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The Taxation of "Real Profit": Towards a Laissez-Faire Revenue Code

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THE TAXATION OF "REAL PROFIT": TOWARDS A LAISSEZ-FAIRE REVENUE CODE

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INTRODUCTION

Although the Internal Revenue Code began as a simple instrument designed to raise monies for use by the federal government, the passage of time has created a statute drastically changed in nature. Pressure on the Congress by a multitude of groups with vested interests, attempts by the legislators to promote "equity" in the Code, and tax breaks for social or fiscal policy reasons have wreaked havoc with the "simple" acts of bygone days. It is the purpose of this article to point out several specific areas which are in desperate need of modification or total elimination. However, it is not only with these specifics we deal. Our cry is much broader in scope; we intend to point out and explain how a revenue act may be structured so as to tax "real" income-"real" profits—without regard to social or fiscal policy, with the object being equal treatment for virtually all taxpayers and fewer controls by our Treasury Department over these policies.

In Part I of the article, after setting out the longstanding congressional rationale upon which depreciation and capital gains taxation rests, we shall attempt to demonstrate how these areas of the statute may be modified in order that "real" profit is reflected. In these cases, "real" profit is defined as that amount of actual gain in value of goods or services which accrues or is paid to the taxpayer, taking into consideration the long term inflationary aspects of our economy. Part II sets forth the reasons for departing from what has long been considered "normal" tax policy and why a "simpler" Code would result from this departure. Finally, several provisions of the present Internal Revenue Code are examined with an attempt

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to point up why greater economies are achieved, and thus more revenue raised through their actual elimination.[1]

PART I

I. Depreciation

A. Evolution and Historical Development (Legislative History)

Accounting thought has long suggested that profit may only be arrived at through recognition of a wearing and wasting away of assets. The *contra asset* method of accounting evolved along traditional cost lines in that today it does not recognize replacement costs or funding for purchase of new assets. Instead, accounting principals today refer to the unexpired cost of plant assets and shun any connotation of a decline in market value.

The question at once arises why such a specific and refined science has eluded such concepts as replacement costs. There appears to be no suitable answer, but in recent years considerable turbulence has occured in accounting circles over what the results should be. The American Accounting Association Committee on Concepts and Standards Underlying Corporate Financial Statements in 1951 issued *Supplementary Statement No. 2* dealing specifically with replacement costs. In taking note of suggestions that current or anticipated replacement costs of specific assets be used in measuring the value of capital consumed, the committee observed that this would represent a departure from recorded historical cost and thereby would destroy (at least to a considerable degree) the objectivity of accounting. The cost of consuming existing properties must be recognized, the committee maintained, irrespective of the intention to replace in kind, to replace with a different type of property or not to replace at all. The committee, while rejecting the idea of restating specific assets in terms of current cost, gave full support to the preparation of supplementary statements in which all items are adjusted for the changes in the value of the dollar.

More recently, the American Institute of Certified Public Accountants' Accounting Principles Board authorized a research project by the Staff of the Accounting Research Division to study the effects of price-level changes on accounting reports. The research findings were subsequently published in 1963 as *Accounting Research Study No. 6.* This study concluded that:

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[1] V. Tanzi, The Individual Income Tax and Economic Growth (1969), provides an interesting analysis of the general principles of taxation in our economy.

> The effect of price-level changes should be disclosed as a supplement to a conventional statement. In the supplementary data, all elements of the financial statements should be restated by means of a single index of the general price level as of the balance sheet date, so that all the financial data will be expressed in terms of dollars of the same purchasing power.

Thus, it seems that accounting science has begun to reflect more accurately the method of income reporting, which has undoubtedly been appreciated by management. In addition to informing management of where the business stands financially (Net Worth), price level accounting has introduced what might be termed the *real profit.*

Real profit accounting has not developed at all in the tax structure, although it has at least been suggested through connotation upon a number of occasions. The legislative history of depreciation indicates a trend of events quite the reverse from accounting history. In the tax law history, replacement costs were first recognized, and then by more definative refinement, the theory was lost in a maze of new tax legislation, never again to be found. Perhaps the best way to illustrate the evolution of depreciation in the tax law is to briefly describe it.

The concept of depreciation was first introduced in the *1913 Revenue Act,* Section II(B): "A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business shall be allowed as a deduction in computing net income for *the purpose of the normal tax.*" This wording does not indicate what was meant by the term "reasonable allowance," but the term "net income" connotes the desire of the legislature to tax on the basis of real and accurate net profit. In the congressional discussions it was noted that this allowance was another effort, of course, to *maintain the capital intact.*[2]

In 1918, Congress added to the depreciation allowance deduction (*i.e.,* a reasonable allowance for obsolescence) but left untouched any further refinement of the original act. But in the 1934 Revenue Act, concern shifted to cut down on excessible depreciation deductions via new legislation. It was proposed that allowances be reduced by twenty-five percent in subsequent years. Tlthough the attempt failed, some interesting comments were made in the committee reports. For example, the Ways and Means Sub-Committee stated in its report: "[I]t must be remembered that these amounts

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[2] 50 CONG. RECORD 3847 (1913) (remarks of Senator Cummins).

deducted from income do not represent cash outgo like wages, repairs, and similar expenses, but are annual reserves generally theoretically set aside to replace plant and property investment."[3]

Could this statement indicate that Congress was cognizant of the real and only significant purpose of a depreciation allowance? At least it appears it understood the concept of replacement cost, which was further illustrated in a dissenting report by this same Sub-Committee:

> What is the object of an annual depreciation allowance? Manifestly, to build up by such annual allowances a fund to replace the property at the end of its service life. Such annual allowances constitute a fund which increases from year to year not only by the amounts of the allowances themselves, but also by the normal interest earnings of the fund.[4]

Although the Sub-Committee was concerned with annual interest growth of the hypothetical depreciation fund, which is not the present issue in this paper, it is indicative of the fact that some constructive reflection on replacement cost transpired.

Review of the legislative history of the depreciation provisions indicates that no direct comprehensive study has ever been made of the effects of inflation on depreciation replacement funds. However, early in the 1950's businessmen began to complain about unrealistically long service lives embodied in depreciation formulas, some of which dated back to the 1920's. They argued that technological change called for accelerated obsolescence. Thus, the Internal Revenue Code of 1954 allowed business to employ either of two methods of accelerating depreciation on new assets. Double declining-balance and sum-of-the-years digit methods evolved, and to a limited extent, they provided a short-term stop gap for the overstatement of real profit. Since these methods were not designed to offset inflation, they served only to prevent overstatement of corporate profits in the early 1960's. However, since they do not increase the total write-off, their helpfulness was quite limited.

Notwithstanding the fact that the 1954 depreciation changes offered some relief in reducing the corporation's dilemma, the Treasury Department in the 1969 Reform Act saw fit not to increase write-offs as was certainly indicated, but rather to significantly limit accelerated depreciation on new investment. By reducing the maximum write-off on new non-residential property (plant facilities, etc.) to 150 percent of the straight line method, it was claimed

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[3] H.R. REP. No. 704, pt. 1, 73d Cong., 2d Sess. 4 (1934).
[4] H.R. REP. No. 704, pt. 2, 73d Cong., 2d Sess. 5 (1934).

that there was to be $1.2 billion increase in revenues. Of course, this increase did not reflect the lost taxes resulting from a slowdown in corporate expansion and resultant lost future profits.

Whatever the reason the Treasury had for its chosen action, it will certainly take its toll. Perhaps the government hoped to throw large corporations into bankruptcy so that there could be more serious consideration of government ownership of free enterprise, such as is going on now over the Penn Central failure. In a more serious vein, it is likely that the mathematics required to facilitate this method of assets revaluation would be too speculative and evasive. Moreover, there has not always been a variety of price level indices from which to select. Recently, proper and more advanced information gathering has led to highly accurate indices such as the Consumer Price Index and the Wholesale Price Index.[5]

Regardless of the reasons for the failure to cope with this problem in the past, there does not seem to be any foundation for its neglect today. In the estate tax laws, mathematics in the form of present value annuity computations have evolved to reflect present worth of future earnings. Further, the depreciation computations of our present law are at least as complex as well as speculative. Whether one speaks of amortization of costs or depreciation or depletion, a certain degree of inaccuracy and prediction is inevitable. Hence, there appears to be no formidable argument for the continuation of an unrealistic method of income reporting by failure to recognize a true depreciation expense.

B. Criticism

The historical cost disbursement method of depreciation has created gross overstatements of income for most companies resulting in the overpayment of taxes. This point was recognized by the Supreme Court of the United States as early as 1909 in the decision of *City of Knoxville v. Knoxville Water Co.*[6] It has even been suggested that many corporations have failed due to poor planning and heavy tax burdens which were conditioned by an erroneous method of accounting for the wasting away of assets employed for the production of income. A number of eminent academicians have ad-

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[5] For an interesting analysis of the accounting principles involved when price indices are employed, see H. SIMONS & W. KARRENBROCK, INTERMEDIATE ACCOUNTING (4th ed. 1964).

[6] 212 U.S. 1, 13-14 (1909). "[A company] is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning."

dressed their talents to the subject of true profits, notably Professor George Stegler of the University of Chicago and Professor Soloman Fabricant of New York University, member of the Board of Directors of the National Bureau of Economic Research.

Professor Fabricant, in a paper entitled *Inflation and the Lag in Accounting Practice,* adjusted and restated profits not only for insufficient depreciation but for rises in the general price level. He argues that: "No labor union fails to mention the consumer price index when engaged in a labor negotiation. Yet companies may report record profits and say nothing about the contributions of an attenuated dollar to these record highs. . . . Accounting practice has not yet been adjusted to the fact of inflation."[7]

From the corporate kingdom one hears the pleadings of George Terborgh, retiring director of the Machine and Allied Products Institute. He argues that the difficulty with historical cost write-off as a method of depreciation is that it makes no allowance for inflation which raises the cost of replacing the asset without, of course, raising the depreciation set aside for it. Resulting from this oversight, United States business over the years has underdepreciated its assets, overstated its profits and paid income taxes on this overstatement. The chart in Appendix B, based on calculations by Mr. Terborgh, shows the difference in profits as reported by the Commerce Department since 1945 and profits adjusted for insufficient depreciation and inflated inventory values. Over those years, by this reckoning, the cumulative overstatement of profits has amounted to approximately $130 billion, on which business has paid taxes of nearly $60 billion. Because of the severe current inflation, adjusted profits have been declining steeply since 1966, and the recent overstatements have been large—$11 billion in 1969, and an estimated $12 to $13 billion in 1970. And when adjusted profits are expressed in constant 1946 dollars, they are back down to the levels of ten to fifteen years ago.

Finally, a comparison of depreciation deductions, and their tax treatment, with countries abroad sheds some very interesting light on this theme. A study has been prepared by the Treasury Department showing a comparison of depreciation policies between the United States and nine major industrial nations, before and after the new guidelines for services lives and the now terminated investment credit became effective in 1962. The results appear in Appendix A.

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[7] Burak, *The Hard Road Back to Profitability,* FORTUNE, August 1970, at 101.

It might be noted that the table indicates that the United States has the least liberal depreciation deduction even after 1962. And taking away the investment credit and some accelerated depreciation allowances, as was accomplished by the 1969 Tax Reform Act, would more than slightly amplify this situation. The reasons for the larger deductions in other countries, such as France, is to permit revaluations and special allowances to adjust for higher replacement costs.[8]

C. The Proposed Statutory Changes Reflecting Inflation

Obviously when one attempts to account for inflation in analyzing a wearing or wasting away allowance, he must talk in terms of replacement costs. That is to say that a businessman when arriving at a true net profit should seek actual dilution in value of his assets. Today very little has been accomplished in this area except for the accelerated methods of depreciation and additional first year allowances.[9]

Granting the argument that some effort has been made is not sufficient to make out a case for no change. This is similar to other sections of the Code where we have lost sight of taxing real income and instead have created a maze of complicated tax mechanics alleged to make a stab at equal and fair taxation to all. However, most government theoreticians are quick to argue their catch-all defense: To change depreciation allowances to reflect inflation is much too complicated and, more importantly, too speculative and precarious to offer any intelligent basis for arriving at true income.

The problem of inflation or price changes as affecting the corporate and business worlds is best exemplified in the following example. Suppose that a businessman purchased new manufacturing equipment for $300,000 and formed a corporation in pursuit of

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[8] The Tax Foundation has completed an excellent study concerning the effects of depreciation on inflation in DEPRECIATION ALLOWANCES: FEDERAL TAX POLICY AND SOME ECONOMIC ASPECTS (1970). However, it must be noted that the Foundation is limited in its ability to influence legislation in this area because of the danger of its tax-exempt status being removed, especially under the new restrictions imposed under the 1969 Tax Reform Act.

[9] Certain inroads toward recognition of inflationary trends when considering depreciation have been made in specialized areas, primarily through efforts of the public utilities to obtain consideration of inflationary effects in arriving at actual profits for the purpose of price regulation. See Clarence H. Ross, *Inflation as an Element in Determining Depreciation,* N.Y.U. 16TH INST. ON FED. TAX 828 (1958). Also for an indepth discussion of public utilities depreciation as affected by inflation see Brickly, *Inflation Factor in Utility Depreciation,* 72 PUB. UTIL. FORT., Dec. 19, 1963, at 19.

profit. The equipment is set up on the tax books and depreciated over a period of twelve years to a salvage of $60,000 or twenty percent of cost. Each year the corporation could get a depreciation expense of $20,000 in figuring its taxable income (using the straight line method). The corporation operated for twelve years showing an average of $40,000 taxable income per year. Each year the corporation would show a cash flow (taxable profit plus depreciation) of $60,000. The tax paid on $40,000 would be $12,700 (twenty-two percent on first $25,000 and forty-eight percent on the excess). Multiplying $12,700 by twelve years will give the total taxes paid for the period of $152,400.

Therefore, at the end of twelve years of operation, the corporation's financial structure has changed as noted in the following balance sheets.

BALANCE SHEET #1 (Initial)

Assets:	
Cash in Bank	—0—
Equipment	300,000[1]
Liabilities:	—0—
Capital:	
Capital Stock	300,000

BALANCE SHEET #2 (After twelve years)

Assets:	
Cash in Bank	567,600[2]
Equipment	60,000[3]
Total Assets	$627,600
Liabilities:	—0—
Capital:	
Capital Stock	300,000
Retained Earnings	327,600[4]
Total Capital	$627,600

FOOTNOTES TO BALANCE SHEETS:

[1] At cost.

[2] Computer by multiplying the cash flow 60,000 x twelve years and then subtracting total tax paid of $152,400.

[3] Accumulated depreciation of 240,000 was subtracted.

[4] Computed by subtracting from the annual taxable profit ($40,000) the annual tax paid of $12,700 and multiplying by twelve years.

Analyzing the change in balance sheets that took place over the twelve year span, it becomes apparent that the corporation was profitable and the net worth has more than doubled. But what happens when inflation becomes a mathematical variable? To interject this variable into our analysis, we must think in terms of replacement costs. Replacement cost of old equipment changes from year to year affected principally by inflation. Thus the equipment purchased for $300,000 twelve years ago can be expected to cost considerably more today. In our previous hypothetical, if we were to assume an average of five percent inflation per year, an estimate of replacement cost could be calculated.

$$\begin{aligned}\text{Equipment Replacement Cost} &= (1.05)^{12} \times 300{,}000 \\ &= 1.796 \times 300{,}000 \\ &= \$538{,}800\end{aligned}$$

The replacement cost of $538,800 indicates that the corporation's seemingly good financial condition is somewhat impaired. Functionally speaking, in order for the corporation to get back in the same position in which it started, it would have to purchase new equipment for $538,800, trading the old equipment worth $60,000 and paying cash of $478,800. This transaction would leave the corporation with $88,800 in the bank. Thus, in conclusion, we could say that the corporation operated twelve years to accumulate $88,800, which works out to $7,400 per year. Such a return factor for a $300,000 investment (approximately two percent annual return) is hardly significant.

Some theoreticians argue that taxes are paid on personal earnings (wages) which of necessity reflect a certain degree of inflation and for this reason, it is inherently unfair to give the businessman this advantage. However, this argument loses its effectiveness when one considers that wages and other personal earnings are completely taxable, whereas in the business context we are trying to arrive at real earnings or self-betterment. What is really at issue is the fairness of taxing an entity on something labeled as income which in reality is capital. In the previous example, it was suggested that the hypothetical corporation operated twelve years and wound up with the same equipment (after replacement) and $88,800 cash in the bank. The Treasury says this corporation made $480,000 or $327,600 after taxes. How can this be true? The corporation ends up where it started with an additional $88,800 of cash. Obviously the difference between what the Treasury calls profit after taxes ($327,600) and what we suggest is *real profit* ($88,800) is the inflation on equipment ($238,800).

The problem seems to be reduced to the question of: Where did the glamorous profits go? There are apparently two methods of dealing with this problem in the tax law, once it has been recognized. First we may do away with taxation on corporations and other business entities as has been suggested by many commentators throughout the years. No doubt there would be desirable economies to be gained with this idea. The principal here would be to tax the shareholder when he gets the profits via dividends and other distributions. Code sections such as Section 531 (Accumulated Earnings Tax) which are imposed to prevent abuse of the corporate entity would have to be retained. Most corporate sections would be eliminated and substituted with far less complicated shareholder taxation provisions. This might eliminate a great deal of the often unnecessary confusion and technicality in the Code, which could be reflected in less governmental administration cost and save the taxpayer considerable cost (high-priced tax experts). Perhaps this increased efficiency on both sides and greater working capital would manifest itself in the form of greater industrial growth resulting in more individual tax revenues to offset lost corporate revenues. Since corporate taxation only accounts for approximately 20 percent of total tax revenues, there would be a great shift in tax burden to another economic area.

The second proposed method is to tax corporate net profits after deducting inflation. In the area of depreciation this could be accomplished by increasing the basis annually in an amount sufficient to show increases in the replacement costs due to price increase. The deduction would be computed by use of the current tax methods: straight-line method, double declining balance, declining balance, and sum-of-years digit. Retention of accelerated methods is necessary to reflect obsolescence and early loss of value and not to aid against inflation.

To illustrate the effect of computing depreciation in this manner the previous hypothetical can be used. The corporation was utilizing the straight-line method, and we will follow suit in this illustration.

Under our present tax treatment of depreciation we compute an annual straight line depreciation by use of the formula:

$$\text{Annual depreciation} = \frac{\text{Asset basis (cost less salvage)}}{\text{Depreciable life (no. of years)}}$$

The proposed change in this formula is the addition of the inflation factor.

$$\text{Annual depreciation} = \frac{\text{(Asset basis) X (1 + Annual inflation percentage)}}{\text{Depreciable life}}$$

In order to study the behavior of the above suggested formula change and to apply it to a hypothetical situation, a new formula must be derived to indicate the total depreciation to be taken over the life of the asset. This is easily accomplished with the use of series calculus. The following index will simplify the mathematics:

T.D.=total depreciation to be taken over the life of the asset
A =depreciable cost basis of the asset less salvage value
N =depreciable life in years
i =average annual inflation

The derivation of a formula for total depreciation would work like this:[10]

$$\text{T.D.}=\frac{(1+i)^1A}{N_1}+\frac{(1+i)^2A}{N_2}+\frac{(1+i)^3A}{N_3}+\cdots\frac{(1+i)^NA}{N_N}$$

Note that there is a relationship between each year in the form of an increase power of $(1+i)$; thus by multiplying both sides of our equation by $(1+i)$ we can subtract the two equals giving us our new formula.

$$\text{T.D.}=\frac{(1+i)^1A}{N_1}+\frac{(1+i)^2A}{N_2}+\frac{(1+i)^3A}{N_3}+\cdots\frac{(1+i)^NA}{N_N}$$

Minus:

$$(I+i)\ \text{T.D.}=\frac{(1+i)^2A}{N_2}+\frac{(1+i)^3A}{N_3}+\cdots+\frac{(1+i)^NA}{N_N}+\frac{(1+i)^{N+1}A}{N_N}$$

Leaving: $$-i\text{T.D.}=\frac{=(1+i)A}{N}\qquad\frac{-(1+i)^{N+1}A}{N}$$

Or: $$\text{T.D.}=\frac{(1+i)A-(1+i)^{N+1}A}{-iN}$$

Applying the above formula to our previous hypothetical corporation's depreciation situation gives the following result if we assume 5 percent average annual inflation over the 12 year period.

$$\text{T.D.}=\frac{(1.05)\ 240{,}000-(1.05)^{13}\ 240{,}000}{-(.05)\,12}$$

$$=\frac{252{,}000-452{,}640}{-.60}$$

$$=\$334{,}400$$

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[10] As pointed out immediately above, depreciation for one year is $\frac{(1+c)A}{N}$, thus in order to arrive at total depreciation the depreciation allowed or allowable each and every year of the asset's life must be added together. For example, N_3 represents the third year of the depreciable life of the asset.

Note that over the period of twelve years the corporation now gets a straight line depreciation deduction of $334,400 as opposed to the $240,000 currently allowable. Moreover, what appears to be frightening at first is the fact that new depreciation would allow $34,400 more depreciation than the asset actually cost.[11] This, as pointed out before, is of no significance as far as the tax law is concerned, although it might present some accounting problems. As indicated in the previous formula, the taxpayer would receive an additional depreciation deduction of $94,400 and thus a tax savings of $45,312 (at the forty-eight percent tax rate) which would be directly reflected in the form of working capital for the corporation. In this hypothetical the corporation's working capital would be increased from $88,800 to $134,112 for a fifty-one percent increase. This is a substantial increase and would help corporations expand and provide for necessary immediate investment such as pollution control equipment (see our discussion in Part II, *infra.*).

The inflation approach of arriving at a fair and accurate calculation of expiration of capital investment seems to be the only rational way to handle this problem if we are to maintain a corporate income tax system. But it is understandable that this concept of depreciating in excess of cost basis will be difficult to sell to the public (voter). This is especially true today when the emphasis is on individuals as opposed to institutions, thus giving rise to continuous public attack on large concentrations of capital and hence power. Politicians can run on platforms that demand greater taxation on business and less on individuals and gain widespread support from the working class. This is probably true because it is a difficult concept for people to grasp that it is this very concentration of wealth and specialization of process that has led to the high standard of living this country enjoys today. How can the individual be expected to believe that a lessening of institutional income taxation will indirectly effect an increase in individual wealth? Herein lies the problem in developing an accurate income tax base on real business profits. Thus, through elimination of fiscal and social policy from the structure of taxation, which inevitably provides food for untrained political minds, we have insured that there will be a more fair and comprehensive tax basis.

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[11] But an even greater shock to orthodox minds will be the effect during a *deflationary* period. In order to maintain the same *real profit* thesis, we find that depreciation allowances will be decreased, instead of increased as in the case of inflationary periods. As an example, suppose one purchases a machine with a service life of five years and suffers 10% deflation the first year. Under present law for straight line depreciation, 20% could be written off the first year. However, the "real

II. Capital Gain Taxation

A. Introduction—Evolution & Historical Development (Legislative History)

The capital gains method of taxing a casual sale of property has long been recognized in the federal income tax system. The Revenue Act of 1921 initiated a policy of long term capital gains at preferential tax rates. Although this addition to the tax system was said to have a policy of encouraging taxpayers to make sales of their capital investments, it has never been fully articulated by Congress. One of the theories most frequently enunciated is that the lower rates on capital gains avoid the harsh effects of bunching of income in the year of realization.

This concept of preferential tax treatment has spread throughout the federal tax code structure in the form of legislative safeguards and other forms of public policies. In effect, today's tax law (and especially tax planning) is structured around the concept of capital gain taxation. The never-ending conflict between ordinary income tax treatment and capital gains treatment has provided much judicial processing of an already voluminous amount of tax legistlation. It could be said that capital gains involve more complex Code sections than any other tax device.[12]

B. Criticism

The taxpayer has both profited and suffered due to capital gains taxation. This is best analyzed by breaking taxpayers into two groups, each of whom have unrelated and dissimilar tax personalities.

The first group consists of the investment speculators who are motivated by the pursuit of profit. These persons usually have considerable wealth and credit which constitute the tools with which to better their economic status. It is apparent that they have prospered by the advent of capital gains taxation in that the Code has evolved into a network of complicated puzzles, the solution of which rewards the careful investment speculator with generally at least a fifty per-

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profit" method would necessitate a 10% reduction in the basis in order to reflect deflation before taking the 20% pro rata writeoff. The end result in this example is an 18% (20% x 100%–10%) depreciation deduction the first year which is a 2% decrease from methods currently employed.

[12] In order to realize the full significance in dollar amounts of revenues derived from capital gains taxation see U. S. Internal Revenue Service, Statistics of Income (1966).

cent reduction in his tax burden.[13] (The maximum tax on corporations will not exceed thirty percent for taxable years beginning in 1971, which is less than a fifty percent reduction.[14])

Speculation has been condemned by many economists and other theoreticians as being non-productive and providing no service to society. It is reasoned that the speculator merely makes profit in the transfer of goods and resources to the eventual consumer while adding nothing to their value. Yet, the federal tax system has seen fit to reward this type of conduct by providing a tax incentive under the guise of relief for the bunching effect. The 1969 Tax Reform Act, however, has eliminated this problem to a considerable extent with the change in the income averaging section.[15] Now capital gains qualify for income averaging. Although one can only spread income over a five year period, this is surely adequate relief against income grouping, if you take into account the deferral of periodic tax payments on annual growth enjoyed by the investor.

On the other side of the coin is the non-speculative investor who finds himself paying capital gains tax on necessary conversions of property. The homeowner is perhaps the best example of this group although taxpayers involved in involuntary conversions are similarly representative (See discussion in Part II, *infra*). The example of the homeowner demonstrates just how inequity may result in the tax law when policy becomes too involved in the process of revenue acquisition.

Let us take, for instance, the taxpayer who elects to sell his home and retire at the age of fifty. (At the age of sixty-five no gain would result under certain situations as provided in section 121.)[16] If he does not reinvest the sale proceeds in another residence within a period of one year,[17] he will be subject to capital gains taxation. This may at first appear to be valid on its face, since he did receive more money than he originally paid out for it. But if one looks at the overall picture, he will most likely discover that this taxpayer has in reality lost wealth instead of gaining it. This would be true because of the effects of inflation or the decline in the value of the dollar. If one can validly argue that monetary gains resulting from inflation are real profits, then surely if there is to be a devaluation

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[13] *See* INT. REV. CODE of 1954, §§ 1201 *et seq.* [hereinafter cited as 1954 CODE].
[14] 1954 CODE § 1201.
[15] 1954 CODE §§ 1301-05.
[16] 1954 CODE § 121.
[17] 1954 CODE § 1034.

of the dollar, everyone would realize gains on their properties. In other words, there is some congruency between the effect of inflation and the effect of a dollar devaluation. Both are products of the monetary system, and to a certain extent, within the control of the government. However, not many experts argue that devaluation constitutes realized gain which should be taxed.

By recognizing the principle that change in net worth or augmentation of net worth is real income, it is easy to conclude that inflation is not income. If one's property doubles in value, but everything else that is useable or consumable doubles in cost in the same period of time, has one made a profit? Surely not, since his property could not be traded for more goods or services at the end of the holding period than at its inception. His net worth has not changed, relatively speaking, since it commands no greater exchange rate. The confusing factor is use of a medium of exchange to facilitate exchange of goods and services. If all records were kept in terms of items of property, services, etc., there would be no issue involving inflation for which to argue. The only concern we would have in determining real gain would be to study relative exchange rate shifts.

An inherent inequity[18] might be argued if inflation were not to be taken into account on all types of investments. Thus in the case of a security (stock) purchased for $2,000 and sold for $3,000, (let us suppose the value of money has fallen by a third during the time the security was held), it is probable that the whole proceeds will be needed to re-invest in securities of similar standing. Now, if the arguments for subtracting inflation out are to prevail, then it is apparent that the security holder would be given preferential treatment over other groups of taxpayers. Thus, a person who invests $2,000 in securities in the above example would gain over the person who invests $2,000 in debentures, savings accounts or bonds. Both have suffered from inflation, it might be argued, and equity demands either that both be compensated or that neither be.

These arguments appear insurmountable at first glance, but further consideration helps to throw more light on the situation. First, it must be recognized that the two types of investment are inherently different. Stocks are by nature more speculative and thus offer the reward of capital growth (not just inflationary but also "real" growth) in addition to devidends. Also, the capital growth,

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[18] These inequities are noted in Hockly, *Capital Gains and Inflation*, 1968 BRITISH TAX REV. 3.

as a part of the income from stocks, remains tied up until the stock is sold. By the nature of the investment there is a forced reinvestment, thus the stock investor has lost the use of the earnings until conversion.

C. Proposed Remedy for Inflation and Gains

Criticism of the present tax laws is easy to come by, for there are endless and needless technical provisions which serve only as vehicles for governmental policy. But agreeing that wrongs exist, such as the inequity of capital gains provision, what solutions are available?[19] The best approach is to eliminate social and fiscal policy from consideration and think only in terms of realistic gains. In order to determine whether a real profit was made in a certain property sale, inflation must be subtracted. This may be accomplished with a reasonable degree of accuracy by the use of mathematics. Once the net gain has been derived, it would be taxed at ordinary income tax rates.

In order to analyze the impact of this proposed change in our income tax structure, it is necessary to reduce theory to mathematics.[20] In order to compare and contrast present law with the proposed law, the formula for each must be derived.

Index Legend

x=Net consumable profits after taxes

r=Investment rate of return per annum (percentage)

p=Investment principal

f=inflation (average annual percentage)

t=Tax rate

n=Number of years invested

The formula for our present tax treatment of capital gains, assuming a given investment percentage of return and tax rate and holding period in years, is developed below using the index above.[21]

$$x=[1\text{-}T/2]\ [p\ (r)\ +\ p(r)\ (1+r)^1+\ \ldots\ +\ p(r)\ (1+r^{N-1}]$$

[19] Several related solutions are discussed in Slitor, *The Carter Proposals on Capital Gains: Economic Effects and Policy Implications for the United States*, 22 NAT. TAX J. 66 (1969), and Hockly, *Capital Gains and Inflation*, 1968 BRITISH TAX REV. 3.

[20] The mathematical analysis used herein is for the purpose of developing the effects on tax revenue. This is not to be confused with *economic* forecasting in the sense of economic growth development as emphasized in the science of econometrics. *See generally* J. JOHNSON, ECONOMETRIC METHODS (1963).

[21] In the first portion of the formula [1-T/2] the tax rate is divided by 2 since capital gains profits are taxed at half the ordinary income tax

By multipying both sides of this equation by $(1+r)$, the following equation evolves:

$$(1+r)\ x=[1-t/2]\ .\ [p(r)\ (1+r)\ +\ p(r)\ (1+r)^2\ .\ .\ .\ +\ p(r)\ (1+r)^N]$$

Subtracting the second equation from the first yields

$$x=[1-t/2]\ [p\ (1+r)^N-p]$$

This equation indicates exactly what the after-tax profit is for a particular investment given certain variables: tax rate; average investment return; amount of investment. However, in order for this to provide any insight into the theories previously expounded, a second formula must be derived for the proposed new tax on capital gains. It would develop as follows:

$$x=p(1-t)\ [(1+r)^N-\ (1+f)^N]\ +\ p\ [1+f)^N-1]$$

Through illustrations, we can see how the proposed tax law change will effect the taxpayer. Suppose one invests $10,000 in common stock at eight percent return and inflation is at four percent for a period of five years. By substituting into the first formula and assuming a tax bracket of seventy-eight percent (including state and local taxes), we can arrive at the net profit after taxes.

$$x=\ \left[\frac{1-.78}{2}\right]\ [10{,}000\ (1.08)^5-10{,}000]$$

$$=\$2{,}863$$

Then to obtain net profits after taxes under our proposed tax law:

$$x=10{,}000\ [-.78]\ [(1.08)^5-\ (1.04)^5]\ +\ 10{,}000\ [(1.04)^5-1]$$
$$=\$2{,}724$$

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rate. This quotient is then subtracted from one in order to reflect after-tax profit in percentage form.

In the record portion of the formula, $p\ (r)\ +\ p\ (r)\ (1+r)^1+\ .\ .\ .\ .\ .\ +p(n)\ (1+r)^{N-1}$, we arrive at total profit on investment principal over (N) years. Thus p(r) represents the amount of profit realized in the first year. In the second year we must compound investment profit by increasing principal by the profit made in the first year — p(r) — and then multiply by the rate of investment return. This process is repeated over N number of years.

Hence after tax profit percentage [1-T/2] times total profit over N years $p(n)\ +\ p(r)\ (1+r)^1+\ .\ .\ .\ .\ .\ +\ p(r)\ (1+r)^{N-1}$, yields net consumable profits after taxes (x).

Thus in this hypothetical the taxpayer ends up with less net profit under the proposed law because he has to pay more taxes ($139).[22] This would indicate that this method of handling gains will be no friend to the investor-taxpayer, for his tax burden will most frequently be higher than under the old law. But when basis adjusted for inflation exceeds the sales price it will be an ordinary loss, thereby providing some taxpayer relief and eliminating all those recapture and hotchpot sections that have consistently produced some confusion down through the years.

Assuming a four percent inflation one might wonder at what point of investment return does the proposed tax law provide a lesser tax for the investor. This answer can be obtained by setting the two formulas to equal each other and solving for (r) investment return.

$$(1\text{-}t/2)\ ([1+r]^N-1) = (1\text{-}t)\ ([1+r]^N)-[1+f]^N) + [1+f]^N\text{-}1$$

When solving for r, this algebraically reduces down to a single equation:

$$r=(2\ [1+f]^N\ \text{-}1)^{1/N}\ \text{-}1$$

Substituting in the variables mentioned above you get the following answer:

$$r=(2\ [1.04]^5\ \text{-}1)^{1/5}\ \text{-}1$$

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[22] Conversely, in a deflationary period, when the consumer index falls, the real profit method of taxing gains on the sale of capital assets would produce an even greater increase in tax burden. Consider an asset purchase at $100, and held during a deflationary period of 20% drop in the consumer index. If this asset is sold for $120, the present gross monetary gain is $20 of which $10 (50% x $20) is taxable (presuming long term treatment). Under our proposed method for taxation of "real profit," we *reduce* basis by the amount of inflation yielding an adjusted basis in this example of $80 ($100 – 20% x $100). Sales price less adjusted basis results in a taxable gain of $40 which is $30 more than under present tax law.

Perhaps it is worth noting that many economists have theorized that during times of depression it is important that government increase taxation and spending in order to prevent stagnation of wealth. As demonstrated above, a real profit approach would in fact be self-adjusting, thus fortuitously facilitating sound fiscal policy. *See, e.g.*, PECHMAN, YIELD OF INDIVIDUAL INCOME TAX DURING A RECESSION, POLICIES TO COMBAT DEPRESSIONS (1960).

But one cannot help but be somewhat dismayed at the possibility that an asset could be sold at its purchase price, yet still be taxed on a real profit gain. This is a reality and can be better understood if approached in terms of exchange value rather than monetary value. In other words, during deflation an asset's conversion value increases.

This answer indicated that at seven and one-half percent return on investment or above, the tax burden will be greater under the proposed treatment of capital gains on investments. Note that if we take the limit of $(2\ [1+F]^N - 1)^{1/N} - 1$ as N approaches infinity (r) will approach F. This means that the longer an asset is held, the lower the investment return has to be before the taxpayer has to pay more taxes than he would have been liable for under old law.

Basically this change would offend the investor for he inevitably would pay more taxes. But the homeowner who sells his house for twice as much as he purchased it after holding it for 20 years will most probably pay no taxes because his total gain would likely be attributable only to inflation. This proposal, if enacted, would almost certainly cause the wealthy financiers to jump out their office windows. But this is the big loophole in federal taxation, and as long as preferential treatment exists, those with the most powerful lobby in Congress will profit most. There are, however, sound arguments for this special treatment to those who are willing to invest their savings. It is said that we need to offer an incentive to investors and an incentive for people to convert property or else the flow of commerce will be impaired. These arguments may be realistic, but they still offer no foundation for maintaining inequity in the tax law. If policy dictates that investment incentive needs to be spurred, then other programs to handle this problem should be instituted. This method of facilitating governmental policy would, as stated in Part II of this article, be more direct and flexible. There certainly could not be any greater administrative and judicial cost involved than is presently involved with administration of the present tax law with its endless loopholes and complexity.

PART II

I. The Major Premise

As pointed out in the introduction to this article, we now set out to describe a simpler revenue code: one, though not devoid of any and all fiscal and social policies, in which such policies are substantially reduced to minimal levels.

But first let us turn to our major premise once again. Why, indeed, eliminate provisions from the statute which delineate and implement policies which are not in nature purely related to taxation? That is, what is wrong with the implementation of fiscal and social policy through tax legislation? The answers to such questions are numerous, but we list the reasons in full if for no other reason than that what we are explaining *is* a major premise.

1. *Sound economic policy depends upon governmental influence and control* (at least to some extent depending upon one's political persuasion). When these policies are placed into practical effect through legislation, direct, non-tax laws are preferable. Results are less difficult to measure and future consequences easier to predict. When such policies are enacted through tax legislation, the results may be even contra the original legislative policy.

2. *Code simplicity.* The Internal Revenue Code is the one common thread which binds *all* business, large and small, together. Businessmen, of necessity,[23] must become, if not experts, at least competent in the general area of income (and to a lesser extent, excise) taxation. When other than business policies (that is, "pure tax policy") are involved, the statute becomes unnecessarily complicated resulting in lost economies both for the individual business and, incidentally, the entire economy. While the businessman's actions may be to reduce his taxes through his carrying out of a desired social or fiscal goal, the end result may be a distortion of *economic* goals and a net *reduction* in the "desired" results. Although much of the remainder of this article will attempt to point up specific examples in illustration of this principle, it may be stated simply now: an attempt to implement social and fiscal policies through tax legislation may in fact produce an end result of anti-social (or anti-fiscal) policies.

3. In a less theoretical vein, *a simpler code will require significantly less administrative expense,* thus, in all probability, increasing total revenues available for use outside the Treasury Department (after-collection dollars, if you will). Moreover, fewer mistakes, reduced possibility of fraud, less expenditures on tax planning and more on operations, will all result in higher collections and lower priced (because of increased economies) goods and services.

4. In addition to being less expensively and better administered, *a simpler code would most certainly produce less litigation, fewer mistakes and misunderstandings, and would not profit those who could afford competent tax counsel while discriminating against those who could not.*

It may be argued, however, that the simplification of the tax statute, while increasing social and fiscal legislation in other areas,

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[23] In the corporate area, for example, larger businesses pay over half of their net profit to federal and state government. Thus, as far as "spendable" dollars are concerned, knowledge of tax law may prove to be as valuable as knowledge and expertise in operations.

would at least diminish, if not negate, the value of the reasons set out above. In other words, the Internal Revenue Code may be the cheapest place from a source and application standpoint to legislate on social and fiscal policy. Although there may be some validity to this argument at least on the surface, in reality, with the mass of government agencies already available, in operation and *with considerable expertise in the specific area legislated upon,* there is little question that administration would be better left to them. Certainly the Treasury Department through the Internal Revenue Service should not be responsible for the administration and execution of policies clearly beyond its legislative scope. Why should an agency formed to collect monies and administer such collection be responsible for the fiscal and social policy in so many areas? Why indeed should this agency be able to legislate through promulgation of regulations, rulings and administrative adjudication in areas totally without the revenue raising business of that department? The implications of such concentration of power in one governmental department—one portion of the executive branch—are ominous. Moreover, the indirect method of controlling policies not related to tax by our taxing agency leads to increased inefficiency throughout the other branches of government. Simply, would it not be more economical (in the pure sense) to administer housing programs through our housing agency, welfare programs through welfare agencies and conservation programs through agencies dealing with conservation? We submit that litigation in the tax area (and probably on the whole) would decline, persons now involved in tax work and planning for corporations and individuals could be diverted into more socially productive areas, and what planning and computations that remained would be directly in relation to amount of real income and realistic business decisions.

II. Anti-Tax Policy

In order to illustrate the position set out above and to draw these economic inefficiencies into clearer focus, we shall devote the remainder of this article to a study of particular examples of social, fiscal and other non-tax (and in fact *anti-tax*) policies within the Internal Revenue Code, explaining why their inclusion is not desirable for the very policy standpoint from which their inclusion resulted, and suggesting in at least simple terms how the same policy may be effected by other legislation. Each of the provisions has been either affected by or newly-enacted in the Tax Reform Act of 1969, and it is with that statute we deal primarily. The provisions examined are (1) personal exemptions, (2) low-moderate housing,

(3) pollution facilities and coal mine safety equipment, and (4) certain antitrust fines or penalties. It is also our purpose to examine by way of contrast particular sections of the Code which should *not* be deleted since their purpose is purely one of *tax* policy. These provisions include (1) income averaging, (2) involuntary conversions (and certain other non-recognition sections) and (3) multiple corporations. Finally, we shall discuss briefly those areas which, although not involving pure tax policy, accomplish ends which are desired socially, and are at least not *anti-tax* in nature. Such provisions include (1) deductions for charitable contributions and (2) deductions for other taxes paid. We begin with those provisions which, for the reasons outlined above, should not be a part of the Internal Revenue Code.

A. Personal Exemptions

We begin with perhaps the simplest, most easily understood and least-litigated sections of the Code which provide exemptions in dollar amounts for each member of the family of the taxpayer when certain support requirements are met. The congressional policy behind the granting of such exemptions is beyond question to provide tax relief through an exemption in direct proportion to the size of the supported family.[24] It is not our purpose in this article to debate the pros and cons of such a policy (especially in these days of increasing concern over population control) as this is not our purpose throughout this article. What we do wish to illustrate is that such a policy is in reality anti-tax in nature and should not be a part of a revenue code. Certainly it can not be said that any relation exists between real income and the allowances of such an exemption. Assuming the validity of the congressional policy in enacting (and recently increasing) these deductions from income in relation to the size of one's family, we submit that there are more efficient means of accomplishing this end (reduction of rates is one obvious method) without distorting the true income picture.

B. Pollution Facilities and Coal Mine Safety Equipment

The 1969 Act introduced two new sections to the Code providing items of tax preference which include the amortization of pollution control facilities as well as the amortization of coal mine safety equipment.[25] Although we deal here with the former, it is clear

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[24] However, due to the long-term inflationary effects present in the economy (a problem dealt with at length in Part I, *supra*) the exemption has been reduced to a mere token, resulting in a "policy" devoid of substance.

[25] Tax Reform Act of 1969, § 301; 1954 CODE §§ 57, 169, 187.

that neither provision has any tax policy foundation, but rather one in which the policy is social or business-related in nature.

New Section 169 of the 1954 Code allows an individual or corporation to amortize the cost of any "pollution control facility" over a five-year period, receiving appropriate deductions for such amortization in each of the five years. In addition, section 179 still allows additional first-year depreciation. In effect, then, for a facility with a useful life of fifteen years[26] or less, a deduction is allowed for each month equal to an amount computed by dividing the adjusted basis by the number of months remaining. This deduction is available only to those facilities which qualify. Generally, these are plants or devices which serve to: "[A]bate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes, or heat . . . ."[27]

In addition, in order to qualify, such facility must be "certified" by both a state and federal certifiying authority; for example, in the case of air pollution, the state authority is the agency as defined in the Clean Air Act, and the federal authority is the Secretary of Health, Education, and Welfare. Certification means that the facility conforms with the requirements of the state program regarding abatement of water or air pollution. Moreover, the federal authority is in compliance with applicable regulations of federal agencies and is "in furtherance of the general policy of the United States . . . and . . . atmospheric pollution. . . ."[28]

Reference to the Senate Finance Committee Report outlines the rationale for the enactment of such a bill.

> The committee recognizes that an important challenge facing our Nation today is the problem of environmental pollution.
>
> . . . .
>
> In effect, private industry is being asked to make an investment which in part is for the benefit of the general public.[29]

It is at this point we must depart from congressional reasoning. That is, if we are to ask industry to "clean up," are there not better direct methods available? The committee goes on to say:

> The Committee recognizes that the incentive provided in the bill is not a complete answer to the pollution problem. The need for broader and more effective pollution control standards remains.

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[26] Special rules apply to facilities with greater than 15 year useful lives. 1954 CODE § 169 (f) (2).

[27] 1954 CODE § 169 (d) (1).

[28] 1954 CODE § 169 (d) (1) (B).

[29] S. REP. No. 91-552, 91st Cong. 1st Sess. 248 (1969).

> The amortization deduction provided by the bill, however, *should be a useful component of the Nation's total efforts to deal with the pollution problem.*[30]

But here is a perfect example of Treasury control and authority exactly where it should not be. The Act incorporates by reference the Federal Water Pollution Control Act and the Clean Air Act and defines "authority" as both the Secretary of the Interior and the Secretary of Health, Education and Welfare.[31] Our question is merely why should not the government's "total efforts" be concentrated in these departments (or one of them) instead of overlapping into the taxing and revenue collecting arm? Is not concentration of effort usually more efficient and economical? Are not other incentives (such as technical assistance or direct subsidy) more productive and less counter-productive?

We submit that they are. To place provisions such as these in the Internal Revenue Code is to not only ask for confusion and fewer economies, but also to allow the Treasury to begin to "legislate" in areas where it has neither the expertise nor the authority. One final point must be made clear. No issue is being taken with the basic policy of pollution control (or for that matter with any of the policies discussed hereafter). The issue is not "what" but "how."

C. Rollover for Low-Income Housing

As anyone who deals even remotely in real estate well knows by this late date, the 1969 Act provides for non-recognition (or deferred recognition if you will) of gains realized on the sale of certain federally subsidized or assisted housing programs. Briefly, in order to qualify one must make an approved disposition, that is one to the tenant or tax-exempt managing authority, and the project must be one the mortgage on which is insured under Sections 221 (d) (3) or 236 of the National Housing Act. The non-recognition provision is similar to that of other non-recognition provisions of the Code: the gain will be recognized only to the extent that the proceeds are not reinvested in other low-income housing projects within a one-year period. In addition, Section 167 of the Code allows accelerated depreciation on such property. Certainly it was Congress' purpose in passing upon these provisions to encourage investors in low-income housing. Again, looking at the Senate Committee Report:

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[30] *Id.* at 249 (emphasis added).

[31] Section 187 of the Code allowing amortization of certain coal mine safety equipment is an almost identical provision with the Federal Coal Mine Health & Safety Act incorporated and with certification approved by the Secretary of the Interior.

> By providing that no gain is to be recognized in these cases, it would be impossible to decrease the sales price to the occupants or tax-exempt organizations managing these properties. The Committee believes this result would be desirable. *This should enable them to make purchases they otherwise could not make.*[32]

It would seem that there would be available many other more direct, more easily administered, and more efficient means for achieving the legislative policy of enabling low-income families "to make purchases they otherwise could not make." Here again, the availability of direct subsidy, mortgage insurance, etc. are more desirable than the incursion upon the revenue act in the form of low-income housing tax breaks. Surely the total economic effect cannot be completed as easily, nor can the input on the model economic structure be arrived at without considerable more difficulty than through the use of more direct means. Although no concrete figures are available, the effect upon revenue generated for the federal government's use will in all likelihood be increased. This is simply because of lower administrative cost in collection and, more importantly, increased economies result in *larger actual income subject to taxation.*

* * * *

At this point in our discussion, let us pause for a moment to reflect upon the general purpose of the article. We interject this thought again since it becomes especially apparent during the discussion of the low-income housing rollover provisions outlined above that what is proposed throughout this article is the payment of taxes only upon *real income*[33] received or accrued to the taxpayer. The low-income housing incentives must be made available. Although it may be argued that in the case of the deferred recognition provisions no tax is foregone, but its collection merely delayed, it is our contention that real income will not be reflected. This provision substantially differs from other non-recognition sections in policy and consequent reflection of real income.[34]

D. Antitrust Transactions

Our discussion concerning the "new" provisions of the law in this area relates not only to antitrust transactions, but also to all provisions which disallow deductions for illegal, discouraged or

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[32] S. REP. No. 91-552, 91st Cong., 1st Sess. 292 (1969) (emphasis added).

[33] As defined in Part 1.

[34] See the discussion of the "pure tax policy" involved in 1954 CODE § 1033 (Involuntary Conversions) p. 285 *infra.*

political activities. Because of the simplicity of the antitrust-related sections of the Code, we shall confine our discussion to them. It must be kept in mind, however, that similar issues arise when considering political expenditures for business reasons, disallowance of deductions for bribery of officials, and the denial of all deductions of certain payments deemed "against public policy."

Section 162 of the 1954 Code allows deductions for all "ordinary and necessary" business expenses. This is in conformity with our *real income* proposals outlined in Part I, *viz.*, all expenditures made in the course of business in order to produce income should be fully deductible in computing real income. Problems arise, however, when certain payments are made in the ordinary course of business but the making of these expenditures is not favored socially or politically. For example, Section 4 of the Clayton Antitrust Act[35] provides that one injured by antitrust violations may recover damages in an amount equal to three times the economic loss sustained. The Internal Revenue Service had allowed as a deduction the full amount paid or payable by the offending person or organization.[36] Section 162 of the 1954 Code was amended by the 1969 Tax Reform Act in such a manner as to eliminate any deduction for two-thirds of any amount incurred by reason of conviction under the Antitrust Laws. Thus the amount paid in actual damages is allowed as a deduction, but that amount awarded as punitive damages may not be deducted by the offending taxpayer. The announced congressional policy upon which the enactment of this provision rests is succinctly stated in the Senate Report. In so doing the Report states the problem as one dual in nature—concerning tax policy *and* antitrust policy—a problem which cannot arise if a pure tax policy code can be developed.

> The question as to whether antitrust treble damage payments should be deductible must be viewed both from the standpoint of antitrust policy and from the standpoint of tax policy. From the standpoint of antitrust policy, the basic issues are the extent of the penalties intended and whether their impact should be reduced by permitting them to reduce taxes which otherwise have to be paid.[37]

The question then becomes whether the expense so incurred can be termed one which is "ordinary and necessary." This is the issue reached in a similar case before the Supreme Court.[38] In that case,

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[35] 15 U.S.C. §§ 12, 13, 14-27 (1963).
[36] Rev. Rul. 64-224, 1964-2 CUM. BULL. 52.
[37] S. REP. No. 91-552, 91st Cong., 1st Sess. 273 (1969).
[38] Tank Truck Rentals, Inc. v. Commissioner, 356 U. S. 30 (1958).

the Court weighed both policies and decided in favor of the disallowance of the deduction in order not to "encourage violation of declared public policy."[39] It must be recalled, however, that insertion into the Internal Revenue Code of such a provision does not allow the tax to be paid on actual income received or accrued. It cannot be denied that the expenditure was made in the course of business. Certainly it is not our desire to encourage such violations of the law by allowing these deductions. It is merely our contention that whatever *discouragement* that is needed in the antitrust area should be supplied by antitrust laws based on rationalized antitrust policies. Otherwise, priorities become distorted, issues blend and injustices result.

III. Pure Tax Policy

At this point we turn our attention to a brief examination of several provisions of the Code which reflect what we have previously termed "pure tax policy." These provisions are concerned entirely with the equitable levy of taxes, not with fiscal and social policy totally without the ambit of the Treasury's limited jurisdiction.

A. Income Averaging

Because of the very nature of the progressive system of income taxation (which we accept as equitable), inequities result when income is "bunched" into single tax years. Thus one who receives equal portions of income over a five year period pays substantially less tax than one who receives the entire amount in a single year due to the fact that the tax will be levied at higher rates. A system which allows the taxpayer to "average" his income over an augmented time period receives relief from the higher tax rates. Such a system has been a part of the Code for many years.[40] The 1969 Reform Act was the most recent in a series of steps which have resulted in more liberal treatment under the income averaging provisions, *viz.*, capital, gains, wagering income, and prizes are now included as averagable income.

The income averaging sections of the Code are concerned with the equitable treatment of *taxpayers*. In order that the man who receives his income in one year (due to the use of a cash accounting system, contingency fees or occupation, *i.e.*, inventor, artist, etc.) will not be penalized simply because of this fact, these sections were enacted. Discrimination among equally paid (over the long

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[39] *Id.* at 35.
[40] 1954 Code §§ 1301-04.

run) taxpayers is substantiall reduced. Thus a *tax* policy was implemented and real income is still reflected. Unnecessary complications are not introduced. Confusion of issues is diminished.

B. Involuntary Conversions

Section 1033 of the 1954 Code provides that upon destruction or seizure under condemnation of property owned by the taxpayer, no gain will be recognized if the proceeds from such involuntary conversion are reinvested in similar property within a specified time limit. The policy behind such a provision is evident: due to the liquidity problem involved, one whose property was converted through no act of his own (without planning) into cash and who reinvested the amount received would have little chance to raise the money required for payment of taxes. Moreover, because he had no opportunity for advance tax planning, such as involuntary sale or conversion may unfairly affect his business plans. Thus, the non-recognition (or delayed recognition) section was enacted.

Here again, a pure tax policy is illustrated. Such a provision was not made a part of the Code in order to encourage reinvestment in certain types of property (as was the low-income housing rollover provision), but rather was to give *taxpayer* relief when inequities were realized. Such provisions *are* a discrimination against persons in similar economic and income situations. They do not proceed into areas controlled by other policies.

C. Multiple Corporations

Although several rather complicated provisions relate to multiple corporations,[41] the general policy (recently strengthened by the 1969 Act) behind their enactment was the prevention of the abuse of the below $25,000 income tax rate allowed for each corporation. By incorporating each division separately a $6500 tax savings per annum per corporation was realized since the forty-eight percent surtax on income over $25,000 to each division. The multiple corporation provision dissuades such abuse, and after 1975, it will do away with it altogether. Clearly, a tax policy alone is implemented. No attempt is made to discourage (or to encourage) corporate development, or capital investment in certain equipment or other property, and, in addition, the tax is levied equitably among corporate taxpayers. Through a mere change in form, a business cannot achieve more favorable tax treatment. Thus tax is paid on real income for the total entity. Both objects of true tax policy are satisfied.

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[41] 1954 CODE § § 1561-63.

IV. Non-Tax Policy

As previously mentioned above, we lastly set forth for consideration those portions of the Code which, though not expressly anti-tax in nature, do not fall within the ambit of pure tax policy. Such provisions provide for socially desirable ends but, more importantly (at least in this discussion), provide equity in real income taxation. Such provisions include many of the so-called "itemized deductions" and are primarily applicable to individual income taxation. We shall briefly discuss one of these provisions.

Under Section 170 of the 1954 Code donations to charitable organizations are deductible (to a limited extent) from gross income. There is little question as to what policy lies behind this section: an incentive is provided for taxpayers to contribute to charities who receive virtually all of their support from private sources. Because of the progressive system of taxation, the incentive is a strong one. A moderate gift to charity may lower the taxpayer's tax bracket enough so that the tax savings are substantiall yincreased—enough so that the net after-tax income is greater than it would have been had no such contribution (and consequent deduction) been made.

Here it may be argued that such a provision has no place in a revenue code based upon taxation of real income, and thus should be eliminated. But this is not the case. Although the provision was enacted primarily for social policy purposes, it must remain a part of the Code. The reason is clear: there are no alternative plans available which would provide revenue for these organizations without going to the extreme measure of governmental fiscal influence in every charity. Such a provision (at least as far as churches and other religious organizations are concerned) is clearly unconstitutional. Moreover, real income, although distorted, may be computed and lower rates applied—which is simply a different way of allowing the deduction.

The charitable contribution example shows beyond a doubt that there are limitations upon using pure tax theory and the real income model for income tax computation. However, such provisions can be readily ascertained and exemptions made. Though the reader may question our use of exemptions at this point, when we have insisted upon an essentially exception-free, simplified code, may we say that perfection has not been a goal in formulating such a statute. Rather, it is our contention that a simpler and more rational code may be drawn and adopted if specific limitations are recognized and dealt with.

Finally, let us point out that each and every section of the Code is not so easily categorized as those we have chosen to review. However, it must be noted that when new revisions are considered, indeed, when a thorough revamping of the Act comes, consideration must be given to analysis of the type of policies involved. Those policies which can be categorized as anti-tax should be deleted and other solutions sought, implemented through more appropriate departments of government. Only then will a more understandable, economically sound internal revenue system be achieved.

A FINAL REMARK

We have based this article on the major premise that the primary congressional purpose of our internal revenue system is to raise monies for government use in defense, public welfare, development for the public good, etc. Should we deem this *primary* purpose as one of redistribution of wealth or monetary-fiscal control of the economic system, we daresay much of our thesis would be invalid. We must make clear, however, that we are speaking of the *primary,* underlying purpose—not incidental purposes.

With this major premise always foremost in our minds, we have attempted to develop the bases for a revenue code geared to the accomplishment of this premise. As we have pointed out, our new code would not be totally devoid of all social and fiscal policy. However, we believe the elimination of much of the statute devoted to the implementation of these policies would result in higher revenues and consequent improved economies. The recognition in the act of the reality of inflation (or deflation), which is necessarily present when a monetary (as opposed to barter) system is used, is long overdue. Moreover, the preferences accorded capital gains throughout the Code are dysfunctional. By taxing "real" profit and eliminating virtually all of the social policies from an internal revenue act, we believe a functional system can be developed.

APPENDIX A

Comparison of Depreciation Deductions, Initial and Investment Allowances [a] for Industrial Equipment, Leading Industrial Countries and United States

Country	Representative tax lives (years)	Depreciation deductions, initial and investment allowances (percentage of cost of asset)		
		1st year	1st 2 years	1st 5 years
Belgium	8	22.5	45.0	92.5
Canada	10	30.0	44.0	71.4
France	10	25.0	43.8	76.3
West Germany	10	20.0	36.0	67.2
Italy	10	25.0	50.0	100.0
Japan	16	43.4	51.0	68.2
Netherlands	10	26.2	49.6	85.6
Sweden	5	30.0	51.0	100.0
United Kingdom	27	39.0	46.3	64.0
Average, 9 foreign countries		29.0	46.3	80.6
United States:				
Practice prior to July 11, 1962	15	13.3	24.9	51.1
With new depreciation guidelines	12	16.7	30.6	59.8
With new depreciation guidelines and investment credit[b]	12	29.5	42.5	69.6

Chart from, TAX FOUNDATION INC., DEPRECIATION ALLOWANCE FEDERAL TAX POLICY AND SOME ECONOMIC ASPECTS.

APPENDIX B

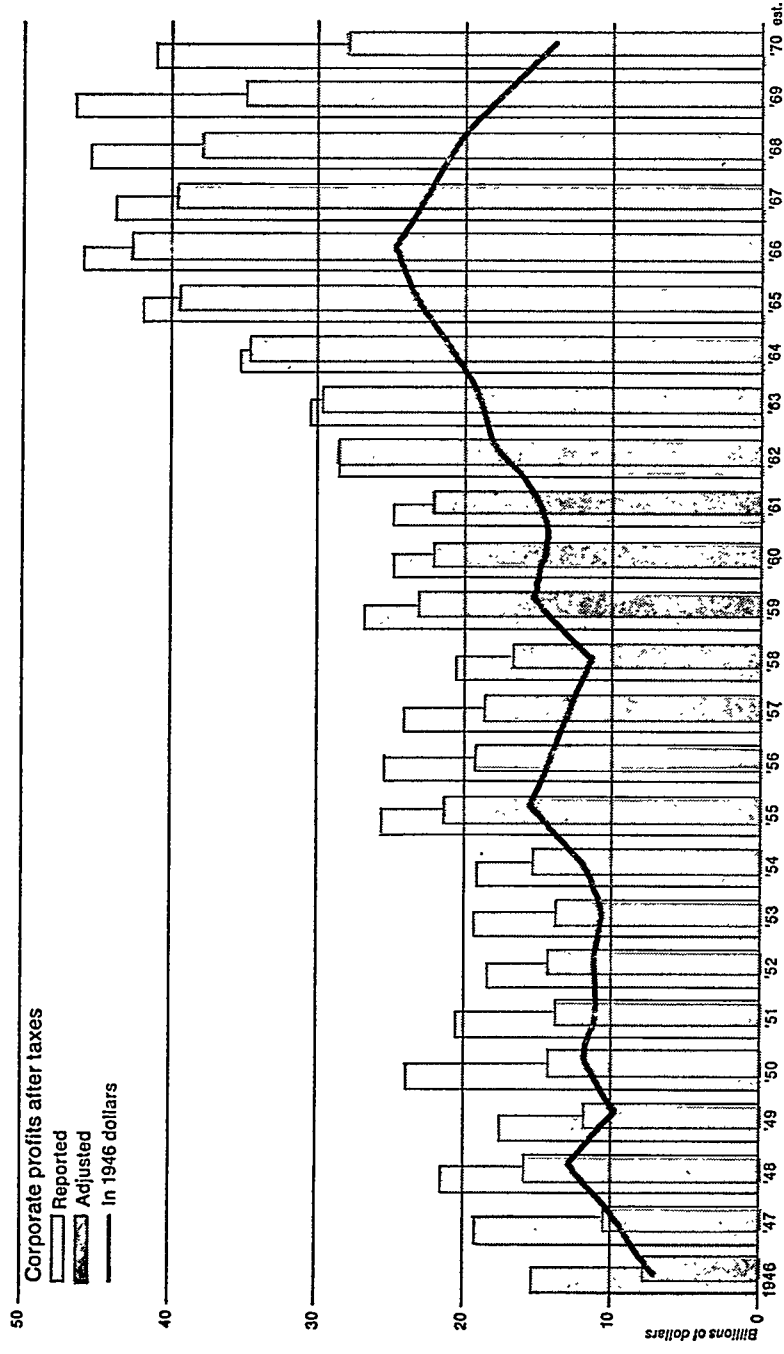

Chart from, Burak, *The Hard Road Back to Profitability*, FORTUNE, August 1972 at 102.