = $86.40 in his retirement year, exactly the same as in the accrual taxation case.

Thus, in the case of a taxpayer who stays in the same marginal tax bracket and receives fully all the retirement income accumulated on his behalf, an accrual taxation system can be approximated by taxing pension fund earnings as they accrue and fully taxing benefits.

In contrast, the current taxation of retirement benefits is a mixture of several elements. Employer contributions are generally excluded from income, but not all employee contributions are currently deductible. Also, while benefits in excess of tax prepaid contributions are generally fully taxed when received, there is no deferral charge for the postponement of tax. In addition, contributions to retirement plans by the self-employed (or by employees who have no employer-sponsored plans) and earnings of retirement plans are exempt from tax. Since most pension plans, with the exception of government plans, require no employee contributions the current system can be characterized as largely on a realization basis, whereas the Blueprints system is an attempt at approximating an accrual basis.

In fact, because of problems created by vesting rights and uncertainty about the length of life, the treatment in Blueprints would be fairer in an ex post sense than would an accrual system. Persons who lived shorter than normal lives would pay less tax than under a pure accrual system since Blueprints would tax benefits when received rather than contributions when made. Conversely, for those who lived longer and therefore had more benefits, Blueprints would subject relatively more income to taxation. In the case of pensions that had not become fully vested, earnings would be taxed to the employer. If the employer were in a higher

marginal tax rate than the employee as could be the case, the attractiveness of this kind of deferred compensation arrangement would be diminished. However, there would continue to be a tax advantage to pensions under the Blueprints scheme to the extent that a person's tax rate is higher in his working years (when his contribution is deductible) than in his retirement years (when his benefit is taxable). The advantage of this treatment would be less under a comprehensive income tax system than under present law because of the smaller differences in marginal tax rates and the wider tax brackets.

The overall impact of the reforms outlined in Blueprints would be to diminish the economic attractiveness and the use of pension plans as vehicles for providing retirement income. With the possible exception of the gain in simplicity from a decreased use of pension plans, little would be achieved in reducing complexity relative to current law for those pension plans which remain in existence. For individual taxpayers, who would receive notices of pension-fund earnings along with their annual W-2 statements, no additional complexity is involved. But pension funds would have the additional requirement of calculating and reporting to employees (and employers for not fully vested plans) their share of the taxable earnings of pension funds. This would be in addition to all other reporting and financial responsibilities under which pension plans would

continue to operate. On the other hand, since all benefits would be taxed, no computation would be needed to determine which portion of pension benefits are a return of tax-paid contributions and which are taxable income. Inasmuch as the current rules are quite complex, this could represent a substantial simplification.

Some 44 million tax returns, or about 52 percent of those receiving wages and salaries, would include in income pension-fund earnings. As noted, this information would be made available on W-2 forms received from their employers. Another 11 million returns would also have pension benefits subject to tax as under current law.

In addition to private pensions, a major source of retirement income for many people today is social security. For example, in 1976 the Social Security system paid out over $6 of retirement income for each dollar paid out by private pension plans. 22/ Under current law, social security benefits are not taxable but only employer contributions are excluded from income. It is possible to view social security as a pension plan under which the benefits actually received result in some *ex post* rate-of-return on employer and employer contributions. However, it is virtually impossible to calculate such a return annually. This is because future benefits depend upon the changing conditions of a worker's marital status, number of dependents, earnings record, and the spouse's earnings record.

Consequently, Blueprints does not attempt to tax the implicit rate of return on employee and employer contributions to social insurance funds, and thus does not implement the same accrual principle for social security as for private pensions. However, as in the case of pension funds, contributions to the fund, by employer and employee would be deductible and benefits would be fully taxable.

About 72 million tax returns would be affected by the deductibility of employee social security contributions from taxable income, although, as in the case of pensions, their receipt of this information would be handled through the usual W-2 forms. Another 23 million returns would be required to report social security benefits. Over 10 million of these returns receive comprehensive income of $5,000 or less, and a large proportion of these as a result would not be expected to be taxable.

The treatment of social security benefits would thus be somewhat more lenient as well as a good deal simpler than pension income. Compared to current law, however, social security would be more heavily taxed. The full taxation of benefits would outweigh the deductibility of employee contributions which are not allowed under current law. Nonetheless, the harsher tax treatment of pensions than social security under Blueprints could lead to pressures for

increasing the size of the social security program relative to private pensions. While in a sense such a development could be regarded as advancing the cause of overall simplicity, equity may not necessarily be improved because the implicit returns earned on social security contributions would not be taxed.

Transition Considerations

Complexity is also likely to be created in moving to the new system of taxing retirement income. For reasons of equity, it would be undesirable to immediately tax all retirement benefits in full. Indeed any benefits paid out of past accruals have a claim for being treated under the current rules. In response to this, Blueprints would allow people currently retired to be taxed under the old rules and people with current retirement accounts to be taxed partially under the old rules. Obviously developing regulations and forms and monitoring compliance during the transition period could impose burdensome chores on taxpayers and administrators. Moreover, the transition period in this case would last a full generation.

Summary

For most proposals presented in Blueprints, the burden of recordkeeping, as in the case of wages currently, would be assumed by the disbursing organization. Information on the W-2 form provided by the employer would include not only wages but various adjustments for pension plans, social security, and employer fringe benefits. Thus, to the extent that simplification is of more concern for individuals than institutions, Blueprints would not pose serious difficulties.

However, because a comprehensive income tax limits exclusions, more taxpayers would have to file tax returns. Filing would be an added burden for the currently nonfiling population. The taxpayer assistance industry could count on new business and the Internal Revenue Service would have a larger workload to process.

The elimination of the standard deduction is certain to have an adverse effect on tax simplicity for the low to average income taxpayer. Elimination of the standard deduction would increase the number of itemizers as Blueprints would continue to allow deductions for five categories of deductions. This would necessitate additional record-keeping and calculations on the part of taxpayers who

now take the standard deduction as well as those who do not have to file. Also IRS would have to scrutinize the expenditures of the new itemizers. However, since many deductions of current law would be disallowed by Blueprints, currently itemizing taxpayers would no longer have to keep records of expenditures that had lost their tax-deductible status.

Proposals in Blueprints that would complicate an individual's calculation of tax liability are the basis adjustments for returns with capital gains and with corporate source income. On the other hand, Blueprints would simplify the decision-making process for investors since most of the tensions responsible for dynamic complexity would be eliminated. By equalizing the tax treatment of different investments, Blueprints would decrease the necessity for investors to research the tax laws -- or have this done for them. Thus, while tax practitioners may spend more time assisting taxpayers with calculations of tax liabilities, they would spend less time counselling them on tax planning.

Blueprints would impose additional reporting requirements on income dispensing institutions. Examples include the share of corporate income and adjustments for changes in basis that would have to be reported to shareholders by corporate management. Pension funds, in

addition to the normal reporting requirements, would have to report the share of pension fund earnings accruing to individuals, or employers if the benefits had not been vested.

Business accounting staffs would have to learn the new accounting rules for measuring capital income, but once these were digested they would not seem to pose any difficulties beyond those of current law. Finally, and perhaps most importantly, the lower structure of tax rates would reduce pressures on legislators to enact the special tax treatments that give rise to dynamic complexity in the first place.

Footnotes

1/ Blueprints for Basic Tax Reform, Department of the Treasury, Washington, D.C. (January 1977). This work will be subsequently referred to as Blueprints. Page numbers for all direct quotations from Blueprints will be shown in parenthesis immediately after the quotations in the text. Actually two model tax systems were developed in Blueprints, one based on a more comprehensive definition of income and one based on personal consumption, but for the purposes of this paper only the income tax model will be considered.

2/ Comprehensive income equals gross wages minus employee contributions to retirement plans and to old age and disability insurance plus fringe benefits in the form of employer contributions for life and health insurance (including medicare) plus earnings in life insurance reserves and pension plan reserves plus self-employment income plus all dividends, interest rents, and royalties, plus inflation-adjusted realized capital gains plus undistributed corporate income plus unemployment compensation, retirement benefits, workmen's compensation, social security payments (excluding medicare), veterans benefits, scholarships and fellowships, welfare payments, the bonus value of foodstamps, and black lung payments plus alimony received minus employee business expenses, alimony paid, state and local income taxes, and

nonbusiness interest expenses. Child care expenses, up to a limit are deductible in determining taxable income, but not in defining comprehensive income.

3/ See, for example, Bittker, B. Tax Reform and Tax Simplification, 29, University of Miami Law Review I, II (1974) and Surrey, S. Complexity and the Management of Tax Detail, 34 Law and Contemporary Problems, pgs. 673 - 691.

4/ Issues in Simplification of the Income Tax Laws, Joint Committee on Taxation issued September 19, 1977, Washington, D.C. (1977), pgs. 69 - 75.

5/ Bittker, B. and Eustice, J. Federal Taxation of Corporations and Shareholders, Warren, Gorham, and Lamont, Boston (1971), p.5

6/ Ibid., p. 10

7/ Ibid., p. 15

8/ Remarks of Jerome Kurtz, Commissioner of the Internal Revenue Code at the 30th Annual Federal Tax Conference, The University of Chicago Law School, October 26, 1977, Chicago, Illinois, issued by the Department of the Treasury, Public Affairs Division, Washington, D.C. (1977) pgs. 1 - 4.

9/ Ibid., p. 5.

10/ Another 3-1/2 million returns received payments under the earned income credit provisions.

11/ "Nonbusiness interest" includes home mortgage and consumer loan interest. Some economists have argued that such interest deductions should be disallowed in order to tax indirectly the implicit income derived from the ownership of consumer durables or housing that these loans are used to finance. However, disallowance of these interest deductions is not only a crude means of taxing this implicit income but it also discriminates against those taxpayers that finance the purchase of homes and consumer durables by borrowing as opposed to those who liquidate financial assets to make such purchases. In addition, disallowance of non-business interest would create artifical incentives to substitute business debt for consumer debt. For these reasons Blueprints would continue to allow non-business interest deductions. Also, while recognizing the existance of implicit income from owner-occupied housing and consumer durables, Blueprints would not attempt to tax this income primarily because of the adverse effect on simplicity of such a policy.

12/ In the short run this simplification option could be inequitable to employees for whom legitimate costs of earning income are no longer deductible. However, over time either wages would tend to rise relatively in those industries or employers would bear a larger share of the costs of earning income for their employees.

13/ Arguments could be made about the merits of allowing most of these deductions. For example, some economists consider children a consumption good and allowing the child care deduction could be viewed as lowering the costs of having children just as the current moving expense deduction reduces the costs of moves that are primarily under taken for "consumption" rather than "business" purposes. Blueprints (see page 7) recognizes, however, that the distinction between consumer and business expenses is not easy to make.

14/ An example may be helpful in explaining the equivalence between the two sets of rules for taxing corporate income to shareholders even when corporate income as measured at the corporate level differs from market valuations of that income. Using the example of the text, suppose that the market values the corporate income halfway through the year at only $30, rather than $50. The shareholder's income by

the alternative method in the text would be $30 = $1,030 - $1,000. By the first method his income would be exactly the same except this time the calculation would be $30 = $100 + $1,030 - $1,100 (adjusted basis).

15/ Foreign source income of corporations controlled by foreign shareholders would flow through to U.S. corporations and citizens only when dividend distributions were made.

16/ The deemed paid foreign tax credit for corporations is calculated by multiplying the ratio of dividends from foreign subsidies and earnings and profits of foreign subsidies by foreign taxes paid.

17/ For example, Charles McLure has raised this issue in discussions at a Brookings Institution Conference on Integration in October, 1977.

18/ For example, a net operating loss carryback or carryover arises because the taxpayer's deductions exceed his gross income. Capital loss deductions are limited to capital gains, deductions for charitable contributions are limited to a certain percentage of income, and the investment tax credit is generally limited to fifty percent of the tax otherwise due.

19/ Debt would not receive an inflationary basis adjustment because of an important distinction between capital income in the form of contractual interest and income generated by other assets. In the latter case, inflation reduces the value of nominal depreciation deductions and capital gains and therefore results in a transfer of resources from private individuals to the government. While inflation can also reduce the value of nominal interest payments, this causes a transfer of resources from creditors to debtors, rather than between creditors and the government. That is, the debtor's gain is the creditor's loss. Furthermore, if allowed to adjust, interest rates may increase in a way that can allow both parties to the loan transaction to offset the effects of inflation which reduce the value of principal repayments.

20/ The current carryover provisions cause great complexity for estate planning. For example, to minimize taxes low-basis assets should be given to low-income heirs or charities and high-basis assets to high-income heirs. Full taxation of capital gains at death would also put a limit on the deferral of taxation on these gains. It may be objected that the proposals in Blueprints would allow gains to go unrecognized currently whereas capital losses would be deductible when realized. Given the other income measurement rules and the integration proposal, the possibilities for manipulation do not loom sufficiently important that they could not be corrected.

21/ Prior to 1976, certain construction costs, such as preproduction interest and taxes and fees paid to local governments, could be deducted as current expenses. The Tax Reform Act restricted the amount of such expenditures that could be expensed somewhat by requiring, for taxpayers other than corportions, that real property construction period interest and tax expenditures be capitalized and amortized over a 10-year period.

22/ Social Security Bulletin, January 1977, Table 9, Department of Health, Education and Welfare, Washington, D.C., p.17.