

The Terrible State of the Tax Base

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Taxable income has become a rotten measure of the nation's economic resources. Years of tax planning, myopic doctrine, and constituent pressure have left the tax base looking like a sponge with large holes and little fiber. The system needs repair. Improving the description of either consumption or income will expand the tax base.

Taxable income figures do not describe the standard of living of our richest taxpayers. A *Forbes* survey estimated that in 2000, the nation's richest 400 taxpayers paid total taxes of "barely" 1 percent of their wealth.¹ Some pay less. Leona Helmsley famously told her maid that "only little people pay tax," which was merely a description of the world as she knew it. Helmsley was married to one of the richest holders of real estate in the country, and the excess depreciation deductions kicked off by their hotels must have meant permanent shelter.² Realization rules also meant that much of the Helmsleys' wealth was never reached by the income tax. According to the taxable income data, the Helmsleys were destitute.

Economic tax rates on capital have decayed to almost nothing. The real tax rates on investment across the economy can be measured by how much interest an investor must give up to get legal tax exemption on long-term municipal bonds.³ By that

¹William P. Barrett, "Unrealized Riches," 172 *Forbes* 60 (Oct. 6, 2003).

²Calvin H. Johnson, "Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation," *Tax Notes*, Aug. 4, 2003, p. 713; Calvin H. Johnson, "Pretty Cruddy Investments Brought to You by Stimulus Depreciation," *Tax Notes*, Feb. 11, 2008, p. 731.

³Calvin H. Johnson, "A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax," 56 *S.M.U. L. Rev.* 13 (2003).

measure, our tax system imposes only trivial taxes on investment. Taxpayers have too many opportunities to avoid tax, and they are willing to, and must, accept only trivial reductions in interest for municipal bonds.

Given the state of the system, tax incentive deductions are wasteful. The federal cost of tax incentives is no longer being passed on to the supposed beneficiaries. Many of the best 500 ideas for base expansion would just repeal existing tax expenditures.

Our tax system also imposes widely divergent tax rates on different kinds of investments. You can measure how tax reduces pretax return by looking at the ratio of adjusted basis to the pretax fair market value of the investment. By that measure, businesses like Macy's that are subject to serious capitalization inventory rules pay tax in excess of the statutory tax rate. Some of the least meritorious companies bear the lowest rates of tax, including, for example, Lorillard Tobacco Co. and the makers of the video games Guitar Hero, Doom III, and Grand Theft Auto IV.⁴

Expand the Tax Base

The best tax base is broad and unavoidable. Avoided tax does no one any good. Taxpayers rationally do themselves damage by planning around tax, and the government collects no revenue from a tax that has been avoided. Both real work and real savings are inelastic in response to tax, but for the federal government to get access to the advantage of the underlying inelasticities, the system needs to cut off easy alternatives to paying tax. Taxpaying cannot be voluntary. The broadest tax base also allows the lowest tax rates for any given level of revenue.

The task force proposals should protect and expand the tax base in 500 good ways. The Shelf Project, which I help lead, is a collaborative effort to offer proposals for raising revenue without raising rates.⁵ Its ideas should help.

⁴Calvin H. Johnson, "The Effective Tax Ratio and the Undertaxation of Intangibles," *Tax Notes*, Dec. 15, 2008, p. 1289.

⁵Calvin H. Johnson, "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077.

We need to use mark-to-market accounting whenever there is a public market for the assets. Accountants have done that for years, although with exceptions about subjective intent that are unnecessary for tax. The realization limitation, which is too indulgently interpreted, creates a kind of quasi-cash method under which a taxpayer can easily avoid tax by avoiding cash. We need to reach noncash resources more broadly by, for instance, repealing the exemption for like-kind exchanges and reorganizations.⁶ We should tax the value of the use of personal-use property, even when the economic value of the use has not been reduced to cash.⁷

Tax accounting also captures the interestlike income from property only if the adjusted basis for the investment is equal to fair market value. The prime directive that adjusted basis must equal investment value implies repeal of last-in, first-out inventory accounting and an end to taxpayer identification of which block of stock has been sold.⁸ Loss deductions should not be allowed when the taxpayer has basis that has not been lost.⁹ Cash received should be treated as a realization of the taxpayer's built-in gain before it is treated as recovery of basis not yet lost.¹⁰

The task force can help the government meet its revenue goals from taxpayers with real economic consumption of more than \$250,000, but it must want to do it. For example, section 1014 gives a taxpayer a basis for inherited property that includes imaginary cost. Wastrel heirs can consume the founder's capital

⁶See, e.g., Calvin H. Johnson, "Impose Capital Gains Tax on Like-Kind Exchanges," *Tax Notes*, Oct. 27, 2008, p. 475 (proposing to tax like-kind exchanges because they are always cash sales except that the cash is kept offstage); Calvin H. Johnson, Andrew Pike, and Eric A. Lustig, "Tax on Insurance Buildup," *Tax Notes*, Feb. 2, 2009, p. 665 (proposing to tax the earnings on a life insurance contract, just as bank account earnings are taxed).

⁷Calvin H. Johnson, "Taxation of the Really Big House," *Tax Notes*, Feb. 16, 2009, p. 915.

⁸Calvin H. Johnson, "End Identification of Stock Certificates," *Tax Notes*, June 16, 2008, p. 1171.

⁹Calvin H. Johnson, "Casualty and Business Losses When Basis Hasn't Been Lost," *Tax Notes*, July 28, 2008, p. 357.

¹⁰Calvin H. Johnson, "End Tax-Free Monetization of Wealth," *Tax Notes*, June 30, 2008, p. 1361; Calvin H. Johnson, "Deferred Payment Sales: Change the Basis and Character Rules," *Tax Notes*, July 14, 2008, p. 157.

without either founder or wastrel paying tax.¹¹ Basis should include only real and provable investment costs. The estate tax should raise significant revenue. When capital gains are consumed, as often happens, the regular set of tax brackets should apply. Capital gains, combined with ordinary deduction of inputs, routinely create negative taxes or shelters.¹²

It may well be that tax accounting under current law is irremediable. The distortions caused by accounting-based income taxes are so severe that we may need to reduce our reliance on accountant-defined income. We should impose a higher tax on carbon put into the air, and we should similarly impose a tax on shareholder and partner access to public markets measured by market capitalization.¹³ Taxes that taxpayers are willing to pay for benefits they need have no deadweight losses. ■

¹¹Calvin H. Johnson, "The Elephant in the Parlor: Repeal of Step-Up in Basis at Death," *Tax Notes*, Dec. 8, 2008, p. 1181.

¹²See, e.g., Calvin H. Johnson, "Sale of Goodwill and Other Intangibles as Ordinary Income," *Tax Notes*, Jan. 14, 2008, p. 321.

¹³Calvin H. Johnson, "Replace the Corporate Tax With a Market Capitalization Tax," *Tax Notes*, Dec. 10, 2007, p. 1082.