Allocative Fairness and the Income Tax

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ALLOCATIVE FAIRNESS AND THE INCOME TAX
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I. Introduction

II. The Structure of Norms Bearing on Taxation

III. Deconstructing Simons Income
   A. The Normative Basis of Simons Income
   B. Problems Inherent in the Simons Definition
      1. Personal Consumption
         (a) The “consumption” ambiguity in the Simons definition
         (b) Consumption as a use of material wealth
         (c) Consumption value vs. cost
            (i) The exercise of a changed-value consumption right
            (ii) Casualty and theft losses
            (iii) Imputed income from home ownership
      2. Realization
   C. Simons and the Objective Ability-to-Pay Principle

IV. What Can Government Legitimately Tax?
   A. Liberalism American-Style
   B. The Privateness of Non-Market Activity
      1. Psychic benefits
      2. Avoided costs
      3. Avoided wage income (leisure)
      4. Off-market services
         (a) Self-provided services
         (b) Services received from others
         (c) Self-created assets
   C. The Rootedness of Realization
   D. Allowances Off the Bottom

V. Constructing the Ability-To-Pay Norm of Substantive Allocative Tax Fairness
   A. What Is Allocative Tax Fairness?
   B. Practical Reasons to Take Allocative Tax Fairness Seriously
   C. The Top-Down Derivation of the Ability-To-Pay Principle
   D. Constructing the Ability-to-pay Principle from the Bottom Up

VI. What Tax Base Embodies the Ability-To-Pay Principle?
   A. The Periodicity of Taxes
   B. Annual Personal Income versus Annual Personal Consumption

VII. The Allocatively Fair Personal Income Tax Base
   A. Gross Income Issues
      1. Intangible benefits
This article seeks to provide a normative justification for the “allocative tax fairness” principle of “objective ability to pay.”

Part II contains a brief overview of norm categories as they relate to taxation. Here, the category of internal-to-tax fairness (“allocative fairness”), referring to how the tax burden should be apportioned among the population is identified as being distinct from a conception of a good or just society. Allocative tax fairness is often referred to as “horizontal equity.” Unfortunately, that notion is purely formal, and the remainder of the article seeks to discern its proper substantive content, which results in an objective ability-to-pay income tax.
Part III is a historical lead-up to the task of deriving an objective ability-to-pay income tax from relevant norms. The definition of an income tax set out in 1938 by Henry Simons on page 50 of his seminal work – namely, that an individual’s personal income (the tax base) equals the sum of her consumption and net increases in wealth for the taxable year\(^1\) - has long been a gold standard of income tax theory.\(^2\) The Simons definition has not, however, been the template for the current income tax in two major respects. First, changes in wealth, rather than being measured by annual changes in asset values, are instead reckoned, under the “realization principle,” upon disposition of assets for cash or its deemed equivalent.\(^3\) Second, consumption is not, in operational terms, an independent category of income (apart from “net increases in wealth”), but instead is viewed as a non-deductible use of income. Part III shows that the oft-cited Simons definition was only tentative, and that Simons himself ultimately favored an income tax that is very close to the one advanced herein.

Part IV explains how political theory and practice, general social norms, and human psychology constrain the concept of income so as to exclude non-market benefits, fix realization as a central principle, and justify allowances off the bottom.

Part V, is the heart of the article. Here it is argued that allocative tax fairness should be taken seriously as a norm category. It then proceeds to construct the objective ability-to-pay principle both from the top down (i.e., from external-to-tax norms) and from the bottom up (from internal-to-tax norms).

Part VI argues that the objective ability-to-pay principle is best embodied in a realization income tax, as opposed to an annual wealth tax or a personal consumption tax.

Part VII follows with an outline of basic features of an objective ability-to-pay tax, which closely follows the existing income tax, except for accrual accounting, depreciation, cash borrowing, and debt-financed purchases.

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\(^1\) HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938). The concept is commonly referred to as the Haig-Simons concept of income, but the contribution of Robert M. Haig (1887-1953), discussed infra note 23 and accompanying text, might be considered “preliminary” and lacking normative foundation and pragmatic constraints.


\(^3\) Suppose X purchases shares of stock for $100K in March of Year 1, the stock is worth $120K at the end of year 1, and X sells the stock for $117K in Year 2. Under the Simons definition, X has gain of $20K in Year 1 and a loss of $3K in Year 2. Under the realization principle, the gain (or loss) is not taken into account until the year of sale. Thus, X has no gain (or loss) in Year 1, but has a realized Year 2 gain of $17K. See I.R.C. §§ 1001(a) & (b), 1012.
The Conclusion, Part VIII, offers a concise summary and offers concluding remarks on tax theory and its applications.

II. THE STRUCTURE OF NORMS BEARING ON TAXATION

Norms can be objectively categorized in terms of their interface between society and the institution of taxation. The norms relating to taxation can be “internal to tax, i.e., derived from the function of taxation to raise revenue, or “external to tax,” i.e., relating to the larger society. At the same time, norms can either be “means” (instrumental in nature) or “ends” (goods in themselves). Cross-cutting these two dyads⁴ yields four categories of norms pertaining to taxation, all of which are familiar to tax theorists.

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<tr>
<th>Means</th>
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<td>Internal</td>
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<td>administrative efficiency</td>
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<td>External</td>
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Tie-ins exist among these norms. For example, the norm of administrative efficiency dictates that the tax base be measured by objective standards, and allocating the tax base by non-objective standards (say, according to the discretion of government officials) would be viewed as allocatively unfair. Similarly, it is hard to conceive of a just society in which its major institutions operated unfairly (in an allocative sense). Economic efficiency is a means for maximizing social wealth, but the latter only makes sense as an attribute (if an insufficient one) for a good society. Both administrative efficiency and economic efficiency are concerned with maximizing outputs from given inputs. Finally, both of the “ends” categories are constrained by ethical and political values.

This article attempts to restore, and give content to, the notion of allocative tax fairness, and not to downgrade or minimize the other categories. Although moves are made in academia to promote the hegemony of a single meta-norm,⁵ it is hard to discern any real consensus as to the content and ranking of norms, which is understandable on account of the heterogeneity of scholars’ academic (law vs. other disciplines), political, and value commitments. Academic discourse would gain if the tension among various norms (content-wise) and norm categories were frankly acknowledged, rather than papered over.

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⁴ The style of analytical abstraction exercised in this section owes an obvious debt to the work of the sociologist Talcott Parsons. See, e.g., Talcott Parsons, An Outline of the Social System, in 1 THEORIES OF SOCIETY 30-36 (Talcott Parsons et al. eds., 1961).

⁵ A currently-fashionable reductionist theory is optimal taxation theory, which is an amalgamation of economic efficiency and a view of a good society known as welfarism. Conceptual problems exist in defining “welfare” or “well-being.” See, e.g., Matthew D. Adler & Eric A. Posner, Happiness Research and Cost-Benefit Analysis, 37 J. LEGAL STUDIES S253-S292 (2008). Additionally, welfarism (a descendant of Utilitarianism) is itself a controversial view of what constitutes a good society. For starters, it suggests that public policy should favor those with abnormally strong psychic needs or desires. See N. Gregory Mankiw et al., Optimal Taxation in Theory and Practice, 23 J. ECON. PERSPECTIVES 147 (2009). Simons, supra note 1, at 7-13, by the way, rejected such an approach. In any event, the most salient prescriptions of optimal taxation theory (low rates for the highest earners, heavy taxation of necessities, and lower rates for secondary workers) have no chance of enactment due to internal-to-tax issues.
III. DECONSTRUCTING SIMONS INCOME

This part re-conceptualizes the Simons income tax as an objective-ability-to-pay personal income tax.

A. The Normative Basis of Simons’ Income

In evaluating the import of Henry Simons seminal 1938 work for the modern income tax, it is useful to examine what Simons was really up to. In the context of the mid-1930s, Simons (a staunch defender of free-market capitalism) was fighting a war on three fronts in defense of the income tax. First, Simons advanced the notion of a personal income tax against other notions of an income tax (especially that of a tax on national income). Second, Simons defended the income concept against the notion of a consumed-income tax (cash flow consumption tax) as then advanced by Irving Fischer. Third, Simons wanted to “translate” the notion of “income,” as understood by economists, into a practical and objective accounting system. These three intellectual positions advance Simons’ principal normative aims of achieving tax fairness in both the internal-to-tax and external-to-tax senses under an income concept that could be practically and objectively administered.

It is significant that the title of Simons’ 1938 book is “The Personal Income Tax” (emphasis added). Simons stated that the problem of (internal-to-tax) fairness is how to apportion the tax burden (a political given) among the relevant population. Only a personal tax can be allocatively fair, because a personal tax is one where the tax base (income) is constituted by one or more relevant attributes “of” individual taxpayers. Additionally, the tax on the personal tax base must be seen as being borne by the individuals who pay the taxes allocated to them. It has been widely assumed in the economics literature that an individual income tax is relatively “clean” in this respect, compared to excise taxes and the corporation income tax.

Simons’ external-to-tax agenda is manifest in his favoring a personal income tax over Fischer’s personal consumption tax. Here, Simons was pushing an explicit redistributive agenda, because a personal tax base constituted by inflows of material wealth, regardless of source and regardless of use as consumption or investment, describes pre-tax inflow available for government appropriation. At the time, Simons took the position that top-down redistribution through a progressive personal income tax was worth attaining at the sacrifice of some degree of

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6 Simons, supra note 1, at v-ix, rails against tariffs, unions, and restraints on free trade, and yet states that taxes are the best means of mitigating inequality.
7 Other early writings advancing income concepts include E.R.A. SELIGMAN, THE INCOME TAX (1911); WILLIAM W. HEWITT, THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION (1925); Carl C. Plehn, The Concept of Income as Recurrent Consumable Receipts, 14 AM. ECON. REV. 1 (1924).
8 See, e.g., IRVING FISHER, CAPITAL AND INCOME (1912). Later (but pre-contemporary) advocates of a personal cash-flow consumption tax include WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION (New York 1947), and NICHOLAS KALDOR, AN EXPENDITURE TAX (1955).
9 Supra note 1, at 3, 41.
10 Id. at 44-49 (rejecting tax base keyed to national income).
economic efficiency, another highly-valued norm. Such a statement implicitly concedes that an income tax is not the most efficient tax, although it is efficient enough (in theory), in not thwarting profitable economic activity or being unduly distortive.

A third Simons aim, namely, constructing a tax base that could be practically accounted for, like the first, lay within the internal-to-tax realm.

Posthumously, Simons’ page 50 definition of income (as opposed to Simons’ final conclusions about realization and other issues) has been co-opted by commentators seeking to advance a “pure” accretion income tax system (i.e., one that reckons annual changes in asset values) in the name of economic efficiency above all else. Although it is useful to be able to use the rhetoric of economic efficiency in advocating desirable reform of the income tax, the purveyors of an accretion income tax are vulnerable to claims that a cash-flow consumption tax, a wage tax, or endowment tax better serve the economic-efficiency agenda. Accordingly, economic efficiency cannot be the true normative foundation of an accretion income tax. Instead, the motive must be distributional, as was the case with Simons.

Additionally, since a comprehensive accretion tax base is politically impossible, moves to advance accretionism can only result in aggravating the existing hodgepodge of conflicting accretion and realization features. Examples are cash vs. accrual method (including the tax treatment of borrowing) and realization of transactional gains and losses vs. depreciation. These discrepancies in turn distort economic activity, undermining the accretionist aim.

B. Problems Inherent in the Simons Income Definition

Simons is best known for his definition of an individual’s personal income as being “the algebraic sum of (1) the market value of rights exercised in [personal] consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question.” Although the definition adheres to the notion of personal income, it poses (if taken literally) problems for Simons’ goals of allocative tax fairness, a tax base suitable for material redistribution, and administrative efficiency. These problems reside mainly in the notion of “consumption,” if viewed as a separate category of income, and in the “accretion” approach to reckoning changes in wealth. Simons’ book wrestles with these problems – somewhat in the manner of a person “thinking out loud to himself” – but many of Simons’ followers have taken

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12 See supra note 1, at 19-25 (discussing trade-off between progressive taxation and economic growth).
15 Supra note 1.
the definition as Gospel and have ignored Simons equivocations and conclusions. This Section reconfigures Simons’ income concept in accord with his agenda (and mine).

1. Consumption

This subsection argues, on the basis of Simons’ text and aims, against equating consumption with personal utility or well-being and for the proposition that consumption is not a component of income, but (at best) is an incomplete deduction-disallowance principle.

(a) The “consumption” ambiguity in the Simons definition

As a matter of algebra, the Simons formulation of income as “net increases in wealth plus personal consumption” can be restated as a deduction-disallowance principle, on account of the fact that personal consumption itself is one form of a decrease in personal wealth, at least if “consumption” – as Simons himself defines it - refers to the using up (destruction) of economic goods by the taxpayer during the taxable year. (Consumption is “personal” if the destruction is an end use rather than a means of generating gross receipts for the taxpayer.) Accordingly:

Personal Income = net increases in wealth + personal consumption
= gross wealth increases – gross wealth decreases + personal consumption
= gross wealth increases – (gross wealth decreases – personal consumption)

Thus, “consumption” reduces the “decrease in wealth” amount that is deductible in arriving at a taxpayer’s net personal income for the year.

Why would Simons’ equation imply that consumption is a separate category of income? Haig’s formulation of income (net increase in a person’s “economic power”) was designed to yield an income tax, as opposed to a tax on current consumption only. Simons viewed his formulation of income as improving on (or clarifying) that of Haig on account of the fact that the “changes in wealth” component of income is determined at the end of the period by subtracting current consumption along with other decreases in wealth. Therefore, Simons deemed it necessary to add back rights exercised in consumption during the year. Nevertheless, any such “adding back” serves only to cancel out an improper subtraction. Suppose X during the current year earns wages of $50K of which $45K is consumed and $5K is saved. The income of X for the year is $50K ($50K - $45K + $45K = $50K). Since both iterations of $45K represent the same dollars, there is no need to actually account for them. On the other hand, if “consumption” were something other than a decrease in wealth, then both would have to be accounted for separately, an impossible task for tax administration.

Simons was attempting to appeal to accountants by invoking the convention of equating sources ($50K wages) with uses ($45K consumption+ $5K savings). What indeed distinguishes

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16 As Simons states the matter, supra note 1, at 49, “Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods).”
17 See Simons, supra note 1, at 49-50.
18 Costs of producing income are deductible under a normative income tax, and are in fact deductible (with certain exceptions) under positive tax law. See I.R.C. §§ 162(a), 165(a) & (c), 167(a), and 212(1) & (2).
an *income* tax from a consumption tax) is that both consumption and new savings are taxed, but otherwise the attempted accounting exercise does not prove that the essence of income lies in adding together “consumption” and “net increases in wealth,” an approach that puts considerable pressure on the definitions of these terms. The Simons accounting equation is still an *equation*, meaning that “uses” must be denominated in the same way as sources, i.e., as dollars received and expended, set aside, or transferred. In terms of income tax doctrine, this point is well-recognized: decreases in wealth (deductible or not) derive from increases in wealth (after-tax dollars).19 To state the matter differently, if a receipt is excluded from income (say, as a gift), the spending of the excluded dollars on consumption would, if income, conflict with (or override) the exclusion. Coherency can be maintained only if the income exclusion controls.20

(b) Consumption as a use of material wealth

Since consumption spending or use cannot be income, the only remaining scenario where consumption might be income is that of the *in-kind receipt* of a consumption item. But, as will be argued herein on the basis of Simons’ text, in-kind consumption can be income only when the received consumption item is itself an asset or the equivalent of cash immediately spent on a consumption item. Nevertheless, although certain commentators agree (or appear to agree) with this position,21 others take the position that income includes assorted benefits that cannot be characterized as the receipt of an asset or cash.22

Holders of the latter position overlook the fact that both Haig and Simons define consumption in terms of material wealth. Both Haig and Simons were academic economists, and economists have long viewed personal income as a flow of psychic satisfactions.23 But both writers sought to “translate” the economics concept of personal income into a workable and objective tax base. In a paper delivered in 1920, Haig defined *objective* personal income as “the increase or accretion in one’s economic power to satisfy his wants in a given period in so far as that power consists of (a) money itself, or, (b) anything susceptible of value in terms of money.”24 The controlling idea should be that of “economic power” rather than the vague and indeterminate notion of “anything susceptible of value.” The latter phrase has no boundaries,

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19 Expenses, being made with cash, are inherently after tax, and depreciation and loss deductions can only be taken to the extent of the asset’s basis (prior after-tax dollars). See §§ 165(b), 167(d).
20 No authority supports the proposition that the spending of excluded income on consumption gives rise to income. At the same time, the purchase of assets with excluded income generates basis. Excluded in-kind receipts of assets are uncommon outside of gratuitous receipts, for which special statutory rules exist under §§ 1014 and 1015, but no authority supports a rule that such a receipt has a zero basis.
24 Id. at 7.
especially if it refers to anything a person might buy with money, goods, or services under any imagined set of conditions. In contrast, the notion of economic power implies contract or property rights, which entail control over persons and things, rather than subjective satisfactions.

Simons stated the matter with greater clarity by defining consumption in terms of the value of rights exercised in consumption.\(^{25}\) A right is itself an asset capable of being sold or traded in commerce. Of course, many consumption rights are very short-lived, and the tax accounting convention is to treat the cost of acquiring a short-lived consumption right as a nondeductible expense. This convention generally has the effect of ignoring the asset and the manner and timing of its being used up or disposed of. Longer-lived consumption rights are similarly treated, but by a different route: the cost is initially treated as a nondeductible capital expenditure, creating basis in the asset,\(^{26}\) but the basis cannot produce any deductions.\(^{27}\)

For example, suppose that taxpayer X receives economic benefits from another without incurring any material cost, e.g., by receiving free food, beverages, and entertainment in a social or business context, or by benefitting from the government provision of infrastructure? Under the Simons definition of consumption, these benefits – although having “value” to X – are not income of X, because they do not entail the exercise of a consumption right of X. A person cannot have a consumption right without owning it (or having the functional equivalent of ownership, such as possession and control). X in these examples has no entitlement to anything, and is not exercising consumption power previously held or acquired.\(^{28}\) Of course, personal enjoyment of something suggests an inquiry into whether the benefit obtained is income (or the cost thereof is deductible), but this only highlights the fact that lines between income tax categories are often difficult to apply to facts.\(^{29}\)

In sum, the distinction between consumption and wealth dissolves, once it is recognized that rights to consumption is merely a subset of the larger category of wealth. Additionally, rights to consumption exist (in virtually all cases) only as the result of market transactions. If a taxpayer provides labor or capital to another in return for the consumption right, the transaction

\(^{25}\) *Supra* note 1, at 50.

\(^{26}\) See I.R.C. § 1012 (basis equals cost); Temp.Treas. Reg. § 1.263(a)-1T(a), (b) (2012) (amounts paid to acquire or produce real or personal tangible property are capitalized and are not currently deductible).

\(^{27}\) See I.R.C. §§ 165(c) (but with an exception for certain casualty and theft losses), 167(a)(1) & (2) (both requiring business or investment use or purpose). The basis can only reduce or wipe out gain, see § 1001(a), but this result only prevents double taxation of the same dollars to the same taxpayer.

\(^{28}\) Simons, in his discussion (*supra* note 1, at 52-54) of an officer in the prince’s retinue receiving various perks, such as fancy uniforms, food, and entertainment, focuses on the imponderable degree of psychic enjoyment of the officer, implying (to the casual reader) that the income resides in the enjoyment itself. To the contrary, the officer should be charged with income only if the transaction entailed a transfer of the social resources (rights to the facilities and services) provided by the prince in return for the officer’s services. It seems clear that the officer received no entitlements. The spending is at the will, and under the control, of the prince for the prince’s benefit. That the officer might have subjectively enjoyed the benefits is only an invitation to look beneath the surface of the transaction to see if the perks were a form of disguised compensation.

\(^{29}\) Consumption rights are not always easily discerned. Thus, a barter exchange of services can be unpacked as two arm’s-length transactions in which cash wages are paid for rights to services, but no cash actually changes hands due to the fact that the rights to the cash payments are identical in amount. In contrast, a gratuitous service (such as child care or repairing an earring) entails no rights, and cannot be reconstituted as a cash transaction. See Douglas A. Kahn, *Exclusion from Income of Compensation for Services and Pooling of Labor Occurring in a Noncommercial Setting*, 11 FLA. TAX REV. 683 (2011) (also viewing such arrangements as cost-cutting devices).
is the equivalent of the receipt of cash income followed by a purchase of the services. Employee fringe benefits are the paradigm.

(c) Consumption value vs. cost

Simons’ reference to “the value of rights exercised in consumption” appears to refer to various issues involving consumer assets, three of which are discussed below.

(i) The exercise of a changed-value consumption right

Suppose that K purchases a bottle of wine for $20 and five years later it appreciates in value to $50 and is then consumed. Simon suggests that K might be taxed not only on the $20 non-deductible cost but also the $30 of enhanced consumption value. However, the $30 represents unrealized appreciation in an investment. In an accretion income tax, the $30 appreciation would be taxed, but given the impracticality of doing so on an annual basis, a better (if still impractical) approach would be to tax the $30 upon consumption. The $50 investment amount realized would then be seen as spent on nondeductible consumption. This analysis does not establish that consumption value is income. In fact, it does just the opposite in demonstrating that nondeductible consumption is derivative of income (as it would be measured under an accretion income tax).

Now suppose that tastes in wine change and the bottle decreases in value from $20 to $13, at which time it is consumed. If the accretion-income-tax adherent were to be consistent, then X should obtain a deductible investment loss deduction of $7 to go along with the nondeductible consumption loss of $13. Only then would consumption be taxed at its then value. However, no commentator (to my knowledge) – certainly not Simons - has proposed such a result, perhaps because such a system would result in significant revenue loss to the government. Additionally, treating X’s gain of $30 as income or his loss of $7 as a deductible investment loss would be impossible (as opposed to being difficult) to administer, because the exercise of a deferred consumption right happens in private, as opposed to occurring in a market transaction.

Since deferred consumption cannot be reckoned at its current value, then – as Simons concedes - consumption must be measured by its cost, and such cost is reckoned by disallowing any deduction for it. In the case where in-kind consumption rights received in commerce are income, the amount includible is the value when received, which is also the cost of the consumption right in commerce.

(ii) Casualty and theft losses

The one area where the “value of consumption” notion appears to have intruded into the existing income tax is that of the deduction for losses on personal-use assets that result from

\[30 \text{ See supra note 1, at 119-120.} \]
\[31 \text{ See supra note 23, at 6, where Haig makes an offhand reference to tax equity between K in the example and a purchaser of the same bottle for $50. The equity argument is circular by assuming consumption value, rather than cost, to be the equity standard.} \]
\[32 \text{ Supra note 1, at 100, 162.} \]
casualty and theft, where the deduction is keyed to the lesser of the cost or the decline in the value at the time of casualty or theft.\textsuperscript{33} The theory must be that these losses represent decreases in wealth that are not attributable to ordinary personal consumption, in the sense of enjoyment.\textsuperscript{34}

This statutory rule is inconsistent with other rules involving lost (or gained) consumption value.\textsuperscript{35} Additionally, contrary to the realization principle, it calls for before/after valuation. On the merits, non-enjoyment should not automatically result in deductibility. Wanton economic waste is also non-deductible,\textsuperscript{36} as are gratuitous transfers,\textsuperscript{37} because neither type of cost is tied to the production of the taxpayer’s income.\textsuperscript{38} Simons did not favor the casualty loss deduction.\textsuperscript{39}

(iii) Imputed income from home ownership

Although Simons ultimately concludes that consumption income involves the receipt of cash or an asset (right), the apparent exception is his view that the imputed income (the gross fair rental value) of owner-occupied homes should be included in the income tax base.\textsuperscript{40} This conclusion is widely (if not universally) accepted in the tax literature, at least as an ideal.\textsuperscript{41}

Simons, however, does not equate imputed income with consumption value, but instead characterizes it as an investment yield in the form of a “service.”\textsuperscript{42} Although the value of a financial investment asset can be ascertained by discounting future cash returns to the present, it does not follow that all assets having value generate returns in the form of cash or wealth.

\textsuperscript{33} See I.R.C. § 165(c)(3) (allowing a deduction for personal casualty and theft losses); Treas. Reg. § 1.165-7(a)(2) & (5) (1977) (tentative deduction amount is the loss in value, but not to exceed basis).
\textsuperscript{34} See Turner, supra note 2, at 272.
\textsuperscript{35} No deduction exists for “lemons,” items that go unused, and items destroyed or lost by heavy use, oversight, and carelessness, and no income exists due to consumer surplus and above-average use or utility. Simons, supra note 1, at 119-20, agrees with this point.
\textsuperscript{37} See Treas. Reg. § 1.262-1 (1972) (referring to “family expenses”). Deductions are disallowed in other contexts where the expenditure does not yield personal pleasure. Thus, the costs incurred by a person, not currently engaged in a business, of investigating the possibility of acquiring a business or investment are disallowed where the costs bear no fruit (or where the fruit ultimately obtained is too remote from the costs). Frank v. Comm’r, 20 T.C. 511 (1953); Rev. Rul. 77-254, 1977-2 C.B. 63. Another example is the disallowance of human capital acquisition costs where the motive in incurring the costs is purely mercenary. See Welch v. Helvering, 290 U.S. 111 (1933) (clear statements that costs of improving human capital are not deductible); Treas. Reg. § 1.162-5 (1967) (educational costs not deductible if qualifying one for a new trade or business).
\textsuperscript{38} A deduction for casualty and theft losses operates inequitably even in terms of consumption value, if insurance is factored into the analysis. Suppose that J (uninsured) buys 10 Baccarat wine glasses for $1,000 total, and K buys 9 glasses for $900 total plus nondeductible insurance for $100. Each of J and K loses one glass to theft. K uses her $100 insurance recovery to purchase a replacement glass. Both have expended $1,000 to obtain 9 wine glasses. J and K will be taxed the same only if J’s uninsured loss is nondeductible. (No gain or loss exists on K’s insurance transaction, because the recovery of $100 is offset by K’s basis in the lost glass. The insurance premium is not deductible because it is a personal expense.)
\textsuperscript{39} Supra note 1, at 120.
\textsuperscript{40} Id. at 110-22.
\textsuperscript{41} See BLUEPRINTS, supra note 2, at 7 (1977); Goode, supra note 21, at 139-43; Richard A. Epstein, Consumption and Loss under the Internal Revenue Code, 23 STAN. L. REV. 454 (1973).
\textsuperscript{42} See Goode, note 21, at 139-43; Gerald M. Brannon, Tax Loopholes as Original Sin, 31 VILLANOVA L. REV. 1763, 1766-67 (1986).
Services received are not wealth in the tax sense unless embodied in a right to services. Although ownership of a home entails the right to (rent-free) occupancy, such right is not separate from the property itself.\(^{43}\) Imputed income (in contrast to cash or in-kind rent) is not a coming-in from the outside world. The service is provided by the homeowner to herself.\(^{44}\) Without an inflow of material wealth, there is nothing for the government to take as a share.

As a factual description, it is correct to say that homeownership entails deferred consumption. If one takes the present-value theory of cost seriously in this context, then the cost of the home is the present value of future net consumption value over time. Not being able to deduct the cost of a home is the way in which future consumption value is taxed, just as in the case of any deferred consumption right.

This last point undercuts the horizontal equity argument that ignoring imputed income discriminates against the renter paying nondeductible rent relative to the homeowner.\(^{45}\) Actually, it happens that homeowners and renters are taxed the same, albeit from a forward-looking perspective – which is what matters from an economics perspective. Purchasing a home is like paying prepaid rent.\(^{46}\) In both cases the rule is to disallow any deduction for the cost of personal consumption, whether current or deferred. Also, it should be pointed out that, although horizontal equity calls for like-situated taxpayers to be taxed equally,\(^{47}\) homeowners and renters are not really like-situated, apart from the fact that both occupy a dwelling, because the risks, responsibilities, and rewards differ between owners and renters.\(^{48}\)

At this point, advocates of taxing imputed income often invoke a comparison between one who invests in a home and another who invests in an annuity which funds the payment of rent on an equivalent home. The annuity alternative is indeed taxed more heavily than the home-purchase alternative, because not only is the cost of the annuity nondeductible (as with the purchase of the home) but the excess of the annuity cash returns over its cost is taxed as income (and, when paid as rent, continues to be "after tax" by being nondeductible). But this (again) is not a convincing equity argument, because an annuity purchaser and a home purchaser are not the same, as one seeks income and the other consumption. The annuity comparison does illustrate the income tax discrimination between consuming and investing. Taxing imputed income would put the ownership of consumer durables on a par with financial investments in terms of tax treatment, but other consumption would otherwise still be favored (relative to

\(^{43}\)See generally, Chancellor, supra note 21.

\(^{44}\) A right to receive services from a third party (such as under a health club membership) raises different issues that are discussed infra in the text following note 121.

\(^{45}\) See supra note 1, at 112. This argument assumes that the present deductions for mortgage interest, see I.R.C. § 163(h)(3), and property taxes, I.R.C. § 164(a), are eliminated.

\(^{46}\) No meaningful difference (in substance) exists between owning and renting where the rental term (with renewals) equals or exceeds the asset’s useful life and the tenant is responsible for maintenance costs. See Sun Oil Co. v. Comm’r, 562 F.2d 258 (3d Cir.1977); REV. PROC. 2001-28, 2001-1 C.B. 1156 (lease can be installment sale, or vice versa). Hence, if payment is made in advance, it should be in the same amount in both cases.

\(^{47}\) See supra note 1, at 106.

\(^{48}\) The owner pays for future use in advance; the renter makes periodic payments. The owner has to attempt to cover costs of recovering his investment and maintaining the property; the renter does not. The owner bears higher transaction costs of disposing of the property than the renter does in allowing a lease to lapse. The owner bears the risk (both ways) of future changes in underlying value; the renter’s downside risk (of non-habitable premises) is protected by landlord-tenant law, and there is little or no upside risk.
financial investment) under an income tax. Stated differently, the exclusion of imputed income results in treating all consumption (current or deferred) equally. The argument for taxing imputed income then becomes one of economic efficiency, i.e., that an income tax favors “investment” in homes (deferred consumption) rather than financial investment. This discrimination is considered undesirable because homes do not yield economic gain in the form of new material wealth – which is precisely my point as to why imputed income is not “income” in the tax sense.

Taxing imputed income from homes was appealing to Simons because of its perceived potential for redistribution. However, taxing items that are only statistically skewed towards the upper classes – a welfarist notion – violates allocative tax fairness. For example a poor person who owns a recreational fishing boat or home would be taxed more heavily (in this respect) than a wealthy person who lacks an equivalent item.

Even if statistical redistribution were a legitimate strategy in general, taxing imputed income could well backfire. First, inclusion of gross imputed income would necessitate deductions for maintenance costs, mortgage interest, property taxes, depreciation, and losses on sale or abandonment, the accounting for which would entail the expenditure of considerable resources. Enacting a complex scheme that would create tax shelters for homeowners is worse than pointless. And, if homes were to be treated as investments, then consistency would dictate that all consumer durables should be treated as investments, with resulting deductability of transactional losses. Second, even if taxing imputed income from homes were to actually increase taxes on homeowners, the burden would disproportionately fall on the middle class, for which home ownership constitutes a principal vehicle for “investment,” relative to the wealthy, who enjoy low tax rates on capital gains and have other ready investment alternatives.

At the pragmatic level, accurately measuring the gross rental value of homes would require vast recourses. Additionally, the ownership of consumer durables (other than homes and vehicles) is not a matter of public record, rendering a tax on them a virtual impossibility.

Finally, to add a legal point, a tax on fair rental values amounts to a property tax, and it would therefore incur a substantial risk of being held to be unconstitutional as a non-apportioned “direct tax.”

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49 Cf. I.R.C. § 469(a), (c)(2) & (7) (subjecting most rental activities to complex loss carry-forward rules).
50 See James Poterba & Scott Weisbenner, The Distributional Effects of Taxing Estates and Unrealized Appreciation at the Time of Death, in RETHINKING ESTATE AND GIFT TAXATION 422, 440-41 (William Gale et al. eds., 2001) (indicating heavy investment of people with estates under $500,000 in residential real estate).
51 Ironically, early “income” taxes in Germany (and the UK) included imputed income from homes precisely because homes could not be concealed, so that taxing them actually served the cause of administrative convenience, although in a crude fashion.
52 Taxes on imputed income in countries other than the United States, are always on real estate and sometimes only on land. For a brief survey, see HUGH J., AULT & BRIAN, COMPARATIVE INCOME TAXATION 215-17 (3d ed. 2010).
53 See I.R.C. § 164(b)(1); Treas. Reg. § 1.164-3(c) (1964) (defining a personal property tax as a tax imposed annually). The tax on imputed income proposed by Simons (supra note 1, at 117) is precisely of this type.
54 See Eisner v. Macomber, 252 U.S. 189, 217-19 (1920) (holding that a tax on a pro-rata stock dividend, which is a tax on a percentage of the value of the taxpayer’s stock ownership in a company, is a non-apportioned direct tax). A “direct tax” (construed to refer to property taxes and capitation taxes) is (unless it is an income tax) required to be apportioned among the states in accordance with population. See U.S. CONST., Art. I, sec. 2, cl. 3; sec. 9, cl. 4; Amend. XVI. See generally, Joseph M. Dodge, What Federal Taxes Are Subject to the Rule of Apportionment under
2. Realization

The definition of income on page 50 of Simons’ classic work certainly describes an accretion income tax under which assets would have to be valued annually. However, nothing that Simons’ says prior to that point bears on the issue as to when gains and losses should be reckoned, except for the immediately preceding paragraph on page 50 where he states that income pertains to specified time periods and that, ideally, all the data for calculating the tax base should exist within the specified time period (that is, without regard to what happened in prior time periods). An accretion income tax satisfies this criterion, whereas a realization income tax (in which, to oversimplify, gains and losses are computed transactionally by comparing historic cost with selling price) requires information about events in prior periods.

Nevertheless, Simons stated that his accretion income definition was to be only a starting point,\(^55\) to be refined by the ordeal of having to cope with various problems, mostly of a practical nature.\(^56\) Simons’ self-contained-period notion is not tied to any norm or policy other than that of weak accounting pragmatism, but then Simons states that accretion taxation is generally not practicable because of valuation difficulties.\(^57\) Additionally, the accretion idea itself lies uneasily with Simons statement on page 49 that personal income refers to “the exercise of control over the use of society’s scarce resources”\(^58\) (emphasis added), since “exercise” could be read as encompassing realization. Ultimately, Simons accepted the realization principle.\(^59\)

It is worth digressing somewhat to consider, on the merits, the argument that the realization principle, by allowing taxpayers to defer income at will, is systematically advantageous to taxpayers. It is true that the deferral of a fixed dollar amount of income is beneficial in the sense that the present value of the future tax (assumed to be at the current tax rate) is less than what the current tax would be. However, unrealized gain is not a liquidated amount, but is an amount that can grow or shrink as the years go by. In fact, if the “deferred income” grows at the same rate as the discount rate, the present value of the future tax is not

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\(^55\) See supra note 1, at 43-44 (“What is requisite to satisfactory definition of income will appear clearly only as we come to grips with various problems”), 50 (“income may be defined as …”) (italics added).

\(^56\) “Let us now note some of the more obvious limitations and ambiguities of this conception of income.” Id. at 51.

\(^57\) Immediately after the “exercise” passage follows another in which Simons equates economic power with “the value of rights which … might have been exercised in consumption without altering the value of his store of rights.” See id. at 49. The phrase “might have been exercised” at least suggests a high level of liquidity (a low level of transaction costs) as a prerequisite for taxing annual changes in market values.

\(^58\) See id. at 100 (referring to realization principle as “practical expedient”), 162 (stating that realization is “not only indispensable to a feasible income tax system but relatively unobjectionable in principle …”), 168-69 (stating that deferral of realization of gains is relatively harmless, and that realization avoids extreme fluctuations of income), 207 (“outright abandonment of the realization criterion would be utter folly”). Simons’ chief acolyte, Stanley Surrey, supra note 2, at 16-18, also embraced realization.
reduced by reason of deferral.60 (The ultimate avoidance of tax on unrealized gain by the step-up-to-value-at-death basis rule of § 1014 is another matter, strenuously opposed by Simons.)61

C. Simons and the Objective Ability-to-Pay Principle

Simons’ agenda and prescriptions suggest that he was advancing an objective-ability-to-pay tax base principle in substance, if not in name. Such a principle posits that taxpayers should contribute to the government a portion of their net material (cash or asset) realized inflow for the taxable period (taxable year) in excess of subsistence needs. Such a tax base is both fair in the allocative sense and tailored to government’s redistributive role (whether one embraces that role or not). The objective ability-to-pay tax base, being measured by market transactions and avoiding valuations and subjectivity is highly practical, although (as argued in Part IV, immediately below) realization has a normative basis as well. Finally, the (to Simons, subordinate) claims of economic efficiency are satisfied well enough by a realization income tax.

Simons avoided using ability-to-pay terminology, because such notions as “ability” and “faculty” were deployed in Utilitarian “sacrifice theory,” which Simons critiqued at length in the Introduction to his text.62 Simons then cited Adolph Wagner with approval as holding that taxation had to be viewed as a means to correct distributions of wealth and income, objectively determined, and that “ability to pay” makes sense only in such a context.63

In sum, Simons’ work on taxation, far from disparaging the objective ability-to-pay principle, substantially supports it.

IV. WHAT CAN GOVERNMENT LEGITIMATELY TAX?

In this section Simons is (mostly) put aside and the foundation is laid, using norms pertaining to political institutions (of which taxation is one) aid in the construction, in Part V, of the objective ability-to-pay principle of allocative tax fairness.

A. Liberalism American-Style

Writers in tax of an economics persuasion tend to overlook the grounding of taxation and classical (free-market) economics in political theory and values, especially as these have become social norms that govern practice.64 In the United States, the foundation of the dominant political theory (liberalism) - which presents many faces across the political spectrum and is embodied in the Constitution and political practice - is the notion of individual autonomy. Even welfarism

60 A related argument, i.e., that unrealized appreciation is “reinvested income” that obtains favorable consumption tax treatment, is considered (and rejected) infra in the text accompanying note ???.
61 See supra note 1, at 162-67.
62 See id. at 5-15.
63 Id. at 15.
64 See Alice G. Abreu & Richard K. Greenstein, Defining Income, 11 FLA. TAX REV. 295 (2011) (arguing, in effect, that the broad Simons-derived accessions-to-wealth concept of income is justifiably “bent” by the IRS to avoid conflicts with political values). My thesis, in contrast, is that the ability-to-pay concept (and tax legislation) is itself determined with reference to such values. This point is recognized in principle by Stanley Surrey, supra note 2, at ???, and by Joseph Sneed, supra note 22, at 5 (stating that taxes should be compatible with the “political order”).
(descended from Utilitarianism) has its roots in liberal theory insofar as individual preferences are the desideratum and welfare is equated with wealth (which is best generated by a market economy). But welfarism is more of an academic clique than a broad political norm.

Taxation, involving coercion, has posed a problem of justification for liberal theory, which has responded in the form of theories of implied consent and government benefit.65 A principal tenet of liberal political practice is that government power should be constrained.66 In turn, the notion of limited government posits a normative distinction between the public and private (liberty) spheres, and this distinction explains certain stable features of the income tax.

B. The Privateness of Non-Market Activity

Simons defined consumption as the destruction of “economic goods,” i.e., scarce social resources. However, to an economist, the concept of economic resource is not constrained by the public/private distinction, as Simons himself notes when he observes that leisure, self-provided consumables, and self-provided services are economic goods, because they could be purchased and sold in a market.67 Nevertheless, that a resource is a social (public) one is what confers upon the government any interest in (or claim to) it under liberal theory and practice.68 As an initial hypothesis, a resource of a taxpayer is “public” if it entails legal entitlements and/or it arises in a market transaction. Accordingly, purely private activities should not affect the tax base.69 This point was grasped as far back as 1896 by Kleinwächter, who pointed out that the concept of income collapses when it is construed to include private and household goods.70 Additionally, taxing non-market activity would violate social norms that constrain the commodification of private goods. This normative claim (that private activity is off-limits to the tax authorities) has important implications for the tax base issues considered below.

1. Psychic benefits

Psychic enjoyment, even that derived from one’s own material goods (such as an art collection), is clearly “private” and out-of-bounds to the tax authority. If psychic enjoyment were income, the tax base would be indeterminate and incapable of enforcement, unless government were to employ means that fail to respect autonomy and privacy.71 Even then, enforcement would be random (lacking allocative fairness).

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66 See id. at 402-03, nn. 9 & 12.
67 Supra note 1, at 51-52.
68 A similar point is made by Kelman, *supra* note 21, at 842.
69 It has been argued that housework should be taxed so that homemakers would be eligible to receive public benefits that are attendant upon wages. See Nancy C. Staudt, *Taxing Housework*, 84 GEORGETOWN L. J. 1571 (1996). The issues of measurement, privacy, illiquidity, regressivity, and identification of the proper taxpayer, id. at 1628-29, 1641, are rather casually treated. Additionally, no necessary link exists between taxing the value of housework and entitling the homemaker to public benefits.
71 Simons distanced himself from the notion of psychic income by equating taxable “consumption” with a decrease in *social* wealth: an asset or a right (as distinct from pure psychic benefit) is “used up.” See *supra* note 1, at 96. In another passage, Simons says, “Personal income … has to do not with sensations … but rather with rights which
If positive psychic benefits were gross income, then negative psychic states (pain, sadness) would generate deductions. Indeed, the performance of services for wages would entail deductions for wage-earners. Likewise, investment return would be offset by the psychic cost of deferred enjoyment and taking risks. Psychic plusses and minuses are ultimately self-generated, because whether an item brings satisfaction or displeasure is a matter of individual preferences, tastes, and circumstances, which vary in intensity and range among the population. Finally, after the tax-base plusses and minuses have been tallied, aversion to taxes would justify avoidance of taxes. Market transactions are what convert subjective preferences into objective monetary value, and only monetary values can be the basis of an allocatively fair tax system.

2. Avoided costs

If gross income is predicated on acquisitions of wealth (including consumption rights), it follows that the avoidance of costs is not income. For example, if a father has a legal obligation to support a child, and such obligation is prematurely cut short by reason of the child’s death, the relief from a future cost is non-income to the father. Expenditures pose deduction issues, and the avoidance of any given expenditure simply reduces the possibility of obtaining a deduction for it. Decisions about incurring or avoiding costs are lifestyle decisions possessing no direct effect on gross income.

3. Avoided wage income (leisure)

Economists are wont to claim that leisure is a form of consumption, and therefore should be taxed in principle. However, to cite Simons definition of consumption as involving the destruction of a right (or social resource), leisure would not be consumption in the tax sense. Definitions aside, leisure (not being an inflow of material wealth) cannot be appropriated by government and then redistributed. Finally, as Simons recognized, leisure (even if it were material) is not a suitable subject of top-down redistribution, as it is likely randomly distributed across the population, or even skewed toward the bottom.

The same logic of taxing leisure would impute income to capital that is not put to its highest and best use (such as a farm that could be converted to a housing development), or to under-utilized human capital (such as a law professor who would otherwise earn more in the private practice of law). A tax on economic potential (endowment) is not an “income” tax, which is a tax on material economic outcomes.
Economists, on economic efficiency grounds, tend to like the idea of taxing leisure and under-utilized capital in order to remove existing tax disincentives for maximizing material economic return. Nevertheless, taxing only market outcomes respects autonomous decisions to avoid entering markets for labor and capital. Since a tax on leisure would be payable in cash, the taxpayer at the margin would be compelled to enter the market to raise the cash to pay the tax. A truly neutral “tax” on leisure would need to be of the “same kind” as leisure itself (such as compulsory service for the state), which would conflict with core liberal values.\footnote{See Kelman, supra note 21, at 842 (noting that non-taxation of leisure has support across the political spectrum).} The paradox inherent in the notion that leisure (or endowment generally) should be taxed is that markets, the arena in which free choice is the paradigm, would be forced upon people by a paternalistic government policy that would impose a penalty on choosing not to enter markets.\footnote{See Sugin, supra note 75, at, 248-51.}

4. Off-market services

(a) Self-provided services

Benefits obtained from self-provided services (such as, for example, self-provided lawn care) are untaxed, whereas the same services purchased in the market are taxed due to the cost being non-deductible. Economic efficiency considerations favor taxing the value of self-provided services in the name of economic efficiency, but (again) it does not follow that it would be acceptable to tax such value. The value of self-provided services may be variously described as (1) psychic income (referring to the satisfaction obtained), (2) an avoidance of monetary costs (not having to pay someone else to do the job), or (3) avoidance of earning wages (with which to pay another party to do the job). Each of these characterizations has already been shown to be an unacceptable basis for taxation. The self-mower acquires no material good that can be transferred to the government. Additionally, the good is in no way “social,” because it hasn’t entered commerce or even social relations.\footnote{Simons, supra note 1, at 52, states that the value of shaving oneself should not be taxed, but does state why. Personal grooming is private and unobservable by the government, but so are other self-provided services.} The self-mower has merely expended private time in one particular fashion as opposed to possible alternatives.\footnote{Perhaps Simons, id. at 52, is making this point in a different way by stating that the neglect of earned income in kind can be offset by neglecting leisure.}

As an aside, taxing the self-mower would be impractical and perhaps self-defeating for the same reasons as apply to imputed income. Here, the value would need to brought into the open and valued by a coercive government, and the cost of equipment, parts, repairs, and gasoline would also have to be accounted for. The end result of this pointless accounting may well yield very little net income.

(b) Services received from others

If, as noted earlier,\footnote{See text following note 27 supra.} the spending of money by X for Y’s benefit is not income to Y (because Y has not acquired a consumption right), then a fortiori the receipt by Y of X’s services
(such as childcare or hosting a dinner party) cannot be income, unless X’s services are received in a bargained-for exchange for services or goods rendered.

(c) Self-created assets

Although current law treats self-created assets as non-income even if (and when) consumed by the taxpayer, a self-created asset, upon its completion, appears to be an increase in personal taxable wealth. However, a rule that required current inclusion of self-created assets would entail government intrusion into private matters and could only be enforced sporadically and inequitably. Again, if the item is included, the monetary costs (raw materials, seeds, tools, equipment, and supplies) would be deductible, leaving only the value added to the item by the taxpayer’s labor. Given that self-provided services are non-income where the services are enjoyed currently, the same result should occur when the services are deployed toward the creation of personal-use property (yielding deferred enjoyment).

C. The Rootedness of Realization

The realization principle is often thought of being a “mere” concession to administrative efficiency, not founded upon theory, because, by obviating any need for annual valuations, it saves costs and effort, and avoids guesses and estimates. Nevertheless, an annual tax on unrealized appreciation would distort economic activity by requiring, for at least some taxpayers, a sale or borrowing. Transaction costs would be especially severe with illiquid assets like pension accounts, unimproved land, closely-held business interests, unproven mineral interests and intellectual property, and collectibles, such that investment in these kinds of assets would be discouraged. Accretion taxation for only liquid assets would avoid some problems, but it would (1) fail to eliminate forced sales, (2) raise line-drawing issues, (3) encourage investment in illiquid assets, and (4) incentivize the destruction of wealth. It is true that the realization principle also causes distortions (i.e., the postponement of sales and the incentivizing of appreciation-yield investments over cash-yield investments). However, any tax rule having to do

81 Non-market services received are correctly viewed as non-income, rather than as excluded income. See I.R.C. § 102(a). Treas. Reg. § 1.102-1(a) (1960) makes it clear that the gift exclusion only applies to “property” (which includes money).
83 See Comm'r v. Glenshaw Glass, 348 U.S. 426, 431(1955) (holding that “accession to wealth” is at the core of the income concept). However, the self-creation of an asset is not an “accession,” which implies “obtained from outside oneself.” See www.merriam-webster.com/dictionary/accession (defining accession to mean “adding to” property holdings and as being synonymous with “acquisition”). An example of an accession would be claiming undisputed possession of a valuable object found in the ground. See Treas. Reg. § 1.61-14(a) (1993). One does not “accede” to one’s own labor or the fruits thereof. In any event, the Glenshaw Glass formulation of income requires “realization,” and realization would not occur until the sale, etc., of the self-constructed asset.
85 Materials might be obtained from nature without cost, but this is relatively uncommon, as most endeavors to obtain the bounty of nature (agriculture, husbandry, fishing, mining) entail significant material costs.
87 The gift/estate tax, which requires valuations, operates to encourage self-imposed illiquidity and other value-reducing action in order to obtain valuation discounts.
with realization will create economic distortions, and it is not obvious that one set is more harmful than another.\textsuperscript{88}

Economics aside, realization has roots in liberal theory and practice, as well as psychology, and appears to be gaining respectability, or at least acceptance.\textsuperscript{89} The point about “forced sales” can be re-stated as a problem of government intrusion into private-decision-making. Mark-to-market taxation of assets that are closely linked to livelihood and lifestyle (e.g., closely-held business interests, family farms, collectibles, homes, and interests in trusts) would be especially resisted on this basis, because these assets are not really “available to” the market.\textsuperscript{90} In contrast, the realization principle is “public,” because virtually all realization events involve at least one other party, and the other party (or a third party) can assist in IRS enforcement.

It is reasonable (as well as commonplace) to consider unrealized gains (even in the case of liquid investments) to be insufficiently “real” or “final” to justify a current tax thereon payable in cash. Prior to realization, nothing has been appropriated for the taxpayer’s personal use (even if such use is to try another investment). The appreciation is, as far as the taxpayer is concerned, “out there.” Likewise, no cash has been obtained to share with the government and, as noted above, many assets are not readily reducible to cash in a short time frame. In the case of tangibles, the use of the property is likely unchanged. In the case of financial investments, the appreciation would be caused by changes in discount rates, estimates of net future yields, or general economic conditions, phenomena that likewise confer no present economic benefit on the investor. Even with marketable securities, any “paper” gain represented by unrealized appreciation may disappear by the time the value of the property is converted to beneficial enjoyment. For a person who bought property for $50K, followed by an increase in value to $1M, and then followed by a decrease in value to, say, $100K (at which point the property is sold), the huge appreciation bubble above the $100K sales price was only a missed opportunity.

On the government side, accretion income taxation would be a volatile revenue generator, weakening the connection between taxing and spending in annual budget cycles.

The clinching point is that no income tax system in the world follows the accretion model even for liquid securities.\textsuperscript{91} This observation shows that deep social and political norms, as well as psychology, will override (in the political sphere) the prescriptions of economists.

\textbf{D. Allowances off the Bottom}

\textsuperscript{88} For example, the tendency of the realization principle to reduce or postpone sales avoids pointless transaction costs, and it is not clear that a churning strategy gives better investment results than a buy-and-hold strategy.


\textsuperscript{90} Such resistance is manifested under the current income tax by the fact that the gain (and use value) of personal residences largely avoids tax, see § 121, and state property taxes often cap values at the purchase price (or purchase price plus an interest-type adjustment).

\textsuperscript{91} The two mark-to-market provisions in the U.S. tax code, see I.R.C. §§ 485 and 1256, are quite narrow.
Allowances off the bottom (deductions or exemptions for subsistence consumption) are founded on liberal political theory, according to which citizens’ basic needs are “prior” to government, or, more fully, that a person’s subsistence needs precede any tax claims of the government.92

V. CONSTRUCTING THE ABILITY-TO-PAY NORM OF SUBSTANTIVE ALLOCATIVE TAX FAIRNESS

After 100 years of the U.S. income tax, it is no longer necessary, or desirable, to begin (like Haig, Simons, and other early writers) with concepts of income developed elsewhere and then to adapt them to tax. A concept of income for tax purposes can be independently constructed from norms relating to the functions of taxation.93 This Part constructs the concept of “objective ability to pay personal income” as the norm of substantive tax fairness, which is compatible with liberal values in general, to redistribution as a government program, and to the institutional function of taxes. The concept is “objective” in relying on market transactions.

A. What Is Allocative Tax Fairness?

In the pantheon of values, “fairness” – generally meaning “evenhandedness,” “lack of bias,” and so on – has a “procedural” (as opposed to “substantive”) flavor because it refers to the process of distributing (allocating) benefits or harms. However, this generalized notion of fairness does not say anything about the purpose of the allocation or the nature of the benefits and harms. The meta-norm for institutional fairness is “equal treatment” in terms of the function of the institution, which in the case of taxation is government-coerced personal sacrifice of cash. In light of that function, fairness in taxation (as noted by Simons) pertains to how to allocate the tax burden (a political given) among its subjects.94 As noted earlier,95 a major contribution of Simons was to demonstrate that a fair tax must be a “personal” tax.

Applying the institutional meta-norm of equal treatment of like-situated individuals to taxation yields the familiar tax maxim of “horizontal equity.” At this point, however, the maxim remains formal and empty, or even trivial if one is referring simply to the “rule of law” (where equal taxable incomes will mechanically produce equal taxes). The “substantive” problem is “What should constitute the tax base from a tax fairness perspective?” That is, what should be the index, standard, or criterion of likeness and difference, i.e., what principle should define the tax base?

93 Andrews, Personal Deductions, supra note 2, at 311-13, stakes out a similar approach in stating that the issue is whether the “purposes underlying any [tax-base] provision are indeed extraneous to the purposes of the tax.”
94 Supra note 1, at 3, 41.
95 See supra note 10 and accompanying text.
The “vertical equity” problem of how differently situated taxpayers (in terms of the tax base) should be treated is not resolved by the concept of the tax base, but instead by the rate and exemption structure. The configuration of the rate structure requires consideration of external-to-tax norms, such as economic efficiency, welfare enhancement, or other distributional theory. It follows that the concept of the tax base does not itself imply a uniform (“flat”) tax rate. Nevertheless, the distributional effect of the rate and exemption structure operates only in terms of the concept of the tax base, a point also noted by Simons.96 Thus, under an objective ability-to-pay income tax, the distributive effect of the rate structure bears on the net income (as opposed to, say, the well-being or aggregate net wealth) of taxpayers.

Importantly, the distribution of the pre-tax tax base (income) immediately after application of the rate structure is only tentative, because the after-tax distribution is then altered by government action (some of which might be carried out through tax credits). Because both the rate structure and government action depend on external-to-tax considerations, the term “vertical equity” has no internal-to-tax meaning.

B. Practical Reasons to Take Allocative Tax Fairness Seriously

The basic allocative fairness maxim (equal treatment of equals) is so basic to humanity that it is well understood by ordinary folk and political actors alike, and it is the latter – not philosophers, economists, or social engineers – that make tax law.97 Equal treatment is the basic form of argumentation at all levels of discourse. Individuals often prioritize fairness over (even) rational self-interest.98 Tax proposals, good and bad, are typically sold by appeals to fairness (as well as to self-interest).99 Importantly, tax schemes advanced by theorists that are widely viewed as being allocatively unfair (such as a head tax, an accretion income tax, or an endowment tax) have no chance of becoming law.

Why should one care for institutional (specifically, tax) fairness? As a cognitive heuristic, people routinely focus on the part rather than the whole. This phenomenon, referred to disparagingly as “myopia” or more neutrally as “disaggregation bias,” is necessary to cope with life’s complexities. On the positive side, disaggregation bias enables the framing of manageable problems that can be dealt with according to specialized technical and institutional competence. In the case of taxation, politicians and constituents can debate tax systems and rules apart from the big-picture issues of what is a just society and the size and proper roles of government, about which no political (or academic) consensus exists. Congress and the Executive themselves are compartmentalized branches of government. Compartmentalization allows for a “tax insider”

96 See supra note 1, at 13-19.
97 The United States appears to lead the Western world in its marginalization of policy expertise. A likely contributor to this situation is the constitutional separation of the executive and legislative branches.
99 Thus, the term “fair tax” has been adopted by a political movement seeking to replace the federal income tax by a retail sales tax. See, e.g., http://www.fairtax.org/site/PageServer?pagename=HowFairTaxWorks.
culture to develop, relatively free of disparate personal ideological commitments. This culture, which interacts with explicitly political currents, has an interest in the integrity of the tax system, and therefore a commitment to the concept of tax fairness from a system perspective.

As noted earlier, norms fall into at least four categories, and plural norms (such as, for example, conceptions of a good or just society) may exist within a given category. The various norms may converge or diverge with respect to any tax issue. Accordingly, the project herein of identifying a tax base that satisfies allocative tax fairness criteria should not be taken as a comprehensive programmatic analysis of tax provisions. Simons himself was a norm pluralist in advancing allocative tax fairness and using the tax system to redistribute material wealth, at some cost to another norm he valued, namely, economic efficiency.

It is curious that contemporary tax theorists generally ignore or downgrade the notion of allocative fairness relative to the external-to-tax concerns of economic efficiency and social (re)distribution. In areas of legal theorizing other than tax, internal-to-law allocative norms (sometimes referred to as “mid-level norms”) are taken seriously. Examples include “retribution,” “restorative justice,” “bindingness of promises,” “property rights,” and “equal rights.”

Some legal academic commentators of a welfarist orientation appear to claim that allocative tax fairness norms are useless and therefore irrelevant. However, a principle of allocative tax fairness should be shunned only if it, by itself, thwarts or obstructs some larger social goal. Inherently, this cannot be true of tax-base principle, because after-tax outcomes can always be reshuffled by government programs. Therefore, it is puzzling that critics of the notion of an internal-to-tax allocative fairness norm complain that such a norm might not, by itself, further their notion of a just society. (The usual manner of stating this complaint is that allocative tax fairness is disaggregated from social “equity.”) This critique asks too much of the tax system.

Other welfarist writers in tax concede that an allocative fairness principle constructed along objective, market-outcome, lines is a proxy – perhaps overall the best proxy - for measuring the well-being of individuals, given the problems of subjectivity inherent in the welfarist program. This concession is huge, because it sets up an objective market-based tax base principle to be a “default” tax base index.

C. The Top-Down Derivation of the Ability-To-Pay Principle

101 See supra Part II.
102 See supra note 1, at 89-97.
A somewhat different claim is that tax fairness is subordinate to external-to-tax norms, or, specifically, that horizontal equity is subordinate to vertical equity. Although it is not necessary that the allocative tax fairness principle be linked to one or more external-to-tax norm – again because government action can undo after-tax outcomes – government policy coherency is gained if the tax fairness principle is aligned with such norms.

Advocates of economic efficiency appeal to fairness intuitions by invoking the “level playing field” metaphor and conflating equal treatment of things with equal treatment of people. Often this works, mainly with respect to the breadth of the income tax base, but sometimes it does not. For example, a provision that appears to satisfy allocative tax fairness norms (such as a deduction for basic medical care) might still be critiqued from the perspectives of the other norm categories. And, an allocatively fair personal income tax would include transfers received, resulting in an inefficient double tax in the economy. In any event, economic efficiency is an instrumental norm directed to the goal of maximizing social wealth, without regard to how it is obtained or distributed. Total subordination to economic efficiency would effectively wipe out allocative tax fairness (except by coincidence). And, it would be odd if an “end” (even if only an institutional one) were subordinated to a “means.” The appropriate nexus of subordination of allocative fairness would be to the norm category of social ends, specifically social justice.

Indeed, the one issue that appears to be the universal concern of commentators on the subject of social justice (who, grudgingly or not, accept a market economy based on property rights) is that of top-down redistribution relative to market outcomes, an issue that government is uniquely situated to deal with. It happens that the objective ability-to-pay allocative tax fairness principle is wholly in accord with all views pertaining to this issue, because the objective ability-to-pay tax base is the base-line for the redistribution among the population of material wealth, the only personal attribute that government can effectively redistribute. Even a principled opponent of redistribution should (in principle) favor an ability-to-pay tax base, because, if combined with a flat tax rate, the resulting tax would not alter relative market outcomes. Any tax base principle that deviates from that of ability to pay would necessarily alter relative market outcomes in a perhaps disingenuous fashion. For example, a consumption tax would, ceteris paribus, produce bottom-up redistribution, and a wealth tax would yield top-down redistribution.

Returning to the subordination of horizontal equity to vertical equity, the subordination occurs not in any particular program of redistribution, over which views differ, but rather in the coordination of what it is to be redistributed.

D. Constructing the Ability-To-Pay Principle from the Bottom Up

Here the aim is to begin to construct the ability-to-pay substantive norm of tax fairness from the bottom up, as opposed to from the top down.

One begins with the observation that only personal economic attributes can operate as a relevant basis of apportioning the tax burden among the population in a systematic and fair way.

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105 See id., at 3-4. See generally, James Repetti & Diane Ring, Horizontal Equity Revisited, 13 FLA. TAX REV. 135, 139-45 (2012).

106 See Kelman, note 21, at ???.

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Since taxes entail the sacrifice of money by individuals, the tax base should be conceptualized in terms of the money - as opposed to the welfare, or other characteristics - of taxpayers. Practically speaking, the government cannot appropriate or redistribute a person’s welfare in any subjective sense. Moreover, the government has no legitimate business in reducing the welfare of individuals as a general matter, because destroyed welfare simply disappears and cannot be re-transferred. Although government welfare-enhancing programs can take many forms other than cash payments to individuals, money is a prerequisite for all government programs of whatever nature (including tax credits). Money is wholly objective, universal, transferrable, convertible to other goods, and easy to account for. Money (as opposed to in-kind goods and services) is what can and should be redistributed even from a welfarist perspective, because tax dollars come out of the transferor’s lowest spending priorities and are available to satisfy the transferee’s own spending priorities. A tax base keyed to money outcomes respects individual autonomy, because it does not second-guess the earning and expenditure choices of taxpayers.107

The basic implication of taxes being cash exactions is that a suitable tax fairness principle has to produce a cash amount for a particular taxpayer that the taxpayer is able (or is deemed to be able) to pay over, in part, to the government. The notion of “objective ability-to-pay” precisely captures this notion.

VI. WHAT TAX BASE EMBODIES THE ABILITY-TO-PAY PRINCIPLE?

This part sets out arguments that the ability-to-pay principle translates into a realization income tax, not a wealth tax or a consumption tax.

A. The periodicity of taxes

It might be supposed that an annual wealth tax is an appropriate means of implementing the ability-to-pay principle. Such a conclusion would be incorrect on account of the same reasons for favoring a realization income tax over an accretion income tax.108

At the deeper level of political theory, the tax base should conform to the principle that a government is an agent of (and is accountable to) its constituents and, therefore, must operate on a periodic budget cycle. Government does not (and should not) own an endowment that would enable it to operate autonomously for an indefinite period (as is the case, say, with a charity).

Additionally, since a responsible government must operate on a periodic (say, annual) budget cycle, the funding of government must be conceptualized in the same terms. In other words, the tax base should be viewed as a flow, a portion of which is diverted to the government.109 In the world of tax, the flow must be of money (and its deemed equivalent), which the government takes a portion of. In contrast to a tax-base concept based on flow, a tax base keyed to wealth or endowment is static, like a core sample, frozen section, or balance sheet, disconnected from the notion of continuous government finance, not to mention life itself.

107 See Sugin, supra note 75, at 250-51.
108 See supra text accompanying notes ???.
109 Haig conceived of income as a flow. See supra note 23, at 7, Simons disliked this metaphor, but was insistent on the periodicity of the tax base. See supra note 1, at 50.
A wealth tax destroys economic capital unless the tax rate is less than a safe rate of return. In that case, the so-called wealth tax is really a tax on an imputed rate of return, because it could not exist without an average return on the portfolio in question. The notion of “ability to pay” expresses the idea that taxpayers should contribute to government only out of what they can presently contribute to government (namely, cash or its deemed equivalent). Accordingly, imaginary or hypothetical flow (or return) would not conform to the ability-to-pay principle, which posits a tax on economic outcomes, not economic potential.

The foregoing is not an argument that a wealth tax (or wealth transfer tax) could serve no legitimate programmatic purpose, but only that it does not embody the ability-to-pay principle.

B. Annual Personal Income versus Annual Personal Consumption

The notion that government shares in the flow of money passing through individuals also dictates that tax fairness should not be conceptualized in terms of comparisons of present values of future cash flows, as is advocated by those favoring a personal cash-flow consumption tax (or an endowment tax). Discounting future flows to present values is a useful investment heuristic. However, the government is not investor, and is (therefore) not indifferent to when during an investment/consumption cycle a tax is imposed. Present-value analysis arrests time, but the flow of real time lies at the very heart of personal, social, and political activity and, of course, of the institutions of taxation and government.

To state the matter more concretely, the flow of money through a taxpayer can be reckoned either when the money is obtained by the taxpayer (under an “income tax”) or when it is dis-invested and spent on consumption (under a “cash-flow consumption tax”), in both cases with subtraction for costs of producing revenue. The ability-to-pay concept dictates that a person cannot avoid tax in the current year by making free choices pertaining to the uses of income that result in decreasing her own tax base. (Although deferral of realization might also be characterized as self-help tax base reduction, it is not, because it does not decrease current income, but instead postpones an increase in income.)

Ability-to-pay exists by reason of, and in the moment of, the receipt of cash (or its deemed equivalent) during a taxable year, and is not determined at the end of the year. The taxpayer receiving cash has the ability to pay tax (in the current year) with a portion of that cash, regardless of the disposition of that cash. The tax base is the same for a taxpayer whether cash is saved, invested, or spent on consumption. On an annual basis, an income tax does not discriminate among saving, investing, and consuming.

Consumption tax supporters claim that an income tax in fact discriminates against investors, relative to spenders on current consumption, because of the so-called double taxation.

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110 See BLUEPRINTS, supra note 2, at 39 (asserting that lifetime comparison is appropriate); Lawrence Zelenak, Tax Policy and Personal Identity Over Time, 62 TAX L. REV. 333 (2009) (noting those who make such normative claims). Since equal taxes for equal lifetime incomes (reduced to present value) are obtained only if the tax rate is constant over time, advocacy of this approach is incompatible with a government that can change tax rules (even non-retroactively), or else it amounts to preference for an endowment tax.
of deferred consumption resulting from (1) the non-deductibility of the purchase price of investments (which represents the present value of all future yield ultimately spent on consumption) and (2) the inclusion in the tax base of the excess of future net yield over the present value thereof (the investment net income). But, as noted above, present-value analysis is not apt for comparing taxpayers in terms of what they should contribute to government on an annual basis. In real time, no double taxation occurs under an income tax: the investment income received in the future is new wealth when received. (By the same token, a consumption tax does not – notwithstanding the claims of its detractors - “exempt” income in real time, because, given a positive net yield, the future taxable amount will exceed the currently invested - and deducted - amount.\[111\])

The immediate deduction for investment under a consumption tax would presumably be more salient to taxpayers than the alleged double taxation under the income tax. This must be so, because consumption tax advocates argue that such a tax would significantly increase national savings and investment. Thus, from an annual perspective it is more accurate to state that a consumption tax discriminates in favor of investment than that an income tax discriminates against it.

The comparison between an income tax and a consumption tax, in tax fairness terms, is sharpened when one considers only pure savings for deferred consumption. Suppose X and Y each earn $60K in Year 1 but Y (unlike X, who spends it all on consumption) puts $10K aside in a checking account before spending it on consumption in Year 3. No good reason exists to defer Y’s tax on $10K until Year 3, or for allowing Y to defer tax by spending $10K on a fancy audio system that will yield enjoyment over 20 years.\[112\]

It is sometimes said that the realization principle (not taxing unrealized appreciation) is itself a consumption tax feature of the income tax by being the equivalent of a taxable receipt of the unrealized appreciation coupled with an offsetting deduction for the reinvestment of realized gain in the same property. Basically, this argument is circular, because it assumes that unrealized appreciation in a year is current income. However, factually speaking, no receipt is obtained that would be taxed under a consumption tax, which itself contains a realization requirement at its very core.\[113\] Nor is there is any reinvestment (which, under a consumption tax, would be deductible). Unrealized appreciation is not an increase in the taxpayer’s investment, as would be the case with a realization followed by a reinvestment of the proceeds.

As a general matter, the ability-to-pay norm rejects any notion that one can avoid tax at will. In contrast to a consumption tax, an ability-to-pay income tax does not allow cash income to go untaxed by investing the proceeds. Of course, the realization principle should be protected from abuse, a matter considered in Part VII infra.

\[111\] Under a personal consumption tax, investments made are deducted; under an income tax, they are not.
\[112\] Even consumption tax supporters draw back from allowing deferral of taxation in this case. See BLUEPRINTS, supra note 2, at 122. Andrews, Consumption Tax, supra note 22, at 1160-62, is unsure of the theoretically proper treatment of checking account (cash) balances, but concludes that additions to savings accounts should be deducted, because they earn a return. This demonstrates that the consumption tax is about privileging investments relative to consumption, not about fair treatment of individuals.
\[113\] Under a (cash-flow) consumption tax, borrowed cash, wages, and the reduction of assets to cash (potential consumption) are the central components of the tax base.
In conclusion, no allocative fairness reason exists to tax consumption rather than income, and no broader normative reason exists for the privileging of investment over consumption.\textsuperscript{114} Redistribution only makes sense if the tax base is constituted by income, regardless of its uses.

VII. THE ALLOCATIVELY FAIR PERSONAL INCOME TAX

This part – which is somewhat sketchy due to its broad scope - describes how various common income tax issues would likely be resolved under an objective ability-to-pay income tax. No attempt is made to discuss the full policy implications of the conclusions reached.

A. Gross Income Issues

1. Intangible benefits

As noted earlier,\textsuperscript{115} the following intangible benefits would be \textit{non-income}: avoided costs (as opposed to incurred costs); avoided income (leisure); psychic benefits; the value of self-provided services; the value of using assets owned by another; in-kind support; imputed income from homes and consumer assets; consumption benefits received as business promotions; non-denominated benefits received from government; and employer-provided working conditions, equipment, and (generally) reimbursed business expenses. None of these entail an intake of cash or its deemed equivalent (an example being in-kind employee compensation).

2. Price discounts, prepaid consumption, and insurance benefits

The principle that consumption is derivative of income, and therefore is measured by what is paid for it (rather than the value obtained) leads to the conclusion that price discounts in commerce (including tuition reductions conferred by educational institutions) do not give rise to income.\textsuperscript{116} Of course, price discounts can amount to disguised compensation (or other) income, and in such cases they should be taxed.\textsuperscript{117}

A similar scenario to that of price discounts is presented by a “consumer club,” in which the individual pays a fixed fee that gives her the right to liberally obtain services or goods provided by the club. Examples are auto clubs, fitness centers, and country clubs. Here, the correct taxable amount is the fee paid, not the value of the consumption obtained.

Insurance involves the payment of an annual premium to an insurance company, which agrees to reimburse the insured for specified cash outlays (such as for medical care or tort liability).\textsuperscript{118} It might appear that the insured would have gain equal to the excess of the

\begin{footnotes}
\item[114] For a critique of the fairness claims of consumption tax advocates, see Barbara H. Fried, \textit{Fairness and the Consumption Tax}, 44 STAN. L. REV. 961 (1992).
\item[115] See \textit{supra} text accompanying notes 67-86.
\item[116] Tuition and fee scholarships are generally excludible under I.R.C. § 117(a), (b), (d), but the exclusion implies that non-conformity to the qualification rules results in inclusion.
\item[117] See I.R.C. §§ 83(a), 117(c).
\item[118] The insurance company will normally pay a third-party claimant directly to prevent the insured from diverting the cash to some other use, and will pay the insured only upon proof that the insured paid or lost a specified amount.
\end{footnotes}
reimbursement over the premium, and that the payment to the claimant would (depending on the facts) be a nondeductible personal expense. However, the correct analysis follows that of the consumer-club scenario. The “expense” (nondeductible if “personal”) is the payment of the premium, by which the insured, in an arm’s length commercial transaction, obtains the contractual right to avoid personally having to pay covered monetary claims. The insurance contract is not a wager, because the insured cannot reap a gain relative to her initial position. However, the correct analysis follows that of the consumer-club scenario. The “expense” (nondeductible if “personal”) is the payment of the premium, by which the insured, in an arm’s length commercial transaction, obtains the contractual right to avoid personally having to pay covered monetary claims. The insurance recovery is an offset against the payment (or deemed payment) of the claim by the insured, which is a capital expenditure giving rise to the claim for reimbursement. The taxpayer ultimately has obtained the service she paid for.

3. Realization of income and gain items

The realization concept does not countenance manipulation by arranging to receive value in kind. Thus, the value of property (including consumption rights) received in exchange for services or property would generally count as gross income (or amount realized upon sale), because cash is the commercial norm. Deferred realization with respect to installment sales would be allowed only for unique non-liquid assets for which bank financing is not obtainable.

In-kind receipts from nature (say, from mining) and so-called “found objects” would not be included in income until realized (if ever), because these items are not obtained in transactions with other humans designed to avoid receiving cash.

4. Transfers received

A key difference between a “personal” income tax and a tax on national “economic” income is the inclusion in the tax base of transfers received (such as gratuitous receipts, life insurance proceeds, and tort recoveries), which increase the taxpayer’s ability to pay.

An issue is how the realization principle should be applied here. For structured-settlement (i.e., deferred-payment) tort recoveries, the claimant should be taxed only upon the receipt of cash, as occurs under present law, since the wages that are being replaced by the

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119 The premium is an “expense” by reason of providing coverage for a short period.
120 More elaborate versions of this analysis are found in Halperin, supra note 21; Joseph M. Dodge, The Netting Of Costs Against Income Receipts (Including Damage Recoveries) Produced By Such Costs, Without Barring Congress From Disallowing Such Costs, 27 VA. TAX REV. 297, 339-50 (2007); Jeffrey Kahn, Justifying the Exclusion of Insurance, 125 TAX NOTES 1216 (2009).
121 With property insurance, gain or loss exists where the recovery differs from the adjusted basis in the property. See Clark v. Comm’r, 40 B.T.A. 333 (1939), acq., Rev. Rul. 57-47, 1957-1 C.B. 23.
122 Insurance is distinguishable from other three-party scenarios, where the relieved party constructively receives compensation, a gift, a dividend, etc. See Old Colony Trust Co. v. Comm’r, 279 U.S. 716 (1929).
123 Exchanges of property would rarely occur except to evade tax or to legally avoid tax, such as under I.R.C. § 1031 (providing for no current recognition of gain or loss on certain like-kind exchanges).
125 The taxation of an installment purchaser is discussed infra in the text accompanying notes 119-122.
126 I.R.C. § 104(a)(2) (“… whether as lump sums or periodic payments”).
cash would only have been taxable when received. As for gratuitous receipts, the starting points are that (1) in-kind bequests and gifts are not inherently tax avoidance schemes and (2) trusts are not true taxpayers for allocative tax fairness purposes. Accordingly, deferred realization of income is at least permissible in principle. In the case of outright in-kind gifts and bequests, deferred realization would occur by way of a zero basis for (illiquid) property received. In the case of trusts, deferred realization has the practical advantage of simplification: beneficiaries would be taxed only upon receiving distributions, not upon receiving interests in trusts (many of which are contingent and difficult or impossible to value). Since a beneficiary would have a zero basis in her trust interest, all trust distributions would be includible in income, whether from “income” or “corpus.” Inside-the-trust net income could be ignored as not being the personal income of anybody.\(^{129}\)

In all gratuitous receipt scenarios, the transferor’s basis would disappear, thereby avoiding administrative problems attendant upon deemed-realization-upon-transfer or carry-over-basis reform proposals.\(^{130}\) Basis, as with other tax attributes, should be viewed as being personal to the investor. Incidentally, the prospect of losing basis at death should counter the investment lock-in effect, perhaps the most distorting aspect of the existing realization system.

**B. Allowances off the Bottom**

The ability-to-pay concept not only mandates allowances “off the bottom” for subsistence consumption, but also implicates the taxation of the family and certain personal deductions.

1. **Subsistence allowance**

The subsistence allowance should take the form of a universal per-taxpayer fixed-dollar deduction (the “personal exemption”) key to the level of subsistence (currently about $12K).\(^ {131}\) The exemption would not be phased out, because all taxpayers must maintain subsistence.\(^ {132}\) The existing standard deduction would be repealed as being redundant.\(^ {133}\)

2. **Taxation of the family**

The notion that income equates only with personal consumption would create havoc for family taxation, because family income would be allocated according to beneficial enjoyment—an unworkable principle, and one obviously inconsistent with the ability-to-pay concept.

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\(^{129}\) If this approach is considered too lax, it can be remedied by a system of taxing inside-the-trust trust income pending future distributions, but such a withholding/credit system would be quite complex. Cf. §§ 665-667 (throwback rule for accumulation distributions from domestic trusts prior to 1998).

\(^{130}\) These proposals entail keeping track of historic basis over long stretches of time. Simons, *supra* note 1, at 163-67, favored taxing unrealized gains to gratuitous transferors, as well as taxing gratuitous receipts to the transferees.

\(^{131}\) The U.S. “poverty guideline” for 2015 was $11,770 for an individual maintaining a household only for herself. See 80 Fed. Reg. 3236 (Jan. 22, 2015).

\(^{132}\) A phase-out amounts to a marginal rate increase that operates only in the “bubble” described by the phase-out range, which, under current I.R.C. § 151(d)(3), occurs roughly at the lower end of the top 1% of the population.

\(^{133}\) For 2015, the sum of the standard deduction for an unmarried individual ($6,300) and such person’s personal exemption amount ($4,000) was $10,300. A person could also obtain a maximum earned income credit of $503, which is the equivalent of an additional deduction of $5,030 to a taxpayer in the 10% marginal rate bracket. (This credit is subject to phase-out.) Rev. Proc. 2014-61, 2014-47 I.R.B. 1, [http://www.irs.gov/pub/irs-drop/rp-14-61.pdf](http://www.irs.gov/pub/irs-drop/rp-14-61.pdf).
(a) Who counts as a taxpayer?

Husband and wife (however defined) would be treated as separate taxpayers, as would other members of the household. Treating a family as a single taxable unit requires that the unit’s income be re-allocated among its members for purposes of applying the rate schedule(s), and any such re-allocation principle would be arbitrary. An additional problem would be that of who is to bear the ultimate tax burden for any such “entity” tax.

(b) Income attribution

The objective ability-to-pay principle dictates that gross income be attributed to the earner of the income or the owner of income-producing property, because such person has the right to obtain and control the income. Deductions would be attributed to the payor if the payor is also liable for the payment or is the person who incurred the deductible cost.

(c) Support received

Obtaining enjoyment from another person’s spending or disposition of income is not itself income, because it does not represent any ability to contribute to the federal Treasury. It follows that beneficial enjoyment by way of in-kind support is non-income of the beneficiary and is nondeductible consumption of the donor.

(d) Support provided

Involuntary exaction by government is a justifiable ability-to-pay basis for excluding an item from the income tax, because the exaction itself amounts to an earmarked tax. The psychic benefits of domestic bliss are irrelevant to the analysis. Accordingly, both alimony and child support payments would be deducted by the payor and included by the payee.

Even if the provision of support is seen as consumption spending, consumption is deductible off the bottom to the extent it is subsistence. The provider of the support assumes the dependent’s subsistence living expenses and is entitled to a dependency deduction. Since the dependent enjoys economies of scale by living in the provider’s household, the dependency

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135 Extending joint-and-'several liability to all members of a household would often produce the unfair result of some household members paying the tax on the income of other household members.
137 See, e.g., Treas. Reg. § 1.164-1(a) (1978) (tax payments deducted only by person on whom the tax is imposed).
138 The payment of support is not a transfer “by gift,” but rather pursuant to a legal mandate. See Harris v. Comm’r, 340 U.S. 106 (1950). The distinction between (excludable) support and (includible) gifts already exists under the federal gift tax, where a “cushion” between the two is provided by the annual exclusion, I.R.C. § 2503(b) & (c), and some version of this would need to be imported into the income tax. Another cushion would be to exclude gifts of in-kind consumables below a certain value but to assign them a zero basis, resulting in income if the asset is sold.
exemption would be much less than an independent individual’s personal exemption.\textsuperscript{141} This subsistence-allowance-shifting notion is partially embodied in current-law provision wherein the dependent loses her personal exemption.\textsuperscript{142}

3. Business and investment losses

Deductions related to the production of (business or investment) income are justified to the extent that they plausibly produce (or be aimed to produce) income. Accordingly, deductions should be confined to the activity that generates related gross income. Thus, net operating losses from a business should not be deductible against unrelated wage or investment income, but a carryover to other years of the business is proper.\textsuperscript{143}

The practical problem here is determining what constitutes an “unrelated” activity. In the case of investments, the argument can be made that portfolio theory (diversification) implies that losses from some investments be allowed to offset income from other investments, but not salary or (unrelated) business income.

Contrary to current law, carried-over losses should expire upon termination of an activity, as they have ultimately failed to produce income and do not reduce current ability to pay.\textsuperscript{144}

4. The personal deductions

Although none of the existing personal deductions represent costs of income production, a few of them – excluding the deduction for mortgage interest\textsuperscript{145} – are worth considering in terms of the notions of “subsistence” and “involuntary exaction.”

(a) Personal casualty and theft losses

Unlike alimony and support, casualty and theft losses are not truly involuntary to the extent that the risks could normally have been insured against.\textsuperscript{146}

\textsuperscript{141} According to 2015 poverty guidelines, supra note 131, it cost about $4.2K to support a household dependent at the poverty level.

\textsuperscript{142} See I.R.C. § 151(d)(2).

\textsuperscript{143} Under current law, net business operating losses (NOLs) of an individual are deductible against other income, with excess NOLs being carried over to other years. I.R.C. § 172. However, losses from “passive activities” are confined to the activity. I.R.C. § 469. Net losses from not-for-profit activities are not deductible against current or future income. I.R.C. § 183(a), (b).

\textsuperscript{144} The ability to pay occurred in the year the expenditures were made but not deducted for whatever reason.

\textsuperscript{145} Mortgage interest is not an involuntary exaction, and subsistence housing costs (of whatever nature) are already factored into the personal and dependency exemptions. Moreover, since consumption (under an income tax) is measured by its initial cost (which, in the case of a debt-financed home, equals the present value of future principal and interest payments, plus the down payment), deduction of the interest reduces the net cost of the home relative to the cost incurred by a cash purchaser. Thus, horizontal equity also requires disallowance of the interest deduction.

\textsuperscript{146} This observation leads to a policy critique of the deduction: insurance provided by government through the deduction is irrationally skewed in favor of high-bracket taxpayers, who are the very persons most able to purchase casualty and theft insurance!
Also, as noted earlier, the consumption value of personal-use assets is measured by cost, which represented ability to pay in the year of purchase. No diminution of current ability to pay occurs in the later year of casualty or theft loss, except where cash is stolen or (perhaps) where an objectively compelling need to replace a subsistence item exists. (Alimony and support, which reduce current cash income, are distinguishable.)

(b) Costs of health care

Personal health care costs aim to improve personal welfare and, therefore, fall into the category of consumption. Nevertheless, unreimbursed health care costs could be viewed as “subsistence” if they prevent premature death or incapacitation or keep a person in normal functioning condition relative to the person’s genetic and physical endowment and stage of life. The notion of subsistence would exclude the unreimbursed cost of treatments that are elective, discretionary, lifestyle-enhancing, or directed to high-priority goals unrelated to subsistence (like being able to bear children or having frequent sex). Also, any deduction should only be for the excess of subsistence health care costs in excess of the amount that is implicitly built into the subsistence allowance.

The foregoing leaves out of account the fact that unreimbursed medical costs are “voluntary” to the extent that the taxpayer could have acquired health insurance coverage. However, since some persons cannot obtain insurance, and since insurance coverage of illnesses and conditions is variable, it would be hard to actually apply an “involuntariness” test in practice. The tax issue, at this point, cannot be disentangled from the larger web of federal health care policy, which currently uses carrots (including tax benefits) and sticks (including excise taxes) to increase the scope of health insurance coverage for those not covered by Medicare and Medicaid.

Arguably, then, health insurance premiums are a plausible candidate for deduction, but only to the extent of the coverage for subsistence health care. Since actual insurance policies and programs are not limited to subsistence care, the second-best approach would be to construct a uniform subsistence medical-care amount, and this amount would constitute an addition to the low-income allowance amount for persons paying premiums, in lieu of any separate deduction (or exclusion) for health care premiums. Out-of-pocket subsistence health care costs should be viewed as voluntary consumption if the taxpayer’s net income exceeds a level (say, $100,000) where it is deemed that the taxpayer could have obtained insurance, unless the taxpayer can prove that the costs could not reasonably have been insurable.

147 See supra text accompanying notes 30-49.
148 A casualty loss deduction is not typically found in the tax systems of other countries. See Ault & Arnold, supra note 52, at 283-84.
149 Health care paid or reimbursed by insurance is not a health care cost of the taxpayer over and above the insurance premiums. See infra text accompanying notes [122-27].
150 This test is stricter than the current one of “affecting any structure or function of the body.” I.R.C. § 213(d)(1).
151 Cf. I.R.C. § 213(a) (deduction is for unreimbursed medical care costs in excess of 10% of adjusted gross income).
152 Cf. I.R.C. § 63(f) (additional standard deduction for the aged and/or blind, for assumed incremental health care).
153 Currently, premiums paid by self-employed persons are deductible above the line, I.R.C. § 162(l), but employer-paid premiums yield the same result by way of exclusion under I.R.C. § 106.
Under a single-payer national health care system, all tax benefits could be eliminated.\footnote{See Ault & Arnold, supra note 52, at 284-86.}

(c) Taxes paid

The possible justification for deducting taxes is that taxes entail a “forced” decrease in current cash income. However, property taxes are voluntary, because ownership of taxable property is voluntary. Additionally, since property taxes are deductible as maintenance costs where business or investment property is involved, it would be illogical to treat property taxes as a cost unrelated to the property (a coercive “tax”) in the personal-use context.

Likewise, regardless of whether one views retail sales taxes (and the like) as being voluntary,\footnote{See Turnier, supra note 2, at 275-81 (viewing property and sales taxes as voluntary).} they are not really “taxes” but rather a part of the purchase cost. Under income tax principles, transaction costs (of which a sales tax paid by the purchaser is a clear example) are treated as part of the purchase price and, if the cost is a capital expenditure, are added to basis.\footnote{See, e.g., Temp. Treas. Reg. § 1.263(a)-2T(f)(3) (2011); Woodward v. Comm’r, 397 U.S. 572 (1970).} Furthermore, treating sales taxes as part of the purchase price avoids having to account for them separately, an impossible task for most taxpayers.

Of the common tax categories, only state income taxes are involuntary exactions of current cash,\footnote{That taxpayers can move to jurisdictions without income taxes is not sufficient to call such taxes “voluntary,” since such a move entails significant monetary and psychological costs (including loss of the deduction).} which are not already included in allowances off the bottom, because they are not payable by low-income persons, and some states do not impose them at all.\footnote{Transaction costs relating to the determination of tax liability are neither involuntary nor a component of subsistence. Thus, existing I.R.C. § 212(3) should be repealed. See Calvin H. Johnson, No Deduction for Tax Planning and Controversy Costs, 129 TAX NOTES 333 (Oct 18, 2010).}

5. Deductions to carve out other spheres of collective activity

(a) Taxes once again

A political-theory rationale for deducting U.S. state taxes is to carve out state government activity from federal government activity. Since this carve-out is a feature of the basic institutional landscape conceding a measure of sovereignty to states, it would “precede” (as it were) the federal tax system. A deduction removes state (tax-financed) activity from having to contribute to the federal government.

This co-sovereignty rationale does not mandate a deduction, because the constitutional structure of the United States does not immunize state government finance from federal interference.\footnote{See South Carolina v. Baker, 485 U.S. 505 (1988) (holding that the 10th Amendment to the Constitution does not bar a federal tax on state bond interest).} Likewise, the weak federalism rationale does not compel “neutrality” by either allowing all state taxes to be deductible or allowing no such taxes to be deductible. The rationale only “allows” Congress to accommodate the states by way of a deduction.
(b) Charitable contributions

Under an ability-to-pay income tax, charitable gifts are non-subsistence voluntary payments not aimed to generate income, and would be nondeductible. External-to-tax norms are the usual (if contested) rationales for the deduction or perhaps some other government subsidy.

As with state taxes, a non-instrumental rationale for the charitable deduction derives from political values. The charitable sphere bears a relationship to the federal government that somewhat resembles that of state and local governments, in that the charitable domain can be described as one involving private spending choices that pursue collective goals. The charitable sphere is accommodated, without giving it the status of a co-equal sovereign, by way of a deduction. Because the deduction removes (within limits) the contributed amount from claims by the federal government, it fits better with foundational values of individual and associational autonomy than do such alternative mechanisms as tax credits or matching grants, which would effectively allow private persons to control federal spending.

The oft-repeated objection that the deduction disproportionately favors the rich occupying higher marginal rate brackets is not (as is the case for state taxes) responsive to the pre-tax rationale for the deduction. The objection assumes that contributions are within the normative personal income tax base, and that the government, having a monopoly on the production of public goods, is “giving” its tax dollars away. This assumption is contrary (for better or worse) to political and social practice in the United States. Nevertheless, government oversight is necessary to keep the charitable domain in line.

C. Realization of Deductible Costs

Up to this point, the ability-to-pay income tax hews fairly closely to the existing income tax. The contention here is that certain rules pertaining to realization deviate from the ability-to-pay norm and undermine the income tax as a whole. Since the topics discussed below are developed in a separate piece, the exposition here is somewhat abbreviated.

1. The accrual method

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160 See Johnny Rex Buckles, The Community Income Theory of the Charitable Contributions Deduction, 80 IND. L. J. 947, 970-74, 979-86 (arguing that community income should be considered pre-tax); Evelyn Brody, Of Sovereignty and Subsidy: Conceptualizing the Charitable Tax Exemption, 23 J. CORP. LAW 585, 587-89 (1998) (exemption/deduction scheme for charities is less intrusive than other government support mechanisms).

161 The deduction cannot exceed a specified percentage of a taxpayer’s net income. See I.R.C. § 170(b).

162 Instrumental considerations also favor the deduction approach, because a deduction produces greater leverage on those who have the most discretionary income to give away.

163 If P and R are in the 10% and 36% rate brackets respectively, R’s tax savings per deductible dollar are 3.6 as large as P’s. However, the point is undermined (or negated) if one accepts the declining-marginal-utility-of-money thesis, which, as a justification for progressive tax rates, causes the upside-down effect in the first place.

164 Not surprisingly, the benefits for charities under the tax systems of continental Europe, which have more of a statist tradition than in the Anglo-American world, are more restricted than is the case with the United States. See Ault & Arnold, supra note 52, at 286-88.

165 See Joseph M. Dodge, Income Tax Accounting Consistency through Elimination of Accrual, with Particular Reference to Borrowing and Depreciation, ???
The accrual method of tax accounting accelerates the tax reckoning (realization) of gross income and expense deduction items to the time the right to receive cash, or the obligation to pay cash, is fixed, and is contrary to the ability-to-pay realization income tax, which would follow the cash method of tax accounting, in which income occurs with the receipt of cash (etc.) and expense deductions with the payment of cash.

The accrual method has its origins in business accounting theory, but it is now recognized that tax theory is independent of accounting theory. The accrual method, rather than being a true accretion tax feature of the income tax, is just another realization rule that avoids valuations. Inconsistent tax accounting approaches on the income and deduction sides create “tax float” opportunities that in turn have caused ad hoc legislation to be enacted to counter such opportunities, greatly complicating the Code.

“Reserve” accounting (showing statistical predictions of future cash outflows to be charged against income even though not “fixed”) has had a long history in conservative financial accounting, but it has no place in the income tax (as is currently the case), because no acceleration-of-income counterpart exists.

2. Borrowing

Borrowed money has long been viewed as non-income due to the simultaneous accrual of an offsetting liability to repay the principal, resulting in no net “increase in wealth.” This rule applies even to cash-method taxpayers.

(a) Cash borrowing

The exclusion for borrowed cash is inconsistent with the ability-to-pay principle. In the case of cash borrowing, the liability to repay principal represents an expected or predicted future, but as yet unrealized, cost. An accounting liability does not tie up current cash funds or render one’s assets unusable or valueless. An ability-to-pay income tax would (1) include borrowed cash in current income, and (2) allow deduction of principal repayments as they occur.

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168 Accrued items are reckoned at their face amount rather than market value. Although it is said that face value equals fair market value if market-rate interest is charged, accrual is not contingent on any interest charge.
170 Examples are I.R.C. §§ 83(h), 267(a)(2), 404(a)(5), and 1272.
172 An analogous scenario to the acceleration of deductions is deferral of prepaid income, which is sometimes allowed for tax purposes. See generally, RCA Corp. v. United States, 664 F.2d 881 (1981). Such deferral would not be allowed at all under an ability-to-pay income tax.
173 A corollary of the borrowing exclusion is that income arises when such liability disappears without its being satisfied. Treas. Reg. § 1.61-12 (1997) (referring to debt-discharge income, usually known as COD income).
174 Interest is considered an expense relating to the asset or activity financed by the borrowing, and would be deductible or not accordingly. See I.R.C. § 163(a), (h)(1).
(b) Purchase-money debt

Inclusion of purchase-money debt in income would render profitable investments into unprofitable ones, as well as creating an insuperable tax barrier to the debt financing of homes and cars. A workable solution is to treating debt-financed property acquisitions as a deferred investment. Both two-party and three-party purchase-money debt would be excluded from the borrower’s current income, not under the offsetting-liability theory, but instead on the ground that no cash is actually or constructively received by the credit purchaser. Principal payments on the debt would, along with any downpayment, constitute the basis of the asset. To illustrate, suppose that K borrows $1M to invest in bonds yielding an interest rate equal to that of the interest rate on the loan. The borrowed $1M would not be includible as income, and the interest income and interest expense would wash out, but principal payments would constitute the bond’s basis, which would eventually total $1M, fully offsetting the $1M received upon maturity of the bond. These results correctly reflect the economic wash.

This approach would render obsolete the Crane doctrine, which is the foundation of many tax shelters. The rationale for the Crane doctrine would be further eroded if depreciation were eliminated (as is suggested shortly).

(c) Credit card transactions

If credit card transactions were treated as two-party credit purchases, the cost (if needed for tax purposes) of any item would be virtually impossible to determine, because credit card payments (if not for the full amount owed), would need to be allocated among all items purchased. Under current law, credit card transactions are treated as third-party cash loans by the credit card issuer. This approach is well-suited to an ability-to-pay income tax: the taxpayer would include (or deduct) her net increase (or decrease) in credit card debt for the year. Any deductible (or basis-carrying) items would be deemed to have been fully paid for.

3. Depreciation of productive assets

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175 See Joseph M. Dodge, Exploring the Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated, 26 VA. TAX REV. 245 (2006).
176 In a real estate closing, the funds from the purchaser’s mortgage lender go directly to the seller (and/or seller’s lienholders) and not to the purchaser.
177 If the asset is sold, with the debt being taken over by the purchaser, the seller’s amount realized would not include the unpaid debt.
178 See Crane v. Comm’r, 331 U.S. 1 (1947) (standing for the proposition that purchase-money debt is immediately included in basis, even for two-party debt, and regardless of whether the liability is recourse or nonrecourse).
179 Under the Crane doctrine, the debt supports interest and depreciation deductions. Two-party debt is susceptible to being unreal, infecting the interest and depreciation deductions. See Theodore S. Sims, Debt, Accelerated Depreciation, and the Tale of the Tea Kettle: Tax Shelter Abuse Reconsidered, 42 U.C.L.A. L. REV. 263 (1994). The problem disappears if basis only includes cash actually paid for the property.
180 The Crane case was partly decided on the ground that basis had to include purchase-money debt in order for a rational depreciation system to function. However, depreciation could be taken on the initial value, and if basis fell below zero, the negative basis amount would be recaptured as income or gain.
Under the current income tax, cost recovery with respect to determinable-life assets used in an income-production activity ("productive assets") takes the form of annual depreciation and amortization deductions. Under an accretion income tax, depreciation is legitimate, but it would be measured by the annual decline in value of the asset. Since annual valuations of productive assets are impossible, Congress has enacted formulaic methods for computing depreciation. However, avoiding annual valuations by arbitrary conventions does not itself satisfy the realization principle. Realization on the deduction side, in the case of a productive asset, should refer only to a sale or some other final disposition.

The normative claim for depreciation is external to tax, namely, that it does not (in theory) distort the prices of productive investments. The rationale derives from a mathematical model based on dubious assumptions. The exercise simply disguises depreciation as an accretion feature embedded in a predominantly realization income tax. Finally, conforming one feature of a tax to economic neutrality does not render the tax as a whole more neutral. But moving to a 100% accretion tax is administratively and politically impossible.

Depreciation is also an anomaly in the sense that the income tax fails (with one minor exception) to tax passage-of-time gains. Internal consistency with the lax accrual basis for depreciation would require income accruals with respect to all rights to future cash or expectations of receiving future value, such as (for example) the inside build-up of life insurance contracts, remainder interests, market discount bonds, and (most importantly) rights to deferred compensation.

In sum, depreciation – along with the current tax treatment of debt - tilts the playing field of the current income tax towards systematic understatement of income, however defined. Also to be weighed on the side of eliminating depreciation are the vast gains for tax compliance and administration, especially for individuals who own rental real estate.

D. Taxation of Business Entities and their Owners

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182 I.R.C. § 167(a) allows the series of annual deductions for “exhaustion,” “wear and tear” and/or “obsolescence,” all of which denote the “wasting” of the asset over a period of time. Non-wasting assets (such as land and shares of stock) are not depreciable, and neither is property held for personal use.
183 I.R.C. §§ 168, 197.
184 See Simons, supra note 1 at 86-88 (here critiquing E.R.A. Seligman).
185 Apart from depreciation (allowed by statute), partial losses on an indivisible asset are not allowed under current law. See Treas. Reg. § 1.165-1(d)(1) (1977).
187 The Samuelson model treats a productive asset as if it were a financial instrument (like a mortgage) that incurs partial losses that are realized with the passage of time.
188 A productive asset yields no cash returns (like a financial instrument), and has no fixed duration except by statistical prediction. The Samuelson analysis also assumes a before-tax discount rate and no equilibrium effects.
189 The theory of the second-best is precisely this: “In an economy with some uncorrectable market failure in one sector, actions to correct market failures in another related sector with the intent of increasing economic efficiency may actually decrease overall economic efficiency.” http://en.wikipedia.org/wiki/Theory_of_the_second_best.
190 The exception is accrual of original issue discount, but only in the case of certain fixed-dollar obligations. See I.R.C. §§ 1272(a)(1), 1373(a)(1).
From an allocative fairness perspective, only individual taxation matters, and the existing corporate income tax is irrelevant. However, the problem remains of how to tax equity interests in business entities held by individuals. A public corporation cannot realistically be forced to pay dividends, although shareholders can readily sell their shares on an exchange. Equity in non-public entities is, generally speaking, non-liquid. Both pass-through and mark-to-market approaches violate the realization principle. But not imposing any tax until distributions are made to equity-holders would invite indefinite deferral of income to individuals.\textsuperscript{191}

The way to honor the realization principle for individuals across the board, while preventing its abuse, would be to subject virtually all business entities (and their equity-holders) to a withholding/credit system, commonly referred to as an “imputation” system.\textsuperscript{192} Such a system imposes an entity-level flat-rate tax, which operates as a withholding tax pending distributions to equity-holders. Distributions to individual equity-holders would be grossed-up by the entity withholding tax thereon, and the grossed-up amount would be included in the gross income of equity-holders when received. The equity-holder would then obtain (in the year of the distribution) a refundable tax credit equal to the gross-up amount, which represents the tax withheld by the entity.

The imputation system would apply to all business entities with more than one equity-holder. Exceptions would (perhaps) lie only for general partnerships and entities obtaining the unanimous consent of equity-holders.

E. International Taxation

Fair taxation is generally thought of in terms of equal treatment by the government of equally-situated taxpayers, but this approach appears to be non-sustainable in the international arena, because source and nationality (the two accepted jurisdictional bases for taxing income)\textsuperscript{193} are “elective” to a meaningful degree, especially for the wealthy. A taxpayer with economic activities in two or more countries could well end up paying an aggregate tax lower than what would be imposed by any interested country on aggregate income. For example, suppose K, a resident of Country W that imposes no income tax, has $1.2M of taxable income sourced equally in countries X, Y, and Z, each of which would have imposed a tax, at progressive rates, of $480K (@ 40% average rate) if all $1.2M of the income were to have fallen within its taxing jurisdiction. However, each of countries X, Y, and Z is only allowed to tax $400K of the total, and due to the fact that K is now in lower marginal rate brackets in each country (@ 25% average rate), K’s aggregate tax is $300K [3 x ($400K x .25)], for a tax savings of $180K.

The problem is solved if each interested country is allowed to calculate its tax on the basis of the taxpayer’s aggregate (world-wide) taxable income but could only impose a tax equal to its share thereof. In the K example, if we assume that each of Countries X, Y, and Z has a one-

\textsuperscript{191} Simons, supra note 1, devotes Chapter IX of his text to the problem of undistributed corporate earnings.
\textsuperscript{192} See Am. Law Inst., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER’S STUDY (1993) (advocating this approach for corporations only, and discussing technical issues).
\textsuperscript{193} For present purposes, it is not necessary to discuss the pervasive issue of double taxation of the same income that occurs when the nationality jurisdiction of one country overlaps with the source jurisdiction of another. Suffice to say that various mechanisms are used.
third interest in K’s aggregate taxable income, then X, Y, and Z would impose a tax equal to one-third of its hypothetical tax of $480 calculated on the basis of K’s world-wide income of $1.2M. In the end, K would pay aggregate tax of $480K. Such an “equity-interest” system would, of course, require (1) informing all interested countries of the individual’s aggregate taxable income and (2) applying an agreed-upon mechanism for allocating such income among jurisdictions. Such would be an imposing technical and administrative challenge, to say the least.

IV. CONCLUSION

A theory that can’t explain significant and enduring features of positive tax law (such as the realization principle or the exclusion of imputed income) – except as being dictated by administrative convenience - is not a very good theory in the positive (explanatory) sense. Additionally, the co-optation of Simons income by those whose prime normative directive is economic efficiency undermines not only Simons’ agenda but also the status of the income tax itself. These problems, along with the loss of the integrity of the tax system, can be addressed by restating Simons income in terms of objective ability-to-pay income.

An objective ability-to-pay personal income tax is not a tax based on “faculty,” “ability” (income-producing potential), endowment, well-being, or utility. Instead, the tax base is the year’s realized income (inflow of disposable cash or deemed cash-equivalent) decreased by the same year’s realized costs of income production (expenses and losses, but not depreciation). The tax base is also reduced by costs of subsistence and involuntary exactions, although, at the border, issues exist as to what is truly involuntary. Finally, the tax base may be subject to pre-tax carve-outs for other government or quasi-government activity. Consumption” under an objective ability-to-pay tax is not a category of income, and instead expresses only a rule of nondeductibility of the costs of consumption.

The notion of objective ability to pay is an internal-to-tax tax fairness norm that is constructed from the ground up by considering the role of taxation (in a liberal society) to raise cash revenue in an annual budget cycle without unduly intruding into the private (non-market) realm. It also happens that an ability-to-pay personal income tax can, by way of allowances off the bottom, perform a “tentative” redistributive function. Furthermore, allied with progressive rates, it is ideally suited to off-the-top redistribution, although (with a flat rate) it can avoid playing any such role.

This vision of substantive tax fairness is not meant to always trump external-to-tax norms relating to welfare and economic efficiency. Accordingly, the relationships among core tax norms are often going to be messy. Nevertheless, substantive tax fairness warrants a seat at the table of tax system design, and should not be dismissed out of hand on the ground that it lacks specificity or the trappings of science and math. An objective ability-to-pay income tax is compatible with, but clearly a second-best accommodation to, economic-efficiency and welfarist norms, but the first-best approaches favored by them lead back to an unworkable (and politically nonviable) accretion income tax. Mid-level norms of fairness, political culture, and pragmatism yield the good, if perhaps not the intellectually beautiful.