THE FAIR INCOME TAX

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The Simons[1] concept of an income tax – 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 - has for roughly fifty years been a gold standard of income tax theory and policy discussion.[2]

[1] Henry C. Simons (1899-1946) developed the concept in Henry C. Simons, Personal Income Taxation (1938). The concept is commonly referred to as the Haig-Simons concept of income, but the contribution of Robert M. Haig (1887-1953) might be called "preliminary" and lacking in elaboration or discussion of practical issues.

[2] The Simons income concept was advanced as the normative concept of income in Stanley S. Surrey, Pathways to Tax Reform 12-22 (1973). See also, 3 Rep't of Royal Comm. on Tax'n (Canada) 22-23 (1966) (restating the concept in terms of the command of resources for personal use); John F. Witte, The Politics and Development of the Federal Income Tax (Madison WI 1985); Richard Goode, The Economic Definition of Income, in Joseph A. Pechman (ed.), Comprehensive Income Taxation 1, 7-10 (Washington 1977); U.S. Treas. Dept., Blueprints for Basic Tax Reform 1-3 (1977) ("Blueprints"). Pieces in which Simons income is the starting point for analysis include: William Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 313 (1972) (hereinafter "Personal Deductions"); Michael J. McIntyre, *An Inquiry into the Special Status of Interest Payments*, 1981 Duke L. J. 765, 769 (1981); William J. Turnier, *Evaluating Personal Deductions in an Income Tax – The Ideal*, 66 Cornell L. Rev. 262, 270-76 (1981); Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 46-53 (1990); J. Clifton Fleming, Jr. & Robert

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This article seeks to reconstruct the Simons income concept in order to (1) give it a solid normative foundation, (2) conform it to fundamental political values, and (3) avoid unnecessary practical problems. The revised concept of personal income can be called "objective ability-to-pay income," which means, on an annual basis, an individual taxpayer's realized accessions to wealth less realized decreases in wealth aimed to produce income and less amounts deemed beyond the reach of the federal government, such as subsistence allowances off the bottom." The tax that derives from this concept will be called the "fair income tax."

The Simons concept has not been adopted in the tax law as formulated because of two problems that appear to be practical in nature. The first problem is that the "net increase in wealth" (for the year) component of income, if taken literally, would require annual valuations of assets and liabilities. (An income tax that requires such valuations is called an "accretion" income tax.) To the disappointment of those interested only in economic efficiency, annual valuations are impossible (for the most part), and actual income taxes avoid valuations under the "realization principle," which (on the gross income side) is widely understood to refer to the receipt of cash or its deemed equivalent.[3] The second problem is that the Simons concept implies that consumption is an independent category of income (apart from "net increases in wealth"). Treating consumption as income opens the door to claims that subjective and off-market material benefits are income, another impossible task, much to the disappointment of welfarists.

The objective ability-to-pay personal income concept solves these. The "net changes in wealth" component of income would be modified on account of embracing realization, and consumption would be recognized as a principle of non-deductibility. Pushing further, the "consumption" notion would be downgraded, because the term as presently used is ambiguous[4] and is insufficient as an "umbrella" nondeductibility principle by reason of being both under-inclusive[5] and over-inclusive.[6] Under a fair income tax, the "core" deduction categories would only be two, namely, (1) realized costs of obtaining income, and (2) subsistence consumption (not part of the Simons definition). A possible (and controversial) third category might be called "political-structure accommodations" (also not part of the Simons definition).

The notion of "objective ability to pay" is an internal-to-tax substantive tax fairness norm grounded in the function of tax as an institution, and the function of tax as an institution is further grounded in, and constrained by, liberal political theory and practices. 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 the unworkable Simons concept. Mid-level norms of fairness, political culture, and pragmatism yield the good, if perhaps not the perfect.

J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement*, 30 Va. Tax Rev. 135, 154-65 (2010).

[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 an accretion income tax, X has gain of $20K in Year 1 and a loss of $3K in Year 2. Under a realization income tax, 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) gain in Year 2 of $17K. See §§ 1001(a) & (b) and 1012.

[4] See Boris Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925 (1967).

[5] Transfers, although not "consumed," would be nondeductible unless aimed to produce income.

[6] Subsistence consumption would not be taxed on account of off-the-bottom allowances (deductions).

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Part I deconstructs the role of "consumption" under the Simons concept of income. Part II constructs the pragmatic objective ability-to-pay realization personal income tax, with allowances off the bottom, on the basis of political theory and an elaboration of an internal-to-tax notion of tax fairness. Part III follows with an outline of basic features of such a tax, which closely follows the existing income tax, except (controversially) for certain personal deductions, accrual accounting, depreciation, and certain borrowing. The taxation of business entities is touched upon, and a notion of international tax fairness is set forth.

I. THE PROPER ROLE (IF ANY) OF "CONSUMPTION" UNDER AN INCOME TAX

The oft-cited Simons definition of personal income is "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." The term "consumption" refers (tentatively) to the using up (destruction) of economic goods by the taxpayer during the taxable year,[7] and it is "personal" if the destruction is an end use rather than a means of generating gross receipts (incremental wealth) for the taxpayer.[8] This Part argues against equating consumption with 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 of Income

1. Re-stating the equation

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.[9] Since personal consumption is a subset of "decreases in wealth," then:

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.

2. Accounting identity

Why would Simons' equation have taken the form that it did? 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. Since the "changes in wealth" component of income is

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[7] See Simons, note 1, at 49-50.
[8] Costs of producing income are deductible under a normative income tax, and are in fact deductible (with certain exceptions) under positive tax law. See §§ 162(a), 165(a) & (c), 167(a), and 212(1) & (2).
[9] As Simons states the matter, note 1 at 49, "Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods)."

determined at the end of the period by subtracting current consumption, it is necessary to add back rights exercised in consumption during the year. However, 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.

Simons was attempting to appeal to accountants by invoking the convention of equating sources ($50K wages) with uses ($45K consumption+ $5K savings). It is true that the effect of the *income* tax (as op[posed to a consumption tax) is to cause both consumption and new savings to be taxed, but otherwise the attempted accounting exercise does not prove that the essence of income lies in adding together "consumption" and "net savings," 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 or spent. 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).[10]

B. Consumption as a Use of Purchased Wealth

Although certain commentators agree (or appear to agree) with the proposition that consumption is a principle of non-deductibility (rather than one of income inclusion),[11] others disagree.[12] This section attempts to address the merits of the issue by way of a fuller reading and analysis of Simons' text itself.

1. Consumption rights versus pure enjoyment

Those who claim that the Simons concept of income requires that "consumption" - defined as an item that benefits (gives satisfaction to) the taxpayer personally - be treated as an independent component of income 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 fundamentally a flow of psychic satisfactions.[13] The core project of Haig and Simons was to objectify the economic concept of

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[10] 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).

[11] See Richard Goode, The Individual Income Tax 11-12, 17-19 (1976); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World* , 31 Stan. L. Rev. 831, 834 (1979); Daniel I. Halperin, *Valuing Personal Consumption: Cost Versus Value and the Impact of Insurance*, 1 Fla. Tax Rev. 1 (1992); Thomas Chancellor, *Imputed Income and the Ideal Income Tax*, 47 Ore. L. Rev. 561 (19??); Alfred G. Buehler, *Ability To Pay*, 1 Tax L. Rev. 243 (1946).

[12] Those adhering to economics or welfarist approaches view personal consumption as income. Here consumption is viewed as a flow of satisfactions or utility, and encompasses imputed income from consumer durables and even leisure. See Joseph T. Sneed, The Configurations of Gross Income 88-97 (1966) (purporting to follow Simons); William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113, 1114-15 (1974) (hereinafter "Consumption Tax") (stating that leisure and imputed income constitute true accretions).

[13] See Robert M. Haig, "The Concept of Income – Economic and Legal Aspects," in Robert M. Haig (ed.), The Federal Income Tax 54-59 (1921), *reprinted in* Am. Economics Ass'n, Readings in the Economics of Taxation 59 (R. Musgrave and C. Shoup eds. 1959).

personal income to render it workable in terms of market outcomes. 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."[14] The term "economic power" as used by Haig contemplates contract or property rights, as opposed to subjective satisfactions. Similarly, Simons defines consumption in terms of the value of *rights* exercised in consumption.[15] 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,[16] but the basis cannot produce any deductions.[17]

What, then, if the taxpayer (X) receives economic benefits from another without incurring any material cost, as by receiving free food, beverages, and entertainment in a social or business context, or by benefitting from the government provision of infrastructure and subsidized education? Under the Simons definition, these benefits – although having economic 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. X in these examples has no entitlement to anything, and is not exercising consumption power previously held or acquired.

Simons, in his discussion of an officer in the sovereign's retinue[18] (receiving various perks, such as fancy uniforms, food, and entertainment) missed the point of his own definition of consumption by focusing inappropriately on the imponderable degree of psychic enjoyment of the officer, implying that the income resides in the enjoyment itself.[19] To the contrary, under Simons' own definition of consumption 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. In this example, it seems clear that the officer received no entitlements. The spending is at the will, and under the control, of the sovereign, and the arrangement is for the sovereign's benefit. The fact 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 for services.[20]

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[14] Id. at 7.

[15] See Simons, note 1, at 50. Both Haig and Simons, as well as the Canadian Royal Commission on Taxation, note ???, at 22-25, define income in terms of economic power (command of economic resources for personal use). One cannot command what is owned by another or by nobody.

[16] See § 1012 (basis equals cost); Treas. Reg. § 1.263-1(a); Prop. Reg. 1.263(a)-1(c) (amounts paid to acquire or produce real or personal tangible property are not deductible).

[17] See §§ 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.

[18] The problem as stated by Simons, note 1, at 53, is really "solved" by the stipulation that the officer receives the same cash salary as one performing similar duties but without the perks. If the former were paid less than the latter, the perks could well be compensation income, at least in part.

[19] See Simons, note 1, at 52-54.

[20] 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

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.[21] If a taxpayer provides labor or capital to another in return for the consumption right, the transaction is the equivalent of the receipt of cash income followed by a purchase of the services.

2. The irrelevance of "consumption value"

The Simons notion of "the value of rights exercised in consumption" appears to refer to what might loosely be described as timing issues with respect to consumer assets. Three such scenarios are posed: (1) the consumer asset that increases in value before it is consumed, (2) the consumer asset that fails to yield personal satisfaction, and (3) the consumer asset that yields consumption value on an annual basis.

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

Since rights to consumption are assets, then it would seem to follow that the annual changes in value of consumer assets should also be taken into account, at least if annual changes in business and investments values are also taken into account, as occurs under an accretion income tax. Simons concedes that *annual* valuation of consumer assets is impractical, but that the "consumption value" (value of such assets when consumed) might be taken into income.[22] The issue can be posed by supposing that K purchases a bottle of wine for $20 and five years later it appreciates in value to $50 and is then consumed. Consumption (when the bottle has a value of $50) would merely mark the valuation date for measuring the accretion gain of $30.[23] The loss of the $50 value of the bottle attributable to consuming it would be a nondeductible loss. However, what would be taxed here is not consumption value but investment gain that is taxable under an ideal accretion tax. Simons' discussion of appreciated consumption rights is not really an argument that the value of rights exercised in consumption is income. In short, Simons' analysis of this scenario accords with the view of consumption rights as being wealth.

Now suppose that tastes in wine change and the bottle decreases in value from $20 to $13, at which time it is consumed. If Simons were to be consistent, then X should obtain an investment loss deduction of $7 to go along with the nondeductible consumption loss of $13. However, no commentator (to my knowledge) – certainly not Simons[24] - has proposed such a result. Instead, the entire $20K (the cost of the asset) is viewed as the measure of consumption. Treating X's gain of $30 as income or his loss of $7 as a deductible investment loss would be

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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).

[21] 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).

[22] See Simons, note 1, at 119-120.

[23] See Haig, note 14, at 6 (offhand reference to equity).

[24] Simons, note 1, at 100, 162, concedes that consumption has to be measured by cost.

impossible (as opposed to being difficult) to implement, because the exercise of a consumption right occurs in private, and does not occur in a market transaction.

A possible equity argument that X should be taxed the same as Y (who purchases the same bottle for $50K before consuming it) is circular by assuming that value (rather than cost) is the proper measure of comparison. If, instead, cost is the index of consumption, the tax treatment would not hinge on appreciation or depreciation, and valuations would be pointless.

(b) 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 casualty and theft, where the deduction is keyed to the lesser of the cost or (decline in) value at the time of casualty or theft.[25] The theory is that these losses represent decreases in wealth that are not attributable to ordinary personal consumption, in the sense of enjoyment.[26] However, this statutory rule is an anomaly.[27] Moreover, the non-enjoyment rationale for the deduction for casualty and theft losses is unconvincing. From the axiom that consumption is *not* deductible, it does not follow that non-consumption decreases in wealth are per se deductible. The casualty or theft loss fails the core "net income" norm for deductibility, namely, that it is a cost of the production of income. Simons himself did not favor the deduction.[28]

Allowing 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 Chrystal 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.[29]

(c) Imputed income from home ownership

Although Simons concedes that changes in value of consumer items should be ignored, he maintains that imputed income (the gross fair rental value) of owner-occupied homes should be included in the income tax base.[30] This conclusion is widely (if not universally) accepted in the tax literature, at least as an ideal.[31] However, Simons himself does not equate imputed income with consumption, but instead characterizes it as an investment yield in the form of a

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[25] See § 165(c)(3) (allowing a deduction for personal casualty and theft losses); Treas. Reg. § 1.165-7(a)(2) & (5) (tentative deduction amount is the loss in value, but not to exceed basis).
[26] See Turnier, note 2, at 272.
[27] 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.
[28] See Simons, note 1, at 120.
[29] 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.
[30] See Simons, note 1, at 110-22.
[31] See Blueprints, note 2, at 7 (1977); Goode, note 12, at 139-43; Richard A. Epstein, *Consumption and Loss under the Internal Revenue Code*, 23 Stan. L. Rev. 454 (1973).

"service."[32] Although the value of an investment asset is can be ascertained by discounting future cash returns to the present, it doesn't follow that all assets having value generate returns in cash (or cash equivalent). Services are not cash equivalent unless the transaction can be constructed as a receipt of cash followed by a purchase of the service. One can, of course, rent the home, and the rental payments can be funded by an investment in an annuity. The annuity alternative is 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). This argument, however, does not succeed in demonstrating that a homeowner actual obtains an income return on investment, because the purchase of an annuity to pay rent, being pointless, is a superfluous aspect of the comparison between owning and renting.

The real issue posed by the annuity hypothetical is that of tax discrimination between consuming and investing generally, as opposed to the discrimination between two forms of consuming. Taxing imputed income would put the ownership of consumer durables on a par with investments in terms of tax treatment, but consumption would otherwise still be favored (relative to investment) under an income tax.[33] Stated differently, the exclusion of imputed income on consumer assets results in treating all consumption equally.

Another version of the argument for taxing imputed income is that ignoring imputed income discriminates against the renter paying nondeductible rent relative to the homeowner.[34] Equity in taxation calls for similarly situated taxpayers to be taxed equally.[35] However, homeowners and renters are not similarly situated, apart from the fact that both occupy a dwelling, because the risks, responsibilities, and rewards differ between owners and renters.[36] This argument actually backfires, because it turns out that homeowners and renters are actually taxed the same from a forward-looking perspective. The cash used to purchase the home represents the present discounted value of future imputed rental values. Purchasing a home is like paying prepaid rent.[37] In both cases the rule is to disallow any deduction for the cost of personal consumption.

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[32] See Goode, note 12, at 139-43; Gerald M. Brannon, *Tax Loopholes as Original Sin*, 31 Villanova L. Rev. 1763, 1766-67 (1986).

[33] Simons, note 1, at 89-97, does not argue that the tax system should be neutral between savings and consumption, much less that it should favor savings. Instead, Simons thought that giving up some savings for a more equal distribution of social resources would be a net benefit to society.

[34] See Simons, note 1, at 112. This argument assumes that the present deductions for mortgage interest, see § 163(h)(3), and property taxes, § 164(a) , are eliminated.

[35] See id., at 106.

[36] 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.

[37] No difference (in substance) exists between owning and renting where the rental term (with renewals) equals or exceeds the asset's useful life. 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.

On the merits, the so-called investment return is pure consumption value obtained from the use of the asset, and not a consumption *right* separate from the property itself (as would be cash or in-kind rent).[38] Imputed income (in contrast to cash or in-kind rent) is not a coming-in from the outside. The service is provided by the homeowner to herself. Intra-taxpayer transfers (moving economic value from one pocket to another) are not reckoned in taxation. Without an inflow of material wealth, there is nothing for the government to take as a share.

One possible reason for singling out imputed income from homeownership is that homes are usually (but not always) visible, and the ownership thereof is a matter of public record.[39] However, accurately measuring the gross rental value of homes on a case-by-case basis would entail an impossible administrative burden,[40] as no market outcome exists for measuring such value. Moreover, a tax on fair rental values amounts to a property tax,[41] and it would therefore incur a substantial risk of being held to be unconstitutional as a non-apportioned "direct tax." [42] Finally, measuring the *net* rental value of homes would not be worth the effort, because deductions would be allowed for maintenance costs, mortgage interest, property taxes, depreciation, and losses, possibly resulting in a net operating loss. Enacting a complex scheme that creates tax shelters for homeowners is worse than pointless.[43]

The distributional argument for taxing imputed income is that taxing imputed income is a way of taxing the wealthy. However, taxing net imputed income from homes would actually undermine progressivity where it would count the most, as it would disproportionately burden the middle class, for which home ownership constitutes a principal vehicle for "investment," relative to the very wealthy, who enjoy low tax rates on capital gains.[44]

In sum, imputed income is neither an increase in wealth nor consumption. Consumption across the board is taxed equally by viewing the cost thereof as a nondeductible expenditure.

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[38]See generally, Chancellor, note 12.

[39] Taxes on imputed income in countries other than the U.S. 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).

[40] 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..

[41] See I.R.C. § 164(b)(1); Treas. Reg. § 1.164-3(c) (defining a personal property tax as a tax imposed annually). The tax on imputed income proposed by Simons (note 1, at 117) is precisely of this type.

[42] 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. Constit., Art. I, sec. 2, cl. 3 and sec. 9, cl. 4, and Amendment XVI. See generally, Joseph M. Dodge, *What Federal taxes Are Subject to the Rule of Apportionment under the Constitution?*, 11 U. Pa. J. Const. Law 839, 932-37 (2009). The closest thing to a federal tax on imputed income from homes, see Act of July 14, 1798, 1 Stat. 597, was in fact apportioned among the states in accordance with population. The Supreme Court has opined that imputed income is not "income" under the 16th Amendment, which provides that an income tax is exempt from having to be apportioned. See *Helvering v. Independent Life Ins. Co*., 292 U.S. 371 (1934).

[43] Cf. § 469(a), (c)(2) & (7) (subjecting most rental activities to complex loss carry-forward rules).

[44] See James Poterba & Scott Weisbenner, "The Distributional Effects of Taxing Estates and Unrealized Appreciation at the Time of Death," in William Gale et al. (eds.), Rethinking Estate and Gift Taxation 422, 440-41 (2001) (indicating heavy investment of people with estates under $500,000 in residential real estate).

C. The Uncertain Utility of the "Consumption" Notion

If "consumption" is not a category of income, it still (perhaps) could have role to play under a reconstituted Simons definition in which "consumption" refers to a nondeductible cost. The normal notion of consumption (adopted by Simons) refers to the using up or destruction of scarce social resources owned by the taxpayer.[45] But, it is not clear that the "destruction" idea is very helpful, because it is not clear if "destruction" is a physical or economic concept. Income-production "expenses" are physically dissipated within a relative short period of time, but in the economic sense they are aimed to generate revenue, whether directly or indirectly. On the other hand, a non-destructible asset (such as art, jewelry, or recreational land) *is* held to be a consumption (personal-use) asset, not capable of generating deductions, despite having appreciation potential.[46] Similarly, a wealth transfer (such as an inter vivos gift) does not entail the using-up or destruction of anything, but some wealth transfers (such as gifts) are said to be consumption of the donor. At this point, it appears that "destruction" operates only as a timing (realization) rule dealing with *when* a *deductible* decrease in wealth might be deemed to occur.

Personal enjoyment or satisfaction also fails to distinguish between non-deductible consumption outlays, on the one hand, and deductible business or investment outlays, on the other. Costs of producing income are not disallowed just because of a strong element of personal satisfaction.[47] The other side of the coin is that nondeductible consumption can exist without personal satisfaction. For example, net losses for economic waste devoid of any pleasure component are disallowed.[48] Another example is found in the rule that 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).[49] A third example of cost disallowance without regard to personal satisfaction is the disallowance of human capital acquisition costs where the motive in incurring the costs is purely mercenary.[50]

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[45] See Simons, note ???, at 1 ("destruction of economic goods").
[46] In the case of assets that possess appreciation potential, one might suppose that a transactional loss on the sale of such an asset would be treated as a deductible investment loss. However, prior to the enactment of § 183, any significant personal use of such an asset was fatal to deductibility. See *Wrightsman v. United States*, 428 F.2d 1316 (Ct. Cl. 1970) (involving art and antiques). The enactment of § 183 in 1969 does not appear to have changed matters significantly in this regard, even though personal enjoyment is just one factor to be considered in deciding whether an activity is a for-profit activity. See Treas. Reg. § 1.183-2(b)(9). Section 183 bears mainly on expense and depreciation deductions. No case arising after the enactment of § 183 has been found allowing a loss on an isolated sale of a non-wasting personal-use asset.
[47] Travel, meal, and entertainment costs are often deductible, as are costs of carrying on a pleasing occupation.
[48] The losses are disallowed under § 183(a). See, e.g., *Brannen v. Comm'r*, 722 F.2d 695 (11th Cir. 1984) (movie tax shelter); *Fox v. Comm'r*, 80 T.C. 972 (1983), *aff'd unpubl.order* (2d Cir. 1984).
[49] See *Frank v. Comm'r*, 20 T.C. 511 (1953); *Rev. Rul. 77-254*, 1977-2 C.B. 63. The doctrine is not clear-cut, however, because Congress has authorized a loss deduction with respect to non-business "transactions entered into for profit," and courts have allowed deductions for costs of entering into deals that were aborted prior to any income production. See *Seed v. Comm'r*, 52 T.C. 880 (1969) (acq.). Similarly, § 183 is avoided where the taxpayer (as shown by objective evidence) had a goal (even if unreasonable) of making a profit. See Treas. Reg. § 1.183-2(d). The ambivalence may be explained in terms of a policy intuition not to impose a tax penalty on risky ventures.
[50] 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 (educational costs not deductible if qualifying one for a new trade or business).

In light of the foregoing, "consumption" is merely a shorthand expression that refers to something like "personal ends," as opposed to "means" of obtaining income, the costs of the latter being normatively deductible. But it does not follow that all such consumption (in the broad sense) is normatively nondeductible. For example subsistence consumption should be deductible, a point that suggests that norms, rather than definitions, are in play.[51]

II. THE NORMATIVE BASIS OF PERSONAL INCOME TAXATION

This part brings underlying norms relating to taxation to the task of re-conceptualizing the Simons income tax as an objective-ability-to-pay personal income tax. In the following, "internal to tax" norms (relating to fairness and administrative efficiency) are derived from the function of taxation to raise revenue, whereas "external to tax" norms (economic efficiency and theories of social justice) relate to the larger society.

A. Norms Underlying Simons Income

Simons was fighting a war on three fronts in defense of the modern (1913) income tax. First, he wanted to "translate" the notion of "income," as understood by economists, into a practical and objective accounting system. Second, he defended the income concept against the notion of a consumed-income tax (cash flow consumption tax) as then advanced by Irving Fischer.[52] Third, he advanced the notion of a *personal* income tax against other notions of an income tax (such as taxes on national income).[53] What unites these three aims is a 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.[54] Although Simons was a strong advocate of the free market, he stated that top-down redistribution through a progressive personal income tax was worth attaining at the sacrifice of some economic efficiency.[55] Such a statement implicitly concedes that an income tax is not the most efficient tax, although it is efficient enough, in not thwarting profitable economic activity.

Posthumously, the Simons concept of income has been co-opted by commentators seeking to advance a "pure" accretion income tax system in the name of economic efficiency.[56]

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[51] Andrews, note 2 ("Personal Deductions"), at ???, poses the matter in a similar way, i.e., should certain non-income-production costs be deductible for reasons having to do with the purpose of the income tax?

[52] See, e.g., Irving Fisher, Capital and Income (New York 1912); Constructive Income Taxation (1942). 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 (London 1955).

[53] Other early commentators advancing income concepts at variance with that of Haig and Simons include E. R. A. Seligman, The Income Tax (1911); William W. Hewitt, The Definition of Income and Its Application in Federal Taxation (Philadelphia 1925); Carl C. Plehn, *The Concept of Income as Recurrent Consumable Receipts*, 14 Am. Econ. Rev. 1 (1924).

[54] Simons, 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.

[55] See id., at 19-25 (discussing trade-off between progressive taxation and economic growth).

[56] This phenomenon is noted in Nancy C. Staudt, *The Political Economy of Taxation: A Critical Review of a Classic*, 30 Law & Soc. Rev. 651, 652 (1996). Favoring the accretion income tax in the name of economic efficiency are: David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111 (1986) (proposal for comprehensive accretion tax); Calvin H. Johnson, *Soft Money Investing under the Income Tax*, 1989

The "comprehensive tax base" movement in the 1960s and 1970s rendered explicit this "economics" view of the Simons income concept.

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 the cash-flow consumption tax, a wage tax, or an endowment tax better serve the economic-efficiency agenda.[57] It would appear, therefore, that economic efficiency cannot be not the true motive for pushing an accretion *income* tax. Instead, the motive must be distributional.

It is seldom acknowledged that Simons himself did not advocate adoption of an accretion income tax. Simons' famous definition of income early on in his book (page 50) omits any reference to the realization issue, and, if a requirement of annual valuations is implied by the definition, the implication is not grounded in anything Simons says prior to setting forth the definition. In the lead-up to the definition, Simons states that personal income refers to "the *exercise* of control over the use of society's scarce resources"[58](emphasis added). "Exercise" implies realization. Simons then clearly declared the definition to be only a starting point,[59] to be refined by the ordeal of having to cope with various problems, mostly of objective measurement.[60] That ordeal resulted in Simon's embracing the realization principle.[61]

B. What Can Government Legitimately Tax?

Writers in tax of an economics or welfarist persuasion tend to overlook the grounding of taxation in political theory and values, especially as these have become social norms that govern practice.[62] In the United States, the foundation of the dominant political theory (liberalism) -

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U. Ill. L. Rev. 1019 (1989) (investments should always be after-tax, a condition that requires accretion taxation); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 Tex. L. Rev. 243 (1992) (income tax should be moved towards accretion income tax).

[57] The principal point is that a cash-flow consumption tax is neutral between savings relative to current consumption. See, e.g., David F. Bradford, The Case for a Personal Consumption Tax, in What Should Be Taxed: Income or Consumption? 75 (Joseph A. Pechman ed., 1980); Joseph Bankman and David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax,* 58 Stan. L. Rev. 1413 (2006).

[58] See id. at 49. Immediately thereafter (and inconsistently) Simons equates economic power with "the value of rights which … *might have been* exercised in consumption." The phrase "might have been exercised" at least suggests a high level of liquidity as a prerequisite for taxing annual changes in market values.

[59] See id. 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).

[60] "Let us now note some of the more obvious limitations and ambiguities of this conception of income." Id. at 51. Simons, id. at 52-60, goes on to discuss imputed income from services, compensation in kind, the measurement of consumption, valuation, and gratuitous receipts. Many of these topics are revisited by Simons in Chs. 5, 6.

[61] See id. at 88 (noting the contradiction between realization and depreciation), 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, see note 2, at ???, also embraced realization.

[62] 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 "cash income" (ability-to-pay realization personal income tax) concept is itself determined with reference to such values. This point is recognized in principle (if not often followed) in Joseph T. Sneed, Configurations of Gross Income 5 (1967) (stating that taxes should be compatible with the "political order").

which presents many faces across the political spectrum and is embodied in the Constitution and political practice - is the notion of individual autonomy. Taxation, involving coercion, poses a problem of justification for liberal theory, which has responded in the form of theories of implied consent and government benefit.[63] A principal tenet of liberal political practice is that government power should be constrained.[64] 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 system.

1. Market transactions occur in the public sphere

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.[65] 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.[66] 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.[67] 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.[68] This normative claim (that private activity is off-limits to the tax authorities) has important implications for such tax base issues as psychic income, avoided costs, leisure, imputed income, realization, and (indirectly) allowances off the bottom.

2. Psychic benefits

Psychic enjoyment is clearly “private” and out-of-bounds to the tax authority, notwithstanding some rumblings from Haig and Simons to the contrary. Haig observed that income has to be monetized for tax purposes as the net accretion to one’s economic power, but then took the position that private (self-provided) goods and services could be monetized.[69] Simons appears to go along with Haig in principle, but backed off in the case of leisure and self-provided services,[70] and, in another passage, distanced himself from the notion of psychic

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[63] Various liberal theories are discussed, as they relate to taxation, in Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 Tax L. Rev. 399, 401-15 (2005).
[64] See id. at 402-03, notes 9 and 12.
[65] See Simons, note 1, at 51-52.
[66] A similar point is made by Kelman, note 12, at 842.
[67] 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 and 1641, are rather casually treated. Additionally, no necessary link exists between taxing the value of housework to household members (including the homemaker herself) and entitling the homemaker to public benefits.
[68] See Friedrich Ludwig von Kleinwächter, *Das Einkommen und seine Verteilung* [Income and its Distribution], in Hand- and Textbook of Political Sciences, Part I: Political Economy, Volume 5 (Leipzig 1896) (trans. Hannelore T. McDowell), pp. 1-16.
[69] See note 14, at 2, 6, 23 & 24.
[70] See Simons, note 1, at 52 (stating that there is no point in taxing both leisure and self-provided services, because these are not associated with material income class distinctions).

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."[71] In Simons words:

> Personal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has to do not with sensations, services, or goods but rather with rights which command prices (or to which prices might be imputed).[72]

Psychic phenomena (even where prices can be imputed to them) do not constitute "rights" or "social resources," and are transitory, ephemeral, and inscrutable to government, unless government employs means that fail to respect autonomy and privacy.

A psychic-benefits concept of income would be unworkable even if psychic states could be converted to money. If positive psychic benefits were to constitute income, then negative psychic states (pain, suffering, sadness) would generate deductions. Indeed, the performance of services for wages would generate 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. No item has intrinsic value apart from preferences and tastes, and no preference or taste is universal. Market transactions are what convert subjective preferences into objective monetary value.

3. 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 father has no gross income on account of being relieved of a future cost that had even risen to the level of a (contingent) legal obligation. Expenditures pose deduction issues, and the avoidance of any given expenditure simply reduces the possibility of obtaining a deduction for that expenditure.[73] Decisions about incurring or avoiding costs are lifestyle decisions possessing no direct effect on gross income. Of course, a lifestyle decision to enjoy a life of luxury may cause the person to maximize her production of income, just as the decision to become an ascetic is likely to cause one to reduce it. These decisions will be reflected on the gross income side, just as spending decisions will be accounted for on the deduction side.

4. Avoided wage income (leisure)

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[71]See id. at 96. Cf. Andrews, Personal Deductions, note 2, at 314-15 (defining consumption as preclusive use for personal benefit).

[72] Id. at 49.

[73] The notion of "avoiding costs" is distinguishable from the situation where the taxpayer *incurs* a cost that is then avoided in a way that results in the obtaining by the taxpayer of a net material benefit. See *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929) (third party satisfaction of taxpayer's debt); *Bliss Dairy, Inc. v. United States*, 460 U.S. 370 (1983) (deduction taken without required expense).

Simons claimed that leisure is a form of consumption, and therefore should be taxed in principle (if not in practice).[74] However, leisure is neither the obtaining nor the exercise of any kind of wealth or consumption right. 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 is not an "income" tax, which is a tax on material economic outcomes.[75]

A tax on economic outcomes respects 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.[76] 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.[77]

5. Off-market services

This unit deals with the value obtained by the taxpayer from the services of herself or of another party acting out of custom, social impulse, or generosity.

(a) Self-provided services

Economic benefits derived from self-provided services (such as, for example, self-provided lawn care) are untaxed, whereas the same services purchased in the market are taxed. Economics theory maintains that the value of self-provided services should be taxed in the name of economic efficiency, but it does not follow that such value is income in the tax sense. The value of self-provided services may be variously described as (1) psychic income (referring to the satisfaction obtained), (2) an avoidance of 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 fails to justify treating self-provided services as income. 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.[78] The self-mower

[74] See note 1 at 52. Leisure is taken to be a substitute for earning wages, so that it is taken that a tax on wages but not leisure induces individuals to avoid entering labor markets at the margin. According to Simons, leisure would be valued for tax purposes with reference to avoided (gross) wage income. However, the net subjective utility of leisure is a trade-off against the net subjective utility of working for wages, and not the gross foregone wages themselves. Therefore, the conclusion that the value of leisure is the amount of foregone wages is simplistic. Additionally, both leisure and opportunities for work may be inelastic for a given individual.
[75] For critiques of the endowment tax concept, see Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 Tax L. Rev. 229 (2011); Ilan Benshalom & Kendra Stead, *Values and (Market) Valuations: A Critique of the Endowment Tax Consensus*, 104 Nw. U.L. Rev. 1511 (2010).
[76] See Kelman, note 12, at 842 (noting that non-taxation of leisure has support across the political spectrum).
[77] See Sugin, note ???, at, 248-51.
[78] Simons, note 1, at 52, states that the value of shaving oneself should not be taxed, but does state why. Perhaps shaving (or personal grooming) is private and unobservable by the government, as are purely social interactions.

has merely expended private time in one particular fashion as opposed to possible alternatives.[79] Indeed, the self-mower, who pays the nondeductible cost of equipment, parts, repairs, and gasoline, may actually be taxed more than the person who hires a lawn care service.

(b) Services received from others

If, as noted earlier,[80] 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 of X's services (such as childcare or hosting a dinner party) by Y cannot be income, unless X's services are received in a bargained-for exchange for services or goods rendered. Additionally, the benefit of a non-market service occurs in a family or social context.[81]

(c) Self-created assets

A self-created asset might be seen as an increase in wealth that would render it into income upon completion.[82] Nevertheless, current law treats self-created assets as non-income even if (and when) consumed by the taxpayer.[83] This result is intuitively justified: it would be absurd to impose an income tax on a subsistence farmer who consumes all she produces.

A self-created consumer item typically involves monetary costs (raw materials, seeds, tools, equipment, and supplies), as well as self-provided labor, and the costs are after-tax, as is the case with a purchased consumer item.[84] Hence, taxing the value of a self-created asset would entail double taxation of such material costs. The only component that truly avoids tax under current law is the value added by the 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). A rule that required current inclusion of the value of self-created assets would entail government intrusion into private matters and could only be enforced sporadically and inequitably.

An economist would argue that all economic output should be offered to the market, and that a tax would help produce such a result.[85] But, as noted earlier, a *tax* (payable in cash) on

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[79] 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.
[80] See text at note ???.
[81] Non-market services received are correctly viewed as non-income, rather than as excluded income. See § 102(a). Treas. Reg. § 1.102-1(a) makes it clear that the gift exclusion only applies to "property" (which includes money).
[82] See *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431(1955), which held that "accession to wealth" is at the core of the income concept. However, the self-creation of an asset over time 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). One does not "accede" to one's own labor or the fruits thereof. In any event, the *Glenshaw Glass* formulation of income requires "realization" in addition to an accession to wealth.
[83] See *Morris v. Comm'r*, 9 B.T.A. 1273 (1928) (acq.).
[84] 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 monetary or material costs.
[85] See Noel B. Cunningham & Deborah H. Schenk, *How to Tax the House that Jack Built*, 43 Tax L. Rev. 447 (1988) (discussing taxation of self-constructed asset held for business use).

nonmarket activity (that is deemed to be a substitute for a market activity) does not operate in a neutral fashion, but instead forces the taxpayer into the market activity, violating the taxpayer's autonomy. *Tax neutrality can only operate (non-intrusively) in the realm of market activity.*

6. Realization

The realization principle is often thought of being a concession to administrative efficiency, because, by avoiding annual valuations, it saves costs and effort. Nevertheless, it has roots in liberal theory and practice that have been overlooked.[86] The realization principle shifts reporting from the private to the public sphere, because unrealized gains and losses with respect to non-public assets are "one-party" non-transactions, whereas realizations involve other parties (brokers, agents, auction houses, and buyers) to assist in IRS enforcement. An annual tax on unrealized appreciation would be seen as government intrusion into investment decisions by requiring action (a sale or borrowing), with attendant transaction costs.

Taxpayers are more accepting of a tax base constituted by cash transactions, because taxes are payable only in cash. Mark-to-market taxation of assets that are closely linked to livelihood and lifestyle (e.g., closely-held business interests, family farms, collectibles, and homes) would be especially resisted, because these assets are not really on the market.[87] The layperson may reasonably consider unrealized gains to be insufficiently "real" or "final" to justify a current tax thereon payable in cash. Prior to realization, no cash has been obtained to share with the government. Real estate that has doubled in market value obtains only an increased property tax bill, but the use of the property is unchanged. 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 appears to have been unreal in a very tangible sense.

But what about liquid marketable securities, which the taxpayer could easily sell with modest transaction (and no psychological) costs? A rise in the value of securities may be caused by changes in discount rates or estimates of future yields, phenomena that likewise confer no present benefit on the security holder. A reluctance to sell even liquid assets might derive not only by an awareness of transaction costs but also by the endowment effect and optimism bias.[88] A tax on unrealized gains might just be seen as an intrusion on a liberty value.

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[86] Realization appears to be gaining in intellectual respectability among tax academics. Marjorie E. Kornhauser, The Story of *Macomber*: The Continuing Legacy of Realization, in Tax Stories 93 (Paul L. Caron ed., 2d ed. 2009); Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 Tax L. Rev. 355 (2004); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 Tax L. Rev. 1 (1992) (observing economic efficiency aspects of existing realization rules); Edward A. Zelinski, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 Cardozo L. Rev. 861 (1998); Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 Ind. L.J. 77-117 (2011).

[87] 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).

[88] The endowment effect places a value on what you have because you have it (decided to buy it), and optimism bias holds that increases in value are likely to continue whereas decreases in value are likely to be reversed.

Although failure to mark investments to market creates some tax disadvantage for cash-yield investments relative to appreciation-yield investments (resulting in economic distortions),[89] no income tax system in the world follows the accretion model even for liquid securities.[90] This observation shows that political attitudes, in this case having deep roots social and political norms, as well as psychology, can easily ward off the prescriptions of technical experts.

7. Allowances off the bottom

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.[91]

C. Constructing a Norm of Substantive Tax Fairness

After 100 years of the modern income tax, it is not desirable to start (like Haig, Simons, and other early writers) with a concept of income developed in other disciplines and then to adapt it to tax. A concept of income for tax purposes should be independently constructed from norms relating to the functions of taxation.[92] This section constructs the concept of "objective ability to pay personal income" as a norm of substantive tax fairness, which is compatible with liberal values in general and specifically to redistribution as a government program. The concept is "objective" in its application because it relies on market transactions.

1. What is *tax* fairness?

In the pantheon of values, "fairness" – generally meaning "evenhandedness," "lack of favoritism or bias," and so on – has a "procedural" (as opposed to "substantive") flavor because it refers to the process of distributing benefits or harms, but does not say anything about the purpose of the distribution or the nature of the benefits and harms. Taxation is an institution, and the meta-norm for institutional fairness is "equal treatment" in terms of the function of the institution. The fairness notion is particular strong when the institution is governmental and when the function of the institution is to exact personal sacrifice.

The function of taxation is to raise revenue. It follows that the problem of institutional fairness in taxation is how to apportion the tax burden (a given) among the relevant population.[93]

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[89] The present value of the future tax burden is lower for deferred-realization returns. The disadvantage may be mitigated by market equilibrium, that is, the cost of tax-favored investments should be somewhat higher (or the before-tax rate of return lower) than that for equivalent non-tax-favored investments.
[90] The two mark-to-market provisions in the U.S. tax code, see §§ 485 and 1256, are quite narrow.
[91] Even noted Libertarians agree with allowances off the bottom. See F.A. Hayek, 2 Law, Legislation and Liberty: A New Statement of Liberal Principles of Justice and Political Economy 87(1976); Milton Friedman,& Rose Friedman, Free to Choose: A Personal Statement 306-07 (1980); Richard Epstein, Taxation in a Lockean World, in Philosophy and Law 49, ??? (Jules Coleman & Ellen Frankel Paul eds., 1987).
[92] Andrews, note 2 ("Personal Deductions"), at 311-13, stakes out an approach very similar to this in stating the issue is whether the "purposes underlying any [tax-base] provision are indeed extraneous to the purposes of the tax."
[93] See Simons, note 1, at 3, 41.

A major contribution of Simons was to demonstrate that a fair tax must be a "personal" tax in the sense that the tax base must be constituted by one or more relevant attributes "of" individual taxpayers, and the tax in question must be seen as being borne by the individuals who pay the taxes allocated to them.[94] Although no tax is wholly immune from being passed on to others, a personal income tax is considered relatively "clean" in this respect.[95] Thus, a personal income tax is a tax on the income of individuals, as distinguished from a tax on national income (for example, GDP).[96] The importance of this point cannot be overstated.

Applying the meta-norm of equal treatment of like-situated individuals to taxation yields the familiar tax maxim of "horizontal equity." Of course, at this point the maxim is 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 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?

The "vertical equity" problem of how differently-situated taxpayers (in terms of the tax base) should be treated is not itself solved by the concept of the tax base, but instead by the rate and exemption structure. (Nevertheless, the distributional effect of the rate and exemption structure operates only in terms of the concept of the tax base.) The constitution of the rate structure requires consideration of external-to-tax norms, such as economic efficiency, welfare enhancement, or other distributional theory. Importantly, the distribution of (say) income immediately after tax is only tentative, because the after-tax distribution is then altered by government action (some of which might be carried out through tax credits). It follows that "vertical equity" has no precise meaning apart from that rate and exemption structure that will contribute to (or at least not hinder) the desired final social outcome, which can only be achieved independently of tax conceived as a revenue-raising apparatus. Therefore, *vertical equity is not a necessary attribute of a normative tax system.*

2. Why should anyone care about tax fairness?

I happen to be a norm pluralist, meaning that I view the identification of a tax base that satisfies fairness criteria to be a project that is independent of programmatic analysis of tax provisions. Thus, a provision that appears to satisfy tax fairness norms (such as a deduction for basic medical care) might still be critiqued from an external-to-tax rationale.[97] I offer no meta-theory for resolving such tensions or conflicts. Simons himself was a norm pluralist in asserting that the principal issue of tax design was that of fairness as to "how tax burdens should be apportioned among individuals,"[98] and by stating that tax fairness is worth the cost of some economic inefficiency.[99]

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[94] See id. at ??? (rejecting tax base keyed to national income).
[95] See http://www.econport.org/content/handbook/Elasticity/taxincidence/Incidence-Applied-to-the-US.html (last visited Feb. 16, 2014).
[96] The "flat tax" proposed in Robert E. Hall & Alvin Rabushka, The Flat Tax (2d ed. 1985), and the VAT (widely used outside the United States) are basically taxes on national income. The claim (id. at 23-29) that this tax is "fair" simply because it would be imposed at a flat rate ignores the fact that tax fairness is a function of the tax base.
[97] See Kelman, note 12, at ???.
[98] See Simons, note 1, at 3.
[99] See id. at 89-97.

Some prominent commentators hold that internal-to-institution fairness norms are irrelevant or subordinate to external-to-tax norms.[100] However, a norm of tax equity is useless only if thwarts or obstructs some larger social goal. Inherently, this cannot be true of taxation in general, because after-tax outcomes can always be reshuffled by government programs. Additionally, the particular tax fairness norm might actually carry out the desired social goal. The social goal that appears to be the universal concern of commentators on the subject is top-down redistribution relative to market outcomes. The ability-to-pay norm (developed in this article) is wholly in accord with such a program, because an ability-to-pay tax base is the base-line for redistribution of material goods. At the same time, a principled opponent of redistribution should also favor an ability-to-pay tax base, because, if combined with a flat tax rate, the resulting tax would not alter relative market outcomes.

Hence, it is not necessary here to directly challenge the hegemonic claims of meta-theories on their own terms.[101] Even the most imperialistic meta-theory, welfarism, concedes that fairness can play a legitimate role in the welfarist system, whether (1) as constituting an individual taste or preference, (2) as a possible proxy for individual well-being, or (3) as a way of avoiding the costs attendant upon individualized determinations of well-being.[102] A second meta-theory, economic efficiency, also appeals to fairness intuitions by invoking the "level playing field" metaphor and equating economic "neutrality" with "fairness" by conflating equal treatment of things with equal treatment of people. As noted above, redistributional theories can line up precisely with the ability-to-pay internal-to-tax fairness norm.

No single meta-theory commands universal adherence in legal academia, or even presents a unified front.[103] In areas of legal theorizing other than tax, fairness norms are taken seriously. Such internal-to-law norms are "retribution," "restorative justice," "bindingness of mutual promises," "inviolability of property rights," and "equal rights" lie in contrast with such external norms as "deterrence," "rehabilitation," "internalization of externalities," and "welfare maximization." Moving from theory to practice, law and legal argument itself is all about whether the case at hand is the same (or not the same) as the cited precedent.

The compelling instrumental reason for taking fairness seriously is that tax law is made by politicians, not philosophers, economists, or social engineers. In the United States, the constitutional separation of the executive and legislative branches has produced a cleavage between policy wonks and lawmakers. The views of economists, philosophers, and other academics appear to have very little impact on tax law. In the realm of non-academic discourse,

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[100] See Louis Kaplow & Steven Shavell, Fairness v. Welfare 3-4 (2002); Liam Murphy & Thomas Nagel, The Myth of Ownership 25 (2002) (debunking tax norms specifically). The point has sometimes taken the form that horizontal equity is subordinate to vertical equity. See generally, James Repetti & Diane Ring, *Horizontal Equity Revisited*, 13 Fla. Tax Rev. 135, 139-45 (2012).

[101] Nevertheless, one cannot resist pointing out that Kaplow and Shavell's "proof" of the hegemony of welfarism, see ???, applies a welfarist standard as final arbiter.

[102] See Kaplow & Shavell, supra note ???, at 23-24; Louis Kaplow & Steven Shavell *The Conflict Between Notions of Fairness and the Pareto Principle*, 1 Am. Law & Econ. Rev. 63, ??? (2000).

[103] The variations on liberal theory are endless. Welfarists also hold divergent views on the appropriate role (if any) for fairness considerations. See generally, Howard F. Chang, *A Liberal Theory of Social Welfare: Fairness, and the Pareto Principle*, 110 Yale L. J. 173 (2000).

equal treatment is the basic form of argument, and one that even children can deploy effectively. Psychological research shows that individuals often prioritize fairness over (even) rational self-interest.[104] Even unfair tax proposals are typically sold by appeals to fairness (as well as self-interest).[105] Importantly, tax proposals that are widely viewed as being unfair (such as an accretion income tax or an endowment tax) have no chance of being enacted.

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 as "myopia" or "disaggregation bias," is necessary to cope with life's complexities. On the positive side, myopia 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. Congress and the Executive themselves are compartmentalized branches of government. Compartmentalization allows for a "tax insider" 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 is interested in the concept of tax fairness from a system perspective.

The internal-to-tax concept of tax fairness is not only permissible but mandatory, pragmatically speaking, because it yields a tax base definition (elaborated upon in Part III) that is intelligible and internally coherent. In contrast, social meta-theories either yield no tax-base definition or definitions that are endlessly complex and contingent on empirical re-evaluation. The internal-to-tax tax base definition yields a comprehensive set of default rules that can be overridden for persuasive reasons.

3. Deriving the tax fairness norm from the institutional function of taxes

To continue the enterprise of constructing a norm of substantive tax fairness, 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. 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. The government cannot appropriate a person's welfare, which is a subjective state. Moreover, the government has no legitimate interest 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. Money is wholly objective, universal, transferrable, convertible to other goods, and easy to account for.

Money can, of course, be readily redistributed. Since government benefits inevitably inure (to some degree) to all segments of the population, a tax base keyed to money can achieve

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[104] See Paul H. Robinson & John M. Darley, *Intuitions of Justice: Implications for Criminal Law and Justice Policy*, 81 S. Cal. L. Rev. 1 (2007) (finding that persons evaluate criminal law on basis of widely-shared justice intuitions rather than practical reasoning).

[105] The term "fair tax" has been co-opted 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.

a measure of redistribution –even in the absence of redistributive programs - by exempting off-the-bottom subsistence from tax. Tax rates applied to a money tax base can be constructed to achieve "off the top" redistribution as well. A tax base keyed to money outcomes respects individual autonomy, because it does not second-guess the earning and expenditure choices.[106]

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. Accordingly, the proper time to tax material wealth is either when first received (as cash or as an in-kind item that can be deemed to be a bargained-for substitute for cash) or, if not taxed when received in kind, when post-acquisition gain is reduced to cash (or its deemed equivalent). Thus, the "realization" principle is an integral aspect of an objective ability-to-pay tax base.

4. Accountable government and the periodicity of taxes

It might be supposed that an annual wealth tax is an appropriate means of implementing the ability-to-pay principle, but such a conclusion would be incorrect on account of the realization principle alone. 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).

(a) The tax base as a flow

Haig had it right to the extent that he stated that income (conceptually) is a flow,[107] but – in the tax sense - it is not a flow of satisfactions, because satisfactions cannot be appropriated by the government. A tax on subjective well-being would result in heavy taxation of people who are happy or content despite having a low economic status, and low taxation of the unhappy wealthy. The notions of "well-being" and "standard of living" are covers for injecting subjective considerations into the definition of the tax base on an ad hoc basis.[108]

In the world of tax, the flow must be of money, which the government takes a portion of.[109] In contrast too 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. Taxes on wealth destroy 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

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[106] See Sugin, note ???, at 250-51. Welfarism, being concerned with individual well-being, shifts to paternalism when individual choices undermine well-being. See Kaplow & Shavell, note ???, at ???.
[107] See note 14.
[108] In Blueprints, note 2, at 36, where "standard-of-living" is a made-up term the sole purpose of which is to attempt to justify the exclusion of gratuitous receipts, as a proxy for not allowing a deduction to the donor. This analysis cannot apply to bequests, because bequests (far more significant than gifts) do not reduce the deceased's standard of living. The same reasoning could be used to justify, "by definition," deductions for taxes, charitable contributions, some medical costs, and perhaps interest.
[109] See Haig, note 14, at 7.

rate of return. Since 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), imaginary or hypothetical flow (or return) is off the table as a subject of taxation. The tax is on economic outcomes, not economic potential.

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.[110] Discounting future flows to present values arrests time, but the flow of real time lies at the very heart of social and political activity and, of course, of the institutions of taxation and government.

(b) The flow is described by personal income rather than by personal consumption

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 spent (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 by making free choices that result in decreasing her own tax base. (Realization is distinguishable by deferring income rather than decreasing it in the current year.) Ability-to-pay exists in the moment of receipt during a taxable year, and is not determined at the end of the year. The taxpayer receiving cash (or its deemed equivalent) has the ability to pay tax with a portion 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 discriminates against investors, relative to spenders on current consumption, because of the so-called double taxation 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. 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 current invested (and deducted) amount.[111]) The immediate deduction for investment under a consumption tax, entailing no discounting to present value, is more salient to taxpayers than the alleged double taxation under the income tax. Thus, it is more accurate from an annual perspective to state that a consumption tax discriminates *in favor of* investment than that an income tax discriminates against it.

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[110] It is claimed by some that tax fairness should be viewed from a lifetime perspective. See Blueprints, note 2, at 39; Lawrence Zelenak, *Tax Policy and Personal Identity Over Time*, 62 Tax L. Rev. 333 (2009) (noting those who make such normative claims). But what would motivate such a claim other an endowment perspective coupled with a preference for flat rates?

[111] Under a consumption tax, investments made are deducted; under an income tax, they are not.

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]

Normatively, no *fairness* reason exists to tax consumption rather than income, and no broader moral reason exists for the privileging of investment over consumption.

III. CONSTRUCTING THE FAIR INCOME TAX

This Part describes how various income tax issues would be resolved under an objective ability-to-pay realization personal income tax.

A. Gross Income Issues

The following deals with various gross income issues under the fair income tax.

1. Intangible benefits

Under the fair income tax, the following intangible benefits, as intimated earlier,[113] would be *non-income*: avoided costs (as opposed to incurred costs); avoided income (leisure); psychic benefits; the value of self-provided; 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.

2. Price discounts, prepaid consumption, and insurance benefits

The principle that consumption is measured by what is paid for it (rather than the value obtained) leads to the conclusion that price discounts in commerce (including tuition scholarships) do not give rise to income.[114] Of course, price discounts can amount to disguised compensation (or other) income, and in those cases they should be taxed.[115]

A similar scenario 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.

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[112] Even consumption tax supporters draw back from allowing deferral of taxation in this case. See Blueprints, note 2, at 122. Andrews, note 12 (Consumption Tax), at 1160-62, agonized over the treatment of checking account (cash) balances, but concludes that savings account balances 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. For a critique of the fairness claims of consumption tax advocates, see Barbara H. Fried, *Fairness and the Consumption Tax*, 44 Stan. L. Rev. 961 (1992).

[113] See text at notes ??? - ???.

[114] Tuition and fee scholarships are generally excludible under § 117(a), (b), (d), but the exclusion implies that non-conformity to the qualification rules implies inclusion.

[115] See §§ 83(a), 117(c).

Examples are auto clubs, fitness centers, dance studios, and country clubs. Here, individuals are correctly taxed with respect to the fees paid, not the value of the consumption obtained.

The insurance-reimbursement scenario is one in which an individual pays an annual premium to an insurance company, and the latter agrees to reimburse the individual for specified cash outlays (such as for medical care or tort liability).[116] Under the Simons income concept, it might appear that the insured would have gain equal to the excess of the reimbursement over the premium, and that the payment to the claimant would (depending on the facts) be a nondeductible personal expense. Under the fair income tax, the analysis follows that of the consumer-club scenario. The "expense" (nondeductible if "personal") is the payment of the premium,[117] by which the insured, in an arm's length commercial transaction, obtains the contractual right to avoid personally having to pay covered claims.[118] The insurance contract is not a wager for profit, because the insured cannot (and does not) reap a monetary gain relative to her initial position.[119] 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.[120] The taxpayer ultimately has obtained what she paid for.[121]

3. Realization of income

Realization is an integral part of the fair income tax – as opposed to a concession to practicality – because of the fact that "ability-to-pay" refers to an individual's ability to contribute *cash* to the government with respect to the current taxable year.

(a) In-kind compensation; property exchanges; installment sales

In the context of an ability-to-pay system, the realization concept does not countenance manipulation by arranging to receive value in kind.[122] Thus, the value of property (including consumption rights) received in exchange for services or property[123] 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 loans are not obtainable.[124]

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[116] The insurance company will pay the claimant directly, but this makes no difference for tax purposes.
[117] The premium is an "expense" (as opposed to being a capital expenditure), because it provides coverage for a short period of time.
[118] More elaborate versions of this analysis are found in 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); Halperin, note ???; Jeffrey Kahn, *Justifying the Exclusion of Insurance*, 125 Tax Notes 1216 (2009).
[119] With property insurance, gain or loss exists where the recovery differs from the adjusted basis in the property.
[120] See *Clark v. Comm'r*, 40 B.T.A. 333 (1939), *acq., Rev. Rul. 57-47*, 1957-1 C.B. 23.
[121] 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).
[122] The same logic operates on the deduction side to require that capital expenditures of cash be disallowed as deductions. See text at note ???.
[123] Exchanges of property would rarely occur except to evade tax or to legally avoid tax, such as under § 1031 (providing for no current recognition of gain or loss on certain like-kind exchanges).
[124] The current eligibility requirements for the installment method of reporting, see § 453(a), (b)(2), (f)(4), are not strict enough. The taxation of an installment purchaser is discussed in the text accompanying notes ??? -??? infra.

(b) Self-produced consumption rights

Realization is more than a mere timing rule in the case of self-produced (and other untaxed) items that are consumed by the taxpayer, because here the value added by labor is never taxed. This result is consistent with the non-income status of self-provided services, and with the principle that consumption is wholly accounted for, not at its value, but rather at its cost.

In-kind receipts from nature (say, from mining) and so-called "found objects" would likewise 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.[125]

4. Transfers received

Simons opined that all accessions to wealth, regardless of source, should be included in income under a personal income tax. Transfers received (such as gratuitous receipts, life insurance proceeds, and tort recoveries) increase the taxpayer's ability to pay, and should be included in income.[126] The essential difference between a "personal" income tax and a tax on national "economic" income is precisely the inclusion in the tax base of transfers received.

An issue is how the realization principle should be applied here. In the case of structured settlements obtained as tort recoveries,[127] it is rational to tax the plaintiff only upon the receipt of cash, as occurs under present law,[128] since the wages being replaced by the cash would only have been taxable when received. As for trusts and beneficiaries, the starting point is the observation that the trust is not a true taxpayer as far as tax fairness analysis is concerned. The realization principle would require that beneficiaries 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 would be ignored. Although *economic* income would be deferred, no *personal* income exists until the beneficiaries (who have not invested anything) have received it.[129]

Under an ability-to-pay income tax, realization of gain or income entails "more" than an event of asset disposition; it requires a receipt of cash or its deemed equivalent. Hence, contrary to Simons,[130]unrealized gains and losses would not be taxed to the gratuitous transferor.

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[125] See also, Joseph M. Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control*: *Applying the "Claim of Right Doctrine" to Found Objects, Including Record-Setting Baseballs*, 4 Fla. Tax Rev. 685 (2000); Leandra Lederman, *"Stranger than Fiction": Taxing Virtual Worlds*, 82 N.Y.U. L. Rev. 1620 (2007).

[126] See Simons, note 1, at 125-35.

[127] A structured settlement entails the right to receive cash in the future, usually in the form of annuity.

[128] See § 104(a)(2) ("… whether as lump sums or periodic payments").

[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] Simons, note 1, at 163-67, favored taxing unrealized gains to gratuitous transferors, as well as fully taxing gratuitous receipts to the transferees.

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") keyed to the level of subsistence existence (currently around $13K).[131] The personal exemption would only be available with respect to subsistence provided by the taxpayer to herself.[132] The exemption would not be phased out, because all taxpayers must maintain subsistence existence. 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.

(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.[134] An additional problem is that of who is to bear the ultimate tax burden for the "entity" tax.[135]

(b) Income attribution

The objective ability-to-pay principle dictates that gross income be attributed to the earner or owner of income-producing property,[136] because such person has the right to obtain and control the income. Deductions would be attributed to the payor if the payor is liable or is the person who incurred the deductible cost.[137]

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[131] The U.S. "poverty guideline" for 2013 was $11,490 for an individual maintaining a household only for herself. See 78 Fed. Reg. 5182-83 (Jan. 24, 2013).

[132] According to same guidelines, it cost about $4.8K to support a household dependent at the poverty level.

[133] For 2013, the sum of the standard deduction for an unmarried individual ($6,100) and such person's personal exemption amount ($3,900) was $10,000. Such a person could have obtained a maximum earned income credit (in 2013) of $400, which is the equivalent of an additional deduction of $4,000 to a taxpayer in the 10% marginal rate bracket. See *Rev. Proc. 2013-15*, 2013-5 I.R.B. 444, 447-48.

[134] See Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return*, 45 Hastings L. J. 63 (1993).

[135] Extending joint-and- several liability to all members of a household would sometimes produce the unfair result of some household members paying the tax on the income of other household members.

[136] See generally, Lawrence Zelenak, *Marriage and the Income Tax*, 67 So. Cal. L. Rev. 339 (1994).

[137] See, e.g.,Treas. Reg. § 1.164-1(a) (tax payments deducted only by person on whom the tax is imposed).

(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.

Gratuitous receipts and support would be treated differently. This distinction already exists under the federal gift tax,[138] where a "cushion" between the two is provided by the gift tax annual exclusion,[139] 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.

(d) Support provided

Involuntary exaction is a plausible ability-to-pay basis for.[140] Accordingly, court-mandated alimony *and* child support would be deducted by the payor and included in the income of the payee.[141]

Although acquiring dependents may be characterized as voluntary, compliance with support obligations is still arguably an involuntary exaction.[142] But even if the provision of support is seen as consumption, consumption is deductible off the bottom to the extent it is subsistence. The provider of the support assumes (in effect) the dependent's subsistence living expenses and, by doing so, should acquire the dependent's own subsistence allowance, which the dependent probably cannot use in any event. This subsistence-allowance-shifting notion explains the existing rules wherein (1) the dependency exemption is lower than the amount of support actually provided,[143] and (2) the dependent loses her personal exemption.[144]

3. The personal deductions

Although none of the existing personal deductions represent costs of income production, they might still be analyzed with respect to the notions of subsistence and involuntariness.

(a) Mortgage interest

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[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).
[139] See § 2503(b) and (c).
[140] See Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 Va. Tax Rev. 765 (2006)
[141] The payor might obtain satisfaction from the relationship to the child, but does not obtain satisfaction from the payment itself.
[142] See Lawrence Zelenak, *Children and the Income Tax*, 49 Tax L. Rev. 349, 361-69 (1994).
[143] The 2013 poverty-level subsistence consumption of a household dependent was about $4.8K, which is not far from the 2013 dependency exemption amount of $3.9K. See § 151(b), (c).
[144] See § 151(d)(2).

Mortgage interest is unrelated to the production of includible income, nor is it involuntary. Subsistence housing costs (of whatever nature) are already factored into the personal and dependency exemptions.[145] No additional deduction is warranted.

(b) Personal casualty and theft losses

As noted earlier,[146] consumption is measured by cost, rather than value, so that the failure to have obtained full consumption value does not justify a deduction. At this point, it might be argued that (uncompensated) casualty and theft losses are "involuntary" occurrences that reduce objective ability to pay in a way that is analogous to alimony. But the notion of "voluntary" is imprecise, and casualty and theft losses are not truly involuntary to the extent that the risks could be insured against.[147] Furthermore, the analogy to alimony fails, because alimony is an involuntary reduction in current cash income, whereas the expenditure of cash for (current or future) consumption represented ability to pay in the year of purchase.[148] In the later year of casualty or theft loss, no diminution of current ability to pay occurs, except where cash is stolen, and except (possibly) by way of a "compelling" need to replace the lost item.

(c) Costs of health care

Personal health care costs[149] aim to improve personal welfare and, therefore, fall into the category of consumption. Nevertheless, 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 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).[150]

On the other hand, subsistence medical costs are "voluntary" to the extent that the taxpayer could have acquired health insurance that would have covered such costs. At this point, the tax issue cannot be disentangled from the larger web of federal health care policy, which is

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[145] It has been claimed that the mortgage interest deduction creates horizontal equity between purchasing a cash home purchase and a mortgage-financed purchase, because in both cases the purchase price is "after tax" if the interest is deductible. See Blueprints, note 2, at 88. However, this analysis does not withstand scrutiny. Under an income tax, consumption is measured by its initial cost, and, in determining "cost," the future consumption value of a consumer asset is reduced to present value. At market interest rates, the present value of future principal and interest payments, plus the down payment, would equal the price of the home. Being able to deduct the interest reduces the net cost of the home relative to the cost incurred by a cash purchaser. Thus, horizontal equity requires *dis*allowance of the interest deduction.

[146] See text accompanying notes ???-???.

[147] 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!

[148] A casualty loss deduction is not typically found in the tax systems of other countries. See Ault & Arnold, note ??? , 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 text accompanying note ???.

[150] This test is stricter than the current one of "affecting any structure or function of the body." See § 213(d)(1).

currently aimed to mandate near-universal private insurance coverage.[151] If the coverage is truly deemed to be mandatory, an above-the-line deduction should be allowed for the cost of (qualified) health insurance.[152] Additionally, a deduction could be allowed for non-insur*able* non-discretionary (subsistence) health care costs over a floor.

(d) Taxes paid

The justification for deducting taxes (not a cost of income production) must be that they entail a forced decrease in current cash income. However, property taxes are voluntary, because ownership of taxable property is voluntary. Renting a residence is an alternative to owning one, and alternatives exist to owning second and third homes. Additionally, property taxes are viewed as a cost of maintaining or operating property, and such taxes would be deductible where business or investment property is involved. It is illogical to treat property taxes as a cost of maintaining property in an income-production context but as a cost unrelated to the property (a "tax") in the personal-use context.

Likewise, regardless of whether one views retail sales taxes (and the like) as being involuntary,[153] they are not really "taxes" but rather a part of the purchase cost. Under income tax principles, treating sales taxes as a portion of the purchase price of the underlying good or service accords with capitalization doctrine: transaction costs incurred by a buyer of an asset are generally treated as part of the purchase price and added to basis.[154] In fact, existing law requires such treatment in a business or investment context.[155] It would be illogical to treat sales taxes as part of the cost of goods and services in some cases but not others. A separate deduction for sales taxes raises the possibility of a triple tax benefit for the same dollars: first as an implicit component of subsistence allowances, second as a separate expense deduction, and third as adding to an asset's basis. Finally, treating sales taxes as part of the purchase price avoids having to account for them separately, an impossible task for most taxpayers.

That leaves income taxes as being true involuntary exactions[156] that present a plausible case for deductibility.[157] Unlike property and sales taxes, state and local income taxes cannot be

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[151] Countries having a national health program (providing subsidies) generally do not allow a health care deduction. See Ault & Arnold, note ???, at 284-86.
[152] Currently, only premiums paid by self-employed persons are deductible above the line, § 162(*l*), but employer-paid premiums yield the same result by way of exclusion under § 106. Since deductions are of little benefit for low-income taxpayers above the Medicaid level, premium subsidies can be provided through tax credits. See §§ 35, 36C.
[153] See Turnier, note 2, at 275-81 (viewing property and sales taxes as voluntary). Cf. 2 U.S. Dept. of Treas., Tax Reform for Fairness, Simplicity and Economic Growth 62-63 (1984) (claiming that all state taxes are voluntary).
[154] See, e.g., Treas. Reg. § 1.263(a)-2T(f)(3) (2011); *Woodward v. Comm'r*, 397 U.S. 572 (1970);
[155] See § 164(a) (second sentence of the flush language); Treas. Reg. § 1.263A-1(e)(3)(ii)(L). It is not grammatically clear if the capitalization rule applies only to purchases of business or investment assets, but the legislative history suggests that this is the case. See H.R. Rep. 99-841, 99th Cong., 2d Sess. II-20 (Conference Report) (1986).
[156] The fact that taxpayers can move to jurisdictions without state and local income taxes is not sufficient reason, in my opinion, to call such taxes "voluntary," since such a move entails significant monetary and psychological costs (including loss of the deduction).
[157] However, transaction costs relating to the determination of tax liability are neither involuntary nor a component of subsistence. Costs relating to *federal* taxes should not be deductible under any theory, because a reduction in federal taxes is not gross income. Thus, existing § 212(3) should be repealed. See Calvin H. Johnson, *No Deduction for Tax Planning and Controversy Costs,* 129 Tax Notes 333 (Oct 18, 2010).

viewed as being already included (in part) in allowances off the bottom, because income taxes are usually not payable by low-income persons, and some states do not impose them at all. Hence, the deduction should not be subject to a floor.

4. Deductions to carve out other spheres of collective activity

(a) Taxes once again

A political-theory rationale for the deduction of U.S. state and local taxes is that the deduction operates as a carve-out of state government activity from federal government activity. Since this carve-out is a feature of the basic institutional landscape (that concedes 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 require a deduction, because the constitutional structure of the United States does not immunize state government finance from federal interference.[158] Likewise, the weak federalism rationale for deduction does not compel federal "neutrality" in the form of allowing *all* such taxes to be deductible (or allowing no such taxes to be deductible). The most that can be said is that the rationale "allows" Congress to accommodate the states by way of the deduction for state and local exactions.

(b) Charitable contributions

Whether charitable contributions are "personal consumption" depends on the definition of that term, but such a definition would be irrelevant under an ability-to-pay income tax, which would initially disallow the deduction as a non-subsistence voluntary payment not aimed to generate income for the taxpayer. Instrumental (policy) rationales for the deduction[159] only serve to identify the deduction as a "tax expenditure."[160]

As with state and local taxes, a non-instrumental rationale for the charitable deduction derives from the political values underlying the income tax. 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 (if not necessarily majority-favored) goals.[161] The income tax has

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[158] 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). Indeed, the federal government possesses the power to tax even the states themselves (although any tax directly on the states would have to be apportioned according to population).

[159] A tax incentive may be an appropriate inducement for sharing with strangers (as opposed to one's family). See Stanley Koppelman, *Personal Deductions under an Ideal Income Tax*, 86 Harv. L. Rev. 309 (1972) (advancing welfarist argument for charitable deduction); Louis Kaplow, *A Note on Subsidizing Gifts*, 58J. Pub. Econ. 469 (1995) (advancing welfarist argument for tax benefits for contributions). It is argued that the tax law should favor poor-serving charities relative to the others. See, e.g., Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 Va. L. Rev. 1393 (1988). This position makes sense if the deduction is viewed in instrumental terms, because a greater incentive is needed to induce service to the poor than to the donor's own community of interest.

[160] See Staff of Joint Committee on Tax'n, Estimates of Federal Tax Expenditures 2012-2017, JCS-1-13 (Feb. 1, 2013), pp. 2, 37-39 (estimating revenue loss at $39B for 2013).

[161] 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*

accommodated the charitable sphere, without quite giving it the status of a co-equal sovereign, through the mechanism of removing it from the tax base by way of a deduction. Because the deduction simply removes (within limits)[162] the contributed amount from claims by the federal government and allows it to be directed intact to the organizations (and their beneficiaries) that one supports, it fits better with foundational values of individual and associational autonomy than do the alternative mechanisms of a tax credit or matching grants, which would effectively allow private persons to control federal spending.[163]

The oft-repeated objection that the deduction disproportionately favors the rich occupying higher marginal rate brackets is not (as with the case for state and local taxes) responsive to the political-theory rationale that the deduction is "pre-tax."[164] This "upside-down subsidy" argument assumes that charitable contributions are within the normative personal income tax base, and that the all-encompassing government is "giving" its tax dollars) away, the implicit claim being that the government should have a monopoly on the production of public goods. This assumption is contrary (for better or worse) to political and social practice in the United States.[165] Nevertheless, government regulation and oversight is necessary to keep the charitable domain on the straight and narrow.[166]

D. Realization of Deductible Costs

The general realization rule for expense deductions is the payment of cash, and for asset basis it is disposition of the asset.[167] Under current law, however, business and investment deductions and income offsets can be taken in advance of cash payment in the cases of (1) accrued expense deductions and (2) the exclusion of borrowed money.[168] Additionally, basis can be deducted, by way of depreciation, in advance of a wasting asset's complete disposition. These

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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).

[162] The deduction cannot exceed a specified percentage of a taxpayer's net income, with the percentages varying according to the type of exempt charity. See § 170(b).

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

[164] If P and R are in the 10% and 36% marginal rate brackets respectively, R's tax savings per deductible dollar are 3.6 as large as P's. However, the point is seriously undermined (or negated) if one accepts the declining-marginal-utility-of-money thesis. Thus, if the utility of marginal dollars to P is 3.6 times greater than for R, then the utility derived from the unequal-dollar tax savings of P and R is equalized. The declining-marginal-utility notion is commonly used to justify progressive tax rates, and it is progressive rates that create the complained-of upside-down effect. Thus, the upside-down argument trips over its own premise.

[165] Not surprisingly, the charitable deduction 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, note ???, at 286-88.

[166] Donors and beneficiaries generally have no standing to sue charities, and state attorney general offices lack resources and (often) the will to enforce charities. A case study of charitable abuse (and ultimate redress through IRS intervention) is found in Samuel P. King & Randall W. Roth, Broken Trust (2006).

[167] See § 1001(a), (b). An abandonment (or other total exhaustion) of an asset also counts as a realization event on the deduction side. See § 165(a) (stating that loss must be "sustained"); Treas. Reg. § 1.165-1(d)(1) (realization generally); -2 (obsolescence); -5 (wholly worthless securities).

[168] An analogous scenario to the acceleration of deductions is deferral of prepaid income, which is sometimes allowed for tax purposes. See § 456; Treas. Reg. § 1.451-5; Rev. Proc. 2004-34, 2004-1 C.B. 991; Artnell Co. v. Comm'r, 400 F.2d 981 (7th Cir.1968). 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.

rules are based the financial accounting notion of "accrual," which generally refers to the time a loss or liability is "fixed" (in advance of payment or disposition However, it is now recognized that tax theory is independent of accounting theory.[169] Yet the notion of accrual is claimed to be proper in tax under the "change in net wealth" component of the Simons income definition, where rights to cash are assets and obligations to pay cash are liabilities (negative wealth).

1. The accrual method

The accrual method 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,[170] and is contrary to the cash-realization income tax. A fortiori, "reserve" tax accounting (allowing present deduction based on statistical predictions of future cash outflows) would also be barred, as it is under present law.[171]

2. Borrowing

Accrual notions lie behind the existing tax treatment of borrowing, which is that borrowed money is viewed as non-income (not an increase in wealth) due to the simultaneous accrual of an offsetting liability to repay the principal.[172]

(a) Cash borrowing

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.[173]

(b) Purchase-money debt

In a previous piece,[174] I concluded that the approach to borrowing just set forth would be unworkable in some cases and unacceptable in others.[175] It turns out that the problems can be solved by treating debt-financed property acquisitions as a deferred investment. Both two-party and three-party purchase-money debt would be excluded from current income on the ground that

[169] See, e.g., Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979).

[170] See Treas. Reg. 1.446-1(c)(1)(ii). Since 1984, expense deductions cannot be accrued any earlier than "economic performance," which depends on the context. See § 461(h). Taxpayers not required to use the accrual method, see §§ 447, 448, can use it if it keeps its books accordingly, see § 446(a).

[171] See, e.g., *Schlude v. Comm'r*, 372 U.S. 128 (1963).

[172] A corollary of the borrowing exclusion is that income does arise when such liability disappears without its being satisfied. See Treas. Reg. § 1.61-12 (referring to debt-discharge income, usually known as COD income).

[173] Interest is considered an expense relating to the asset or activity financed by the borrowing, and would be deductible or not deductible accordingly. See § 163(a), (h)(1).

[174] 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).

[175] Inclusion in income of acquisition debt for homes and cars in gross income would not be politically acceptable, and an inclusion/deduction scheme for debt principal would render unprofitable marginally viable investments.

no money is actually or constructively received by the credit purchaser.[176] Instead, the tax consequences of a liability would be realized only as and when cash payments are made to reduce the principal amount of the obligation. 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 the *Crane* doctrine[177] obsolete, and if it were combined with the elimination of depreciation deductions (as is suggested shortly), then the problems of negative basis,[178] spurious COD income,[179] incomplete cost recovery (of wasting investments),[180] and the leveraged tax-shelter effect[181] would all be avoided. A problem with this approach is that it might be hard to draw the line between cash borrowing and debt-financed asset purchases.

(c) Credit card transactions

Most credit-card purchases (or charitable contributions) by individuals are for the purchase of services (or for expense items, like household supplies, for which basis would be meaningless). 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.[182] 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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[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] 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).

[178] If depreciation were allowed and cumulatively exceeded aggregate principal payments, the asset's basis could drop below zero. The tax system (perhaps without sufficient justification) has viewed negative basis as an anathema.

[179] Spurious cancellation-of-debt (COD) income exists where the taxpayer never received cash (or other economic benefit) as consideration for the liability that has been wiped out. Such income is spurious in the sense that the transaction as a whole does not result in any realized increase in wealth in the tax sense.

[180] The *Crane* case, supra note ???, was partly decided on the ground that basis had to include purchase-money debt in order for a rational depreciation system to function.

[181] A leveraged tax shelter exists under the current system if basis (and depreciation deductions) are significantly overstated by reason of the loan principal amount not being "real" by reason of being significantly greater than the value of the property at the time of purchase). 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.

[182] See *Rev. Rul. 78-38*, 1978-1 C.B. 68.

Under the current income tax, cost recovery with respect to determinable-life assets used in a business or other income-production activity ("productive assets") takes the form of annual depreciation and amortization deductions until the asset's basis is exhausted.[183] Under an accretion income tax, depreciation is legitimate and would be measured by the annual decline in value of the asset, but annual valuations of such assets are impossible, and depreciation would not be proper under a realization income tax, as was (correctly) noted by Simons.[184] Congress has finessed the valuation problem by enacting formulaic methods for computing depreciation.[185] However, avoiding annual valuations does not itself satisfy the realization principle.

Tax depreciation had its origins trust and business accounting, where depreciation is an offset against income for the purpose of preserving "principal" against erosion, effectively setting aside cash to replace the depreciating asset.[186] Such a "reserve" justification for depreciation is derivative of the accrual notion, by allowing deductions for an expected future cost, but accruals of estimated future costs are not allowed even under the existing income tax.[187]

Another business accounting aim of depreciation is to "match" costs with income, and it is acceptable in accounting to use conventions and estimates based on statistics to carry out this aim.[188] However, matching is an irrelevant criterion for tax,[189] and the approximations and estimates that enter into depreciation formulas would not rise to the level of realization under an ability-to-pay income tax.[190] Indeed, the matching concept cannot really be the underlying rationale for existing tax depreciation,[191] because the cost of an indefinite-life asset *can* be matched (assigned) to future years of the asset ad infinitum, whereas depreciation is actually allowed only for assets that have an ascertainable useful life.[192]

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[183] Section 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.

[184] See Simons, note 1 at 86-88 (here critiquing E.R.A. Seligman).

[185] See §§ 168, 197.

[186] Suppose that a trust, in which net income is payable to B for life, remainder to C, is funded with a building worth $1M, which generates net rents (before depreciation) of $70K/year. The trust adopts a depreciation reserve, which entails debiting $40K/year against income per year for 25 years. The effect is to reduce the cash distributions to B to a net of $30K/year while adding $40K/year to principal. After 25 years, the building is worthless, but the trust has $1M cash with which to buy a new building.

[187] The Supreme Court has held repeatedly that statistics and estimates are not sufficient to justify the accrual of expense deductions. See *Brown v. Helvering*, 291 U.S. 193 (1934); *Schlude v. Comm'r*, 372 U.S. 128 (1963).

[188] Depreciation formulas under the existing income tax are based on assignments of a fixed useful life to broad categories of assets, but these stipulations of useful life are only tenuously based on statistics. See § 168(c) & (e). Depreciation rates, see §§ 168(b), which ignore estimated salvage, are also arbitrary.

[189] See Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 Va. Tax Rev. 1 (1984).

[190] See note ???. See generally, Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 Am. J. Tax Pol'y 17 (1998). Although the Supreme Court has occasionally flirted with the matching concept, see Hertz Corp. v. United States, 364 U.S. 122 (1960), this can be taken as simply a reference to Congressional intent in providing for depreciation, rather than as espousing a fundamental income tax principle.

[191] If the cost of an indefinite-life asset is the sum of the present values of all future receipts to infinity, then a present value can be assigned to each future year ad infinitum.

[192] See § 167(a) (requirement of exhaustion, wear and tear, or obsolescence).

Instead, any plausible tax rationale for depreciation must focus on the asset itself (rather than a related income stream).[193] The only rationale that would pass muster would be that depreciation deductions account for "realized" partial losses that occur irretrievably with the passage of time. A problem with this rationale is that partial losses (apart from depreciation itself, which is conferred by Congress) are not allowed under the existing income tax precisely because such losses are not "final" (sustained), i.e., are not realized.[194] Cases where the basis of the asset is allocated among physical sub-assets (acres, tons, barrels, gallons, component parts) of the larger whole, and deducted as and when such sub-assets are finally disposed of, do not involve partial losses, but instead total losses of separate items that can be said to exist in space. In the case of productive assets, partial losses are not realized with the passage of time. Realization (full basis recovery) occurs only when the asset is finally disposed of.

The depreciation problem is purportedly "solved" by allocating the basis of a productive asset to future time periods, and treating the passage of time as entailing the loss of discrete "temporal" components of the asset. Depreciation is indeed proper in the case of financial assets, but only where the asset is a bundle of claims to fixed payments to be made at fixed dates.[195] Here, the collection of each payment represents an irretrievable total loss (by way of liquidation) of a discrete sub-asset with respect to the bundle of rights.[196] Each sub-asset is a claim to a future cash payment, and when the cash is received, that claim vanishes.[197]

However, in cases not involving financial instruments consisting of a bundle of temporal components, a time period is not a true severable component of the asset.[198] The fact that the method of depreciation ("Samuelson" depreciation[199]), which is favored by accretion income tax theorists, is modeled on the financial-instrument paradigm does not prove that productive assets

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[193] The Supreme Court rejected matching in *Hort v. Comm'r*, 313 U.S. 28 (1941), where it refused to allow accelerated cost recovery to be taken as a match to accelerated income. The Court noted that the taxpayer had no separate investment in the cash flows apart from the taxpayer's investment in the underlying property, so that the cash receipt did not mark the loss of an asset. Accord, Comm'r v. Idaho Power Co., 418 U.S. 1, 10 (1974) (stating that asset is "consumed" over time, but failing to clearly distinguish this rationale from that of "matching").

[194] See *Lakewood Associates v. Comm'r*, 109 T.C. 450 (1997); *Pulvers v. Comm'r*, 48 T.C. 245 (1967), *aff'd*, 407 F.2d 838 (9th[th] Cir.1969); *Citizens Bank v. Comm'r*, 252 F.2d 425 (1st Cir.1957).

[195] Prepaid expenses allocable to fixed time periods are properly amortized. Examples include prepaid rent, interest, and insurance coverage for a fixed period.

[196] No self-evident method presents itself as to how to allocate basis among the various future receipt rights. The basis could be allocated (1) ratably among the receipt rights, (2) according to their respective present values when the asset is purchased, or (3) according to the decrease in the present value of the package attendant upon the current receipt (illustrated in Joseph M. Dodge et al., Federal Income Tax: Doctrine, Structure, and Policy 664-79 (4th ed. 2012)). Accordingly, basis-allocation rules have had to be supplied by statute (see § 72(a) & (b), for annuities), regulation (see Treas. Reg. § 1.461-4(e), for identifying interest on debt obligations), and courts (see, e.g., *Burnet v. Logan*, 283 U.S. 404 (1931)).

[197] An example would be a royalty right for, say, 20 years. A proper allocation can be made (retroactively) only after the aggregate royalty amount for the entire period has been ascertained.

[198] The Supreme Court so held in *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (no basis offset for carve-out sale of right to royalties up to fixed amount); *Comm'r v. Gillette Motor Transport*, 364 U.S. 130 (1960) (no basis recovery against "sale" of carved-out term interest). Likewise, taxpayers cannot obtain depreciation deductions by carving out and retaining a term interest in a non-wasting asset. See § 167(e); *Lomas Santa Fe, Inc. v. Comm'r*, 74 T.C. 662 (1980), *aff'd*, 663 F.2d 71 (9th Cir. 1982), *cert. denied*, 460 U.S. 1083 (1983).

[199] The Samuelson thesis takes its name from Paul E. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. Pol. Econ. 604 (1964).

(like equipment) should be depreciated under a realization income tax.[200] Time, although irreversible, does not necessarily entail a permanent loss of any asset portion or component, and any diminution of productive use can be reversed (or held at bay) by repairs or other events. (Indeed, if depreciation is treated as a series of deductible partial losses for wear and tear, reducing the taxpayer's adjusted basis in the asset, then repairs must really be capital expenditures that restore basis, and should not be currently deductible.) The alleged partial loss under formula depreciation only *seems* irreversible because the underlying mathematical models *assume* irreversibility by assigning portions of the cost to various years and treating the passage of any year as resulting in an irretrievable loss of the cost allocated to that year. Additionally, the construction of the formulas themselves (specifically, the fixing of depreciation periods, the allocation of costs to various years, and deciding on the rate of depreciation) is, at worst, arbitrary and, at best, based on ex ante assumptions and estimates, and the entire exercise flunks the standard for not only realization but also for tax accrual accounting.

Ultimately, the normative claim for formula depreciation is external to tax, namely, that it is a second-best alternative to an accretion system, which would be economically neutral.[201] Economic neutrality is a different norm than tax fairness, and choosing between the two norms is ultimately a political decision. To be weighed on the side of eliminating depreciation is the considerable simplification of tax compliance and administration, especially for individuals who own rental property. And, it would allow the system to abandon the *Crane* doctrine and revamp the tax treatment of borrowing along the lines suggested above.

Stepping back, depreciation sticks out like a sore thumb, because the tax system fails to tax *gains* attributable to the passage of time, except in the narrow case of original issue discount (OID), which correctly requires a financial instrument providing for fixed payments at fixed future dates.[202] 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. Depreciation tilts the playing field of the current income tax towards systematic understatement of income.

E. Taxation of Business Entities and their Owners

From a fairness perspective only individual taxation matters, and the existing corporate tax is irrelevant.[203] However, the problem remains of how to tax equity interests in business

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[200] Basically, Samuelson depreciation is just another ex ante formulaic system based on certain assumptions, the main one being that a productive asset yields a cash flow, which in turn allows one to construct an "internal rate of return" (the discount rate used to reduce a cash flow to present value) for the asset. However, a productive asset in fact generates no cash flow on its own. In *Hort*, supra note ???, the Supreme Court held that that the receipt of advance rents from a building was not a "component" of the building. Only a line of business (generally with a labor input) possesses a cash flow.

[201] The normative point of Samuelson depreciation is that it is the closest formula system to annual valuations, and that it (therefore) not influence the price of productive assets.

[202] See §§ 1272(a)(1), 1373(a)(1).

[203] The burden of taxes on corporations is not really known. See, e.g., Benjamin H. Harris, Corporate Tax Incidence and its Implications for Progressivity, The Tax Pol'y Center (November 2009), available at: http://www.urban.org/UploadedPDF/1001349_corporate_tax_incidence.pdf. If incidence could be known, it would probably vary across industries and firms.

entities. A public corporation may rarely pay dividends, and shareholders cannot compel dividends or redemptions, although they can readily sell their shares on an exchange. Equity-holders in non-public entities usually hold positions that are even less liquid than public-corporation shareholders. Both pass-through and mark-to-market approaches would violate the realization principle. Not imposing any tax until a business entity makes distributions to equity-holders would invite indefinite deferral of economic income. The way to honor the realization principle across the board, while preventing its abuse, would be to subject *all* business entities (and their equity-holders) to a withholding/credit system, commonly referred to as an "imputation" system.[204] 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 unanimous consent of equity-holders.

F. International Taxation

How does one conceptualize the concept of fairness in the international context? Fair taxation is generally thought of along the lines 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 a country to tax income)[205] are "elective" in a sense. 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 Kay, 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 Kay is now in lower marginal rate brackets in each country (@ 25% average rate, Kay's aggregate tax is $300K [3 x ($400K x .25)], for a tax savings of $180K.

The problem is solved (in theory) 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 proper share thereof. In the Kay example above, if we assume that each of Countries X, Y, and Z has a one-third interest in Kay's aggregate taxable income, then Countries X, Y, and Z would impose a tax equal to one-third of its hypothetical tax of $480 calculated on

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[204] 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).

[205] International law and practice allows a "national" of a given country to be taxed by that country on that individual's world-wide taxable income, and it also allows the country (other than that of the taxpayer's nationality) in which the income arises (the source country) to tax such income. 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.

the basis of Kay's world-wide income of $1.2M. In the end, Kay 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' redistributive agenda but also the status of the income tax. 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.

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 forced or 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 non-deductibility (of consumption cost) within the larger principle that (except for allowances of the bottom) only realized costs of producing income are deductible.

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.