



# tax notes<sup>SM</sup>

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<b>SPECIAL REPORTS</b>	<b>Errors in Proposed Neutral Cost Recovery System . . .</b>	<b>1229</b>
	<b>S Corporations and Cancellation of Debt Income . . . .</b>	<b>1239</b>
<b>FROM CONGRESS</b>	<b>Senate's Budget Plan Sets Up Fight With House . . . .</b>	<b>1127</b>
	<b>W&amp;M Members Push Foreign Tax Simplification Bill . . .</b>	<b>1164</b>
<b>IRS NEWS</b>	<b>Compliance Scoring Being Regionalized, Gibbs Says . .</b>	<b>1129</b>
	<b>Electronic Filing Highlights Quiet CAG Meeting . . . . .</b>	<b>1131</b>
	<b>Revisions to APA Procedures Proposed . . . . .</b>	<b>1175</b>
<b>COURTS</b>	<b>Loss Denied: Option Was Used for Disguised Payment . .</b>	<b>1195</b>
	<b>Tax Court Must Go With Valuation of Estate's Expert . .</b>	<b>1196</b>
<b>ABA TAX SECTION</b>	<b>Sweeping Reform: How Simple, How Fair, How Soon? . .</b>	<b>1135</b>
	<b>LLCs: How IRS Got to Check-the-Box Classification . . .</b>	<b>1139</b>
	<b>IRS Will OK Some Bank Stock Inversion Transactions . .</b>	<b>1145</b>
	<b>Officials Address Exempt Organizations Issues . . . . .</b>	<b>1148</b>
	<b>Does Criminal Tax Enforcement Serve Compliance? . . .</b>	<b>1150</b>
	<b>IRS Preparing Controversial Collection Standards . . .</b>	<b>1156</b>
<b>NTA CONFERENCE</b>	<b>Researchers Talk Tax Cuts, Capital Gains, Reform . . .</b>	<b>1133</b>
<b>PRACTICE</b>	<b>Complicating 'Timely Mailing Is Timely Filing' . . . . .</b>	<b>1225</b>
<b>COMMENTARY</b>	<b>Congress vs. Clinton: A Closer Look at the Budget . .</b>	<b>1247</b>
	<b>IRS Ruling Properly Applied <i>INDOPCO</i> . . . . .</b>	<b>1249</b>
	<b>Two Views on Flat Tax Proposals . . . . .</b>	<b>1253</b>
	<b>Sheppard Fails the 'Red-Face' Test . . . . .</b>	<b>1265</b>

## DEPARTMENTS

Accounting News . . . . .	1227	IRS Letter Rulings . . . . .	1171
Bibliography . . . . .	1221	IRS News . . . . .	1175
Calendar . . . . .	1267	IRS Regulations . . . . .	1169
Code Section Index . . . . .	1272	IRS Reviewed Briefs . . . . .	1210
Congressional Hearing Announcements . . . . .	1217	IRS Tax Correspondence . . . . .	1176
Congressional Hearing Transcripts . . . . .	1217	JCT Reports . . . . .	1216
Congressional Tax Correspondence . . . . .	1217	News in Brief . . . . .	1164
Court Complaints and Petitions . . . . .	1212	Pension News . . . . .	1223
Court Opinions . . . . .	1191	Perspectives on Guidance . . . . .	1249
Current and Quotable . . . . .	1253	Practice News . . . . .	1225
Economic Perspective . . . . .	1247	Press Watch . . . . .	1219
Focus on Congress . . . . .	1213	Special Reports . . . . .	1229, 1239
Focus on the IRS . . . . .	1175	Summary of Contents . . . . .	1122
Focus on Treasury . . . . .	1165	This Week's News . . . . .	1125
GAO Reports . . . . .	1217	Treasury News Releases . . . . .	1165
Internal Revenue Bulletin . . . . .	1179	Treasury Reports . . . . .	1165



# current and quotable

## The Flat Tax: A Dissenting View

by Sheldon Pollack

The following statement on flat tax proposals was presented by Sheldon D. Pollack, professor in the Department of Accounting, College of Business and Economics, University of Delaware, Newark, Delaware, at the hearings before the Senate Finance Committee, May 18, 1995.

Mr. Chairman and Distinguished Members of the Senate Finance Committee:

I am honored to have this opportunity to present my views on some of the proposals before the Congress to adopt a so-called "flat" income tax. The Honorable Richard K. Armey, House Majority Leader, and the Honorable Arlen Specter, Senator from Pennsylvania, have both offered serious and thoughtful legislative proposals for a flat tax. A considerable number of newspaper editorials, columnists, and former presidential speech-writers have also recently expressed interest in a flat tax. House Minority Leader Richard A. Gephardt even joined the chorus at one point and proposed his own version of a flat (or flatter) income tax. I would suggest that notwithstanding the great importance of the Senate giving consideration to the concept of a flat tax, several issues need to be clarified first. Conceptual clarity has been sacrificed in the rush to "tear the income system out by its roots" and replace it with a flat tax, or any one of a number of other alternatives floating about Capitol Hill.

I first would like to direct my comments today to two common assertions made by proponents of the flat tax — specifically, that a flat tax is a "fairer" tax and a "simpler" tax. The former claim is invariably put forth without argument or reason, as if the proposition is another of those truths that we hold as self-evident. Likewise, proponents praise the flat tax as much simpler than the current tax regime. Absent radical broadening of the income tax base — a very separate issue that unfortunately has become confused with the flat tax per se — there is no reason at all to presume that a flat tax will be any simpler than the current model. Adopting a broader tax base will be necessitated by the revenue shortfalls that, I am afraid, will follow inevitably in the wake of the enactment of any flat tax proposal that is attractive to the electorate and therefore, politically feasible. But it should be recognized that

broadening the tax base, and not the flat tax, will be the source of any such reduction in tax complexity.

Under the banner of the flat tax, a massive assault is being waged on the federal income tax laws. This campaign is ultimately directed at those interests which have been nurtured by the tax laws over the past 80 years. While probably justified, the inherent difficulty of the enterprise and the magnitude of the political obstacles have been grossly understated by those who would have us believe that the tax code can be reduced to three or four provisions by the mere stroke of a pen. Rather than wage this all-out political war on tax expenditures, deductions, credits, and preferences, a more selective approach is preferable. Congressional policymakers need to distinguish between the different sources of complexity in the tax laws; only those that cannot be justified from the perspective of national policy (i.e., the public interest) should be the target of reform efforts. Recent success in repealing former section 1071 of the Internal Revenue Code, as well as the House's contribution to the demise of the alternative minimum tax, demonstrate the wisdom and possibilities of this approach.

### Flat Tax, Fair Tax?

One of the central arguments of proponents of a flat tax is that it is "fairer" than the current graduated rate structure, which rises from 15 to 39.6 percent on income in excess of \$250,000. To a considerable extent, the case for a flat tax has been advanced under the standard of "fairness." Senator Specter's proposal for a flat tax (in essence, a consumption-based flat tax with deductions only for mortgage interest and charitable contributions, and limits on those as well) asserts that a flat tax would "provide for fairness among all taxpayers."<sup>1</sup> The clear implication is that some taxpayers are treated unfairly by the current progressive rate structure. Representative Armey too has justified his proposal for a flat tax (which apparently eliminates all deductions) on the grounds that "The great virtue of a flat tax is its fundamental fairness."<sup>2</sup>

Claims that a flat tax represents the embodiment of fairness ought to be treated with the same degree of skepticism as the assertion that the income tax must be progressive in order that all taxpayers pay their "fair share" of tax. Elsewhere, I have questioned the

<sup>1</sup>*Congressional Record*, 104th Cong., 1st Sess., Vol. 141, No. 39 (May 2, 1995), S3416.

<sup>2</sup>Richard K. Armey, explanation of H.R. 4585, The Freedom and Fairness Restoration Act, p. 31.

widespread faith in so-called principles of tax "equity" that allegedly demand that an income tax be progressive to satisfy some vague criteria of "fairness."<sup>3</sup> Academics in our law schools commonly assert that "horizontal equity" demands that all income (regardless of its source) be treated comparably (i.e., taxed), while "vertical equity" demands that those with greater income be taxed at higher marginal rates. Underlying these propositions is a very specific theory of equality and justice, one which inevitably goes unstated by the advocates of redistributive tax policies. We almost never hear a justification these days for graduation of the income tax, notwithstanding that it is one of the defining characteristics of the American tax system. It is simply said to be "fair."

**Claims that a flat tax represents the embodiment of fairness ought to be treated with the same skepticism as the assertion that the income tax must be progressive in order that all taxpayers pay their 'fair share' of tax.**

But fair-minded individuals of good faith can and do disagree about the justice and fairness of progressive rates. One can just as easily posit that equity and fairness dictate that all citizens ought to bear the burdens associated with citizenship *equally*, suggesting that a "head" tax is appropriate, or that political equality dictates that taxes ought to be imposed in direct proportion to one's "ability to pay" — supporting the argument in favor of a flat tax.<sup>4</sup> Likewise, there is a sustainable position that equity demands nothing more than that the tax laws be applied equally and uniformly to all taxpayers alike, with no special privileges (e.g., exclusions or exemptions) recognized for wealth, social standing, office, race, etc.<sup>5</sup> Such a notion of fairness or equity will be strictly confined to "process" — holding that tax outcomes are "fair" so long as the process by which they are made is unbiased and impartial.

Perceptive students of the income tax have always recognized and acknowledged the "perennial and unrelenting controversy" surrounding the concepts of horizontal and vertical equity.<sup>6</sup> While economics may indicate which tax system is most efficient, economic principles simply do not dictate that an income tax

must redistribute income from wealthy taxpayers to those with less. But it also must be admitted that bold assertions that a flat tax is fairer than a progressive income tax are no more persuasive and only contribute to the confusion. The choice of a tax rate structure is a normative choice reflecting deep-rooted political values about the role of government and how the cost of government should be shared by the citizenry. In the end, one can hardly do better than economist Henry Simons, who long ago acknowledged that the choice rests upon inherently normative propositions, and not upon economic theorems:

The case for drastic progression in income taxation must be rested on the case against inequality — on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly unlovely.<sup>7</sup>

Simons himself found income inequality to be "unlovely." Others may find the prevailing distribution of wealth and income to be less offensive to their aesthetic sensibilities, and even quite defensible in terms of the great economic wealth produced by individuals motivated by the drive to accumulate and keep the fruits of their labor and industry.

My point is that intellectual honesty requires that assertions such as that the income tax *ought* to be either flat or progressive need to be justified in terms of moral and ethical principles. And the very act of moving from any rate structure to another must be recognized as an inherently political act of the highest order as very specific economic and social interests will be helped, and others hurt, by such fundamental changes to our extant legal structures.

#### Flat Tax, Tax Simplicity?

Another claim commonly made for the flat tax is that it will significantly reduce the complexity of the tax system. The federal income tax has become ever more complicated through a process of gradual, evolutionary, and incremental adjustments to the original statute.<sup>8</sup> However, starting in the 1960s, the development of the federal income tax entered a new phase, and the level of complexity of the tax code and Treasury regulations increased more dramatically. Prior to World War II, the tax code and regulations were published in a single volume. Today, the same material fills a total of 12 comparable volumes. The income tax provisions of the Internal Revenue Code

<sup>3</sup>Sheldon D. Pollack, "Tax Reform: The 1980's in Perspective," 46 *Tax Law Review* 489 (1991).

<sup>4</sup>For a critique of early 20th century theories holding that tax rates must be related to "ability to pay" (i.e., progressive), see John F. Witte, *The Politics and Development of the Federal Income Tax* (Madison: University of Wisconsin Press, 1985), p. 50.

<sup>5</sup>This echoes Michael Walzer's conception of equality and distributive justice in his classic, *Spheres of Justice: A Defense of Pluralism and Equality* (New York: Basic Books, 1983).

<sup>6</sup>See, e.g., George F. Break and Joseph A. Pechman, *Federal Tax Reform: The Impossible Dream?* (Washington: The Brookings Institution, 1975), p. 3.

<sup>7</sup>Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago, 1938), pp. 17-18. Simons himself scolded those who believe that such questions can be answered with slogans, such as that taxes must be determined by reference to the taxpayer's "ability to pay," arguing that such is little more than a statement that "the writer prefers the kind of taxation that he prefers," and such a principle amounts to no more than a "conjurer's hat" from which "anything may be drawn at will."

<sup>8</sup>I have considered some of the causes behind this increase in tax complexity in "Tax Complexity, Reform, and the Illusions of Tax Simplification," *George Mason Independent Law Review*, Volume 2, No. 2 (Summer 1994).

of 1954 contained 103 sections, while the Internal Revenue Code of 1986, including 1993 amendments, contains 698 sections. One recent report estimates that the volume of the income tax regulations increased 730 percent during the same period from 1954-1994.<sup>9</sup> Most of us would agree with Messieurs Hall and Rabushka, who concluded a decade ago that "The current U.S. income tax system is a nightmare of complexity."<sup>10</sup>

In light of the increasingly excessive and oppressive complexity of the income tax laws, tax simplification has emerged as one of the perennial themes in the academic tax literature. The U.S. Treasury Department, the staffs of congressional tax committees, and the tax bar have also devoted considerable time and effort to the question of tax simplification. Indeed, there is a widespread tendency to equate tax reform per se with "simplification." Such a perspective fails to address the fundamental causes behind the rise in tax complexity. Few reformers demanding simplification recognize the inherent difficulties in their position. Excess complexity is rooted in the very process by which U.S. tax policy is made. Some of the complexity is attributable to efforts by policymakers to accomplish too much through the tax laws, using the tax code as the vehicle for implementing so much public policy. Likewise, much of the complexity is attributable to prior reforms enacted in the pursuit of greater purity and equity in the tax laws. As Senator Russell Long once quipped: "The complexity of our code in the main is not there because of some mischief. Most of it is there in the effort to do more perfect justice."<sup>11</sup> Complexity is not a result so much of malevolence as overzealous reform efforts and excessive demands made on the tax laws by policymakers.

***It is difficult to see how a flat tax would of itself contribute anything to solving the problem of excess tax complexity.***

It is difficult to see how a flat tax would of itself contribute anything to solving the problem of excess tax complexity. Section 1 of the Internal Revenue Code (which prescribes the income tax rates for individuals) is not a very complicated provision. The computation of a taxpayer's liability under a flat tax will take no less time than under the current progressive tax — which requires that the taxpayer either look up his or her tax liability under the tax tables or (for those with higher incomes) make a very simple mathematical computation. Calculating 17 percent of one's taxable

<sup>9</sup>Arthur P. Hall, Jr., "Growth of Federal Government Tax 'Industry' Parallels Growth of Federal Tax Code," Special Report No. 39, Tax Foundation, September 1994, reprinted in *Tax Notes*, Nov. 28, 1994, p. 1133.

<sup>10</sup>Alvin Rabushka and Robert E. Hall, *The Flat Tax* (Stanford: Hoover Institution Press, 1985), p. 5.

<sup>11</sup>Senator Russell B. Long, quoted in U.S. Senate, Finance Committee Hearings, *Tax Reform Proposals*, Vol. 3, 99th Cong., 2d Sess., p. 53.

income will be no easier than this inoffensive computation.

Obviously, eliminating all of the tax expenditures, preferences, credits, and mind-boggling economic computations allowed and required under the present income tax regime *will* result in a considerably simplified tax system. This is the stuff that economists at the Brookings Institution (with whom I am honored to be sharing office space this summer) have been dreaming of for decades. But the effort is not likely to succeed, nor is it clear that it should. The conclusive rebuff to those who relentlessly pursue the "Comprehensive Tax Base" was made over a quarter-century ago by Boris Bittker of Yale University Law School.<sup>12</sup> The best I can do is refer the esteemed Members of the Finance Committee to Professor Bittker's article. Beyond that, I suggest that the considerable political effort required to move the Tax Reform Act of 1986 through the tax committees and to a favorable vote on the floor of both Houses of Congress will look like a cakewalk compared to removing every single tax preference from the tax code (to say nothing of reducing the home mortgage deduction). All this will be required to achieve a tax return that fits on a postcard — the dubious goal of flat-taxers.

**Flat Tax, Revenue Shortfalls?**

Any discussion of the various equities and obstacles to the adoption of a flat tax must inevitably turn to the role of the income tax in providing revenue for the federal government. During World War I, the income tax became the single most important source of revenue for the federal government, supplanting the tariff and excise taxes as the "cornerstone of the federal revenue system."<sup>13</sup> Revenue derived from the federal income tax (corporate and individual combined) has increased from \$28 million in 1913 (the first half-year of the tax), to \$29 billion in 1945 during the height of World War II, to \$587 billion in 1990, to a projected \$739 billion for 1995. In 1914, the federal income tax provided 9.7 percent of total receipts of the federal government; by 1985, the figure was 55 percent. In 1950, revenue from the income tax constituted 45 percent of federal receipts from all taxes; by 1985, the figure had risen to nearly 73 percent.

Like it or not, the current federal income tax is an integral component of the federal system. For that reason, I am surprised by those proponents of the flat tax who rather cavalierly side-step the revenue issue. The questions of equity and eliminating tax preferences really concern how the burden of taxation shall be shared among the various social and economic groups which comprise our polity. But the political and economic reality is that we must be sure that any reform initiative raises at least as much revenue as the current income tax. While I personally would prefer to see the overall level and scope of activity of the federal government reduced significantly, fiscal responsibility

<sup>12</sup>Boris I. Bittker, "A Comprehensive Tax Base as a Goal of Income Tax Reform," 80 *Harv. L. Rev.* 925 (1967).

<sup>13</sup>James L. Curtis, "Federal Deficits and the Boundaries of Democratic Politics," (unpublished paper, 1994 Meeting of the Am. Poli. Sci. Asso., New York, N.Y.), p. 11.

suggests that until that becomes political reality, we should proceed on the assumption that we will need to raise much the same levels of revenue going forward and that any alternative tax must be capable of meeting this criteria. On this score, the flat tax proposals come up short. The Treasury Department and Joint Committee on Taxation have both estimated that the flat tax proposals of Senator Specter and Representative Armey would produce significantly less revenue than the current system. This problem can be solved relatively easily by increasing the tax rate — Treasury calculated that a 25.8-percent rate would be needed to make Representative Armey's proposal revenue neutral. I suspect that such an act of fiscal responsibility would not be very attractive politically to proponents of the flat tax.

We are caught in a bind. When imposed at a rate sufficient to be revenue neutral (to satisfy the apparently insatiable appetite of the electorate for public goods), the flat tax will not be very attractive politically. To satisfy those who believe the poor should either pay no tax at all, or only at a very low rate, a flat tax will need be too low to raise anywhere enough revenue.<sup>14</sup> The present system must be recognized as a compromise and accommodation of these and other moral principles and political demands. A tax system based on only one Big Idea (i.e., a flat tax rate) will fail to satisfy other important principles and goals — revenue being but one.

In conclusion, my own view is that an incrementalist approach is the more appropriate mode of policymaking for reasonable and responsible tax reform. While the income tax laws may strike non-tax lawyers as entirely impenetrable and unmanageable, there is an accumulated wisdom expressed in the tax laws (albeit with considerable excess baggage), cultivated over the course of the eighty-year history of the income tax. This accumulated wisdom will be swept away by the flat tax proposals now on the table. The preferable alternative is that of incrementalism — a *strategy* for limited, gradual tax policymaking. After a decade of instability and radical changes to the tax code, the propriety of marginal and gradual change should be all the more obvious. Those who urge radical policy proposals such as abandoning the present federal income tax in favor of a flat tax with a comprehensive tax base, or the adoption of some entirely new mode of taxation altogether (for example, a national sales tax or an expenditure consumption tax), would do well to heed the warning of [former Ways and Means Committee] Chairman Rostenkowski: "Fundamental reform almost always runs the risk of making things worse." At risk is the \$739 billion of federal revenue projected to be raised by the current income tax in 1995.

<sup>14</sup>This is the problem with the Pennsylvania personal income tax. Required to be uniform under the state Constitution, the tax traditionally has been kept low (currently 2.8 percent) to avoid imposing undue hardships on low-income citizens. The inevitable revenue shortfalls pushed the corporate income tax rate upward, eventually reaching a maximum of 12.25 percent — the highest in the nation. This in turn created its own problems, such as capital flight.

## Current Flat Tax Proposals

by Michael J. Graetz

The following statement on flat tax proposals was presented by Michael J. Graetz, Justus S. Hotchkiss Professor of Law at Yale Law School, at hearings before the Senate Finance Committee on May 18, 1995.

Mr. Chairman and Members of the Committee:

It is a great pleasure to appear before this committee to discuss flat tax proposals.

The flat tax proposals introduced in this Congress contemplate the most dramatic changes in the United States tax system since the income tax was extended to the masses during the Second World War. Such extensive change raises many questions — including the critical question of transition: how do we get there from here? I shall highlight only a few of the important issues in this brief statement at this early stage of your deliberations.

### 1. There Is Nothing Novel About a Flat Tax Rate

While a progressive rate income tax has been a feature of the U.S. income tax for more than 80 years and a progressive rate estate tax has been in place for seven decades, flat rate taxes are common in this nation's tax system. Most state sales taxes are leveled at a flat rate, although the tax rates differ from state to state. Both the federal wage tax that funds old age, survivors' and disability insurance, and the separate federal wage tax imposed to fund hospital insurance under Part A of Medicare are flat rate taxes. The corporate income tax is basically a flat rate tax. Until 1993, the alternative minimum income tax on individuals was a flat rate tax and now has only two rates, 26 and 28 percent, with the second rate undoubtedly added to satisfy someone's revenue and distributional tables.

Multiple tax rates generally serve one of two purposes: (1) they enable the legislature to favor certain types of investment or consumption, or (2) they reflect a belief that fairness demands some progressive rates in a tax system. The latter point recently has been put well by *New York Times* columnist William Safire: "Most of us accept as 'fair' this principle: the poor should pay nothing, the middle class something, the rich the highest percentage."<sup>1</sup> The 1986 Tax Reform Act demonstrated that a desired level of progressivity can be achieved with very few different tax rates. In Europe, value added taxes are often imposed with multiple rates, in an effort to eliminate regressivity and perhaps even introduce some progressivity into the tax, and also to favor or disfavor certain forms of consumption.

<sup>1</sup>William Safire, "The 25% Solution," *The New York Times*, April 20, 1995, p. A23.