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Alan L. Feld

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SILENT TAX CHANGES: THE POLITICAL ECONOMY OF INDEXING FOR INFLATION

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Alan L. Feld
Boston University School of Law

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Silent Tax Changes: The Political Economy of Indexing for Inflation

By Alan L. Feld*

Abstract

The federal income tax adjusts many but not all of its dollar components automatically to account for inflation. In this article I analyze the benefits and burdens this process confers on some taxpayers and the political logic behind them. I discuss the choice of the proper index for making the adjustments, as well as the effects of the failure to adjust specific dollar amounts. I conclude that some adjustments have become overly generous, while unadjusted provisions suffer slow repeal, sometimes intentionally. Indexation thus can have the effect of tax legislation by stealth.

*Professor of Law and Maurice Poch Faculty Research Scholar, Boston University School of Law.

A legal rule, no matter how neutral in form, creates winners and losers. To take a sports analogy, a professional basketball hoop sits ten feet above the ground, a neutral rule in form. Now substitute a different neutral rule: imagine the game of basketball with the hoop at a height of five feet or twenty feet. Under a five-foot rule, players of average height might have a more prominent role in the game, while under a twenty-foot rule layups would become more difficult and shooters who are more accurate from outside might be in greater demand. Exceptions to a rule create even further disparate effects. Imagine for example a rule that the hoop must be lowered when shorter players take foul shots.

This paper examines the disparate effects of a rule employed in the federal income tax, indexation of dollar amounts to take account of inflation. Inflation reduces the buying power of a fixed dollar amount. Accordingly, inflation changes the impact of the federal income tax whenever the Internal Revenue Code (the "Code") employs a fixed dollar amount.¹ The rate structure for individuals provides an obvious example. The Code calculates the amount of federal income tax owed by applying to a defined base, taxable income, a series of rates, divided into dollar-denominated brackets. The rates increase with income.² When income rises to the level of a new bracket, any additional income incurs tax at the higher rate. If a person's income rises at the same rate as that of inflation and thus maintains the same before-tax buying power, but those brackets remain unadjusted, the proportion of income the individual must pay in tax generally increases. Inflation thus can cause an increase in the share of real income subject to tax. The aggregate effect on revenue can be substantial. Estimates in the 1970s, a period of unusually severe inflation in the United States, put the rate of increase in tax revenue at 15 - 16% for every 10% of inflation.³

To correct for this effect, the Code currently makes automatic annual inflation adjustments to the dollar brackets in the rate table, based on changes in a consumer price index ("CPI").⁴ The Bureau of Labor Statistics (BLS) calculates a number of CPIs. The Code generally makes its adjustments using the CPI for all-urban consumers ("CPI-u").⁵ Like any rule, the automatic inflation adjustments to the income tax create winners and losers.

¹ Inflation does not alter the value of amounts expressed as percentages or fractions.

² I.R.C. §1.

³ HENRY J. AARON, INFLATION AND THE INCOME TAX 66 AM. ECON. REV. 193, 195 (1976).

⁴ I.R.C. § 1(f) (2012) (cost of living adjustments is based on the Consumer Price Index for urban consumers)

⁵ Certain business credits use a GNP implicit price deflator to make adjustment, e.g. section 43(b)(3).

Social security inflation adjustments, both for calculation of benefits and for the cap on earned income subject to tax, use a different index, the CPI for urban wage earners and clerical workers ("CPI-w"), 42 U.S.C. 415(i).

This paper explores the politics and distributional effects of those adjustments. Part I provides a short introduction. Part II considers the positive and negative effect of Code provisions that adjust automatically for inflation. Part III provides several examples of tax provisions that do not adjust the dollar amounts for inflation and analyzes the political reasoning related to the absence of the adjustment. Part IV provides a brief conclusion.

I. Introduction

Inflation reduces the real value of money. Private parties often adjust their transactions to take account of this effect. As an example, if a worker receives the same dollar wage after a period of inflation, the worker's buying power declines. If the worker instead receives wage increases equal to the rate of inflation, the worker gets more dollars but maintains the same buying power.

The Code contains many fixed dollar amounts. As inflation reduces the buying power of those amounts, it increases the burden of taxation and redistributes it.⁶ Congress could deal with the effects of inflation in one of four ways. It could do nothing; it could adjust dollar amounts periodically through legislation; it could require automatic adjustments, using a specified index of inflation; or it could provide a substitute for the effects of inflation.⁷ Congress has pursued all of these methods at various times. Each will have different effects on the distribution of the tax burden. If Congress refrained from taking action, inflation would produce a gradual increase in total tax revenue and alter the relative distribution of the tax incidence.⁸ When Congress provides for automatic adjustments in all elements of the tax structure, it maintains the previously existing allocation of the tax burden. In the absence of uniform automatic adjustments, periodic changes instead create opportunities for shifting portions of the tax burden among different groups and for changing the amount of revenue produced.⁹

Any change in a tax provision affects one or more groups, either beneficially or adversely. Even an apparently technical adjustment, correction for inflation, has this effect and as a consequence can generate political opposition. The most recent political dustup concerned a proposal to substitute a more accurate measure of inflation for the CPI-u in the income tax and for the CPI-w as applied to social security. Economists have criticized the CPI-u as a flawed measure of the cost of

⁶ DONALD W. KIEFER, CONG. RESEARCH SERV., REP. NO. 83-115, THE EFFECTS OF INDEXATION ON INDIVIDUAL INCOME TAX SYSTEM A SIMULATION RECORD, 15-22 (1983).

⁷ See generally, *id.* at 23-25 (discussion of policy implications of the various approaches).

⁸ See discussion *infra* p. 12.

⁹ See KIEFER *supra* note 6 at 22.

living.¹⁰ One significant flaw consists in its failure to take full account of changes in consumer behavior in response to inflationary price changes.¹¹ To reflect these changes more accurately, the BLS developed an alternative index called the chained CPI ("c-CPI").¹² Prominent economists have advocated substituting the c-CPI for the CPI-u for at least a decade and a half.¹³ The Bowles-Simpson Commission in 2010 had recommended the change, calling it a technical improvement.¹⁴ The President's 2014 budget proposed to substitute the c-CPI for the CPI-u and CPI-w in making income tax and social security inflation adjustments.¹⁵ The widely discussed 2014

¹⁰ See Jerry Hausmann, *Sources of Bias & Solutions to Bias in the Consumer Price Index*, 17 J. ECON. PERSP. 23 (2003). (addressing failure of CPI to account for substitution bias);

Michael J. Boskin, *Causes and Consequences of Bias in the Consumer Price Index as a Measure of the Cost of Living*, 33 ATLANTIC ECON. J. 1(2005);

ADVISORY COMM'N TO STUDY THE CONSUMER PRICE INDEX, 104th CONG., FINAL REPORT TO THE SENATE FINANCE COMMITTEE (aka "*The Boskin Commission Report*") (Comm. Print 1996)(Recommendation # 3 recommending the development of a Cost of Living Index that accounts for substitution bias).

See also JULIE M. WHITTAKER, CONG. RESEARCH SERV., RL32293, THE CHAINED CONSUMER PRICE INDEX: WHAT IS IT AND WOULD IT BE APPROPRIATE FOR COST-OF-LIVING ADJUSTMENTS? (2013)

¹¹ ADVISORY COMM'N TO STUDY THE CONSUMER PRICE INDEX, 104th CONG., FINAL REPORT TO THE SENATE FINANCE COMMITTEE (aka "*The Boskin Commission Report*") 15-16 (Comm. Print 1996)

¹² *Note on a New, Supplemental Index of Consumer Price Change*, BUREAU OF LABOR STATISTICS, <http://www.bls.gov/cpi/cpisuptn.htm> (last updated Apr. 26, 2011).

average rate of inflation for CPI-U & c-CPI:
<http://www.bls.gov/news.release/cpi.t05.htm>

¹³ *See Boskin Commission Report, supra* note 7.

¹⁴ NAT'L COMM. ON FISCAL RESPONSIBILITY AND REFORM, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*, 51-52, (Dec. 2010).

¹⁵ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2014, 46 (2013).

tax reform proposal made by Representative David Camp, then Chairman of the House Ways and Means Committee, included a shift to the c-CPI.¹⁶

But changing the measure of inflation produces winners and losers. For its economist proponents, the virtue of the chained CPI lies in its more accurate reflection of the change in the cost of living caused by inflation. The political reaction to the proposed use of the c-CPI takes the projected impact on particular groups into account. President Obama's budget proposal for fiscal year 2014 to use c-CPI to make the inflation adjustments,¹⁷ provoked a heated reaction from social security advocates.¹⁸ They opposed the change because the new method would produce smaller inflation adjustments and therefore smaller annual increases in social security benefits. The effect of the proposed change on the income tax garnered a more muted reaction, however, notwithstanding that smaller adjustments under the proposal would lead to cumulatively larger increases in tax revenues.¹⁹ The critics' reaction achieved their desired result. The President's 2015 budget dropped the proposal to substitute the c-CPI.²⁰

Had Congress adopted the proposal, it could have produced a fiscal double benefit. As the critics understood, the substitution of c-CPI for CPI-w for social security purposes, results in smaller annual benefit increases. As applied to the income tax, the substitution of c-CPI for CPI-u produces smaller adjustments to the rate brackets. The smaller adjustments result in higher tax burdens than under the

¹⁶ Discussion draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code, Section 1001 (2014), *available at* http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft_0226.pdf.

¹⁷ OFFICE OF MGMT. & BUDGET, *supra* note 11, at 46.

¹⁸ See Gary Koenig & Mikki Waid, AARP Public Policy Institute, *Proposed Changes to Social Security's Cost-of-Living Adjustment: What Would They Mean for Beneficiaries?*, INSIGHT ON THE ISSUES 71, Oct. 2012

3http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/proposed-changes-cola-insight-AARP-ppi-econ-sec.pdf. (criticism of the proposed changes began before the budget was released in 2013).

¹⁹ The 2014 Budget projected that the change would result in a cumulative deficit reduction over ten years of \$230 billion, of which \$130 billion was attributable to social security benefit reduction and \$100 billion to revenue increase. OFFICE OF MGMT. & BUDGET, *supra* note 171, at 186, 191 (Tables S-3 and S-6).

²⁰ See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015 (2014). At about the same time, the Bureau of Labor Statistics stopped publishing annual computations of the c-CPI but continued to publish monthly updates.

CPI-u. In combination, the change to c-CPI would reduce federal government expenditures and increase revenues,²¹ all without any other explicit legislative or regulatory action. In the realm of politics and government budgets, this change appeared to present a nearly painless way to reduce government deficits. Publicity and political reaction, however, ended the flirtation with the more accurate c-CPI..²²

Many provisions of the Internal Revenue Code apart from the rate schedules likewise reference dollar amounts.²³ Some, including the personal exemption and the standard deduction, provide automatic inflation adjustments based on the CPI-u.²⁴ To the extent that the c-CPI constitutes a more accurate corrective for inflation than the CPI-u, some taxpayers who claim deductions or credits using those provisions have been receiving adjustments that exceed the effects of inflation. They have enjoyed unstated cuts in their real tax burdens.

For some provisions that do not automatically adjust for inflation, Congress has changed the dollar amounts from time to time, providing a less systematic offset to inflation.²⁵ Still other provisions have remained unadjusted.²⁶ The failure to adjust the dollar amount of a benefit reduces the benefit's value. Over time, the cumulative reduction acts as a *pro tanto* repeal.

These unadjusted provisions tend to benefit individuals rather than businesses. Business-related tax provisions benefit more consistently from automatic inflation adjustments than personal deductions or credits.²⁷ Often, the legislative process provides no reasons for distinguishing among base-defining

²¹ See OFFICE OF MGMT. & BUDGET, *supra* note 1 at 186 & 191.

²² It calls to mind the statement attributed to Jean Baptiste Colbert: "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing". OXFORD DICTIONARY OF QUOTATIONS, 238 (Elizabeth Knowles ed., 7th ed. 2009).

²³ E.g., I.R.C. §63 (standard deduction), §151 (personal exemption), §21 (child and dependent care credit) and §163(h) (home mortgage interest deduction).

²⁴ I.R.C. § 151(d)(4) (2012)(personal exemption) and I.R.C. § 63(c)(4) (standard deduction) refer to §1(f), which mandates use of the CPI-u.

²⁵ See e.g., I.R.C. § 21 (Child and Dependent Care Credit) In 2001, Congress increased the maximum amounts of creditable expenses from \$2400 to \$3000 for one dependent and from \$4800 to \$6000 for two or more dependents and changed the applicable level of adjusted gross income from which to calculate the credit from \$10,000 to \$15,000 P.L. 107-16 §204a. See discussion *infra* p.)

²⁶ E.g. I.R.C. §§ 79, 1211(b) and 1341.

²⁷ See e.g., I.R.C. § 45(e)(2) (10)(B)(ii). A few business-related provisions make their adjustments using a different metric for the inflation adjustment, the GNP implicit price deflator. For these provisions, assuming the GNP deflator continues to apply, any move from the CPI-u to the c-CPI would have no effect.

provisions that receive adjustment and those that do not. When it enacted automatic inflation adjustments for rates, the standard deduction and the personal exemption, lawmakers argued that no taxpayers should pay more in income tax solely by reason of inflation.²⁸ But as a result of Congress' failure to adjust all dollar provisions, inflation operates selectively to increase the income tax burden on certain groups of taxpayers.

One important area in which the Code does not apply a specific inflation adjustment concerns the measurement of gain and loss from investment.. Under the realization requirement, the tax system defers recognition of gain or loss until a realization event occurs.²⁹ When it does, the difference between amount realized and adjusted basis determines the extent of the gain or loss.³⁰ These dollar amounts derive from different periods. Any intervening inflation reduces the buying power of the dollars received later. The tax-defined gain accordingly will differ from the real gain as measured in goods and services. Thus, a taxpayer who purchases an asset for 100 and sells it later for 110, has a gain of 10 for tax purposes. If inflation occurred during the intervening period at the rate of 7%, the taxpayer needs 107 to restore the buying power of the initial investment and would have only 3 as the amount of real gain. With no adjustment for inflation, the tax rule overstates the gain subject to tax. If the asset appreciated at a much greater rate, the effect of inflation declines, while if the asset appreciated at a rate less than the rate of inflation, the taxpayer might have a real loss but be taxed as having a gain. The preferential treatment of long-term capital gains sometimes is justified as an offset to the effects of inflation, although the benefit conferred does not match well with the loss of buying power to the original investment.³¹ Inflation similarly can distort the proper deduction for depreciation and depletion. The amount of capital initially invested, measured in nominal dollars, deducted over time represents declining real value. Accelerated depreciation arguably provides some offset to this effect in the aggregate. Adjusting debt or interest payments for inflation presents difficult political and practical problems.³² This issue, the measurement of gain and loss from

²⁸ STAFF OF JT. COMM. ON TAXAT'N, 97TH CONG., GEN. EXPLANATION OF THE ECON. RECOVERY TAX ACT OF 1981, 17-18 (Comm. Print 1981) .

²⁹ I.R.C. § 1001(c).

³⁰ I.R.C. § 1001(a).

³¹ As an example, assume an investment of 100 and inflation between purchase and sale of 10%. If the investor sells at 107 and recognizes nominal gain of 7, the reduced rate of tax on the gain fails to compensate for the loss of buying power in the original dollar investment. On the other hand, if the investor sells for 200, at the current reduced rate of tax on 100 of gain, the Code overcompensates for the loss of buying power in the initial investment.

³² See US Dept. of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President* (1984)

investment over time, has received extensive analysis elsewhere and will not be addressed in this paper.³³

This article first considers some of the effects of automatic inflation adjustments using the CPI-u. It then examines some examples of the selective omission of automatic inflation adjustments.

II. Effects of adjustments for inflation

The rate structure

The Code calculates the individual income tax using a progressive rate schedule.³⁴ The rate structure applies increasing percentages to dollar denominated brackets. Progressivity has its critics, but has been embedded in the individual income tax virtually since its inception. Several fairness rationales argue for progressivity.³⁵ One rationale for progressive rate taxation lies in the intuition that the marginal utility of money declines as income increases.³⁶ In other words, the next dollar means more to a poor person than it does to a rich one, so the latter can afford to pay more of it in taxes.³⁷ Determining the extent to which this holds true calls for speculation, but assuming it does, the marginal utility of money probably declines at different rates for different people, and averaging these rates would be arbitrary as a measure of individual utility. The rate brackets in the Code do not

³³ Reed Shuldiner, *Indexing the Tax Code*, 48, TAX L. REV. 537 (1992); Daniel Halperin and Eugene Steuerle, *Indexing the Tax System for Inflation* in *Uneasy Compromise* (Aaron, Galper and Pechman, eds. Brookings 1988), 347 - 383; Michael C Durst, *Inflation and the Tax Code: Guidelines for Policymaking*, 73 MINN. L. REV. 1217 (1989).

³⁴ I.R.C. § 1 contains five rate schedules. Four apply to individuals with varied marital or family status. All impose progressive rates. For convenience, this text refers to a single rate schedule, that for married individuals filing joint returns. A similar analysis would apply to the other three individual rate schedules. The fifth rate schedule, applicable to trust and estates, provides much faster progressivity, in order to discourage using the trust and estate entities to avoid the higher levels of the individual rates.

³⁵ Much writing has discussed the subject of progressivity in the income tax. The classic work is Walter Blum & Harry Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

³⁶ *Id.* at 455-456; see also STAFF OF JT. COMM. ON TAXATION, 97TH CONG., GEN. EXPLANATION OF THE ECON. RECOVERY TAX ACT OF 1981, 11 Dec. 31, 1981

³⁷ *Id.*

purport to track declining marginal utility of money in a systematic way. They constitute only a gross approximation of “ability to pay” as so understood. Another rationale for a progressive rate schedule sees it as offsetting regressive state and local tax systems. Again, no specific legislative effort has been made to assemble and study the widely varying tax systems of the states and localities to determine the appropriate national balance for any regressive effects.³⁸ A third rationale argues explicitly for redistribution of income to achieve greater social equality.³⁹ Taxation constitutes one of the few tools available to government for this purpose.⁴⁰ The rate schedule represents a mix of these objectives, balanced with considerations of efficiency.⁴¹ In short, the progressivity in the rates reflects a political allocation of the tax burden by income which, like any political outcome, can be expected to shift from time to time.

Inflation alters the political bargain represented by the rate structure, as it reduces the real value of the dollar amounts that define the rate brackets.⁴² If the dollar amounts in the rate schedule remained unadjusted, most real incomes, including those that are only keeping pace with inflation, would move more quickly into higher brackets. If rates remained the same, the tax would take a larger share of the individual’s buying power than it had the year before. Assume an individual who receives income adjusted for inflation. When an unadjusted progressive rate structure defined by dollar cutoff amounts applies to the inflation-adjusted income, it increases the percentage of real income paid in taxes at all but the lowest income levels. This increase in effective rates on real income is often referred to as “bracket creep.”⁴³ The effect varies over the range of incomes. A taxpayer with modest taxable income, reduced to zero after deduction and credits, continues to incur no tax.⁴⁴ But once taxable income rises above that level, relatively more income incurs

³⁸ I know of no study/ effort that has been done.

³⁹ See e.g., Donna M. Byrne, *Progressive Taxation Revisited*, 37 *Ariz.L.Rev.* 739 (), discussing the redistribution of wealth.

⁴⁰ Other tools include direct grants and in-kind governmental subsidies.

⁴¹ See generally Blum & Kalven *supra* note 34 (discussion of efficiency).

⁴² See, e.g., illustration *infra* p. 13.

⁴³ See e.g., KIEFER *supra* note 6 at 5 (“bracket creep[:](the increase in taxes resulting from inflation under an unchanged tax system”).

⁴⁴ For 2015 a married couple filing jointly may claim a standard deduction of \$12,600 and two personal exemptions of \$4,000. Rev. Proc. 2014-61, I.R.B. 2014-47. If their income lies below \$20,600, they would have zero taxable income and no tax liability. For a discussion of possible refundable credits see *infra*.

tax at the taxpayer's higher marginal rate than before. Once a taxpayer reaches the highest marginal rate, the rate of increase in tax slows.

Inflation thus increases the government's tax of real income and shifts the relative burden of the tax away from the highest earners. Congress could restore the status quo or make other changes if it chose to respond directly to the effects of inflation. Automatic inflation adjustments prevent bracket creep and maintain both the level of real income paid in taxes and the existing distribution of the tax burden among taxpayers in real terms. Inflation adjustments conserve the pre-existing political arrangement and shift the onus of legislative action to proponents of change.⁴⁵

Indexing the tax rates

Prior to 1980, Congress responded to bracket creep with periodic tax reductions.⁴⁶ As a consequence, the net burden of income taxation for the previous fifteen years (income taxes as a percentage of gross national product) remained relatively constant, notwithstanding the high inflation rates of the 1970's.⁴⁷ The experience of those years, however, drew increased attention to the relationship between price inflation and income taxation.⁴⁸ In 1978 leading members of the Republican party in the House of Representatives pressed for automatic inflation adjustments.⁴⁹ One of their stated reasons for change criticized the periodic adjustment process. Democrats, they argued, took credit for tax cuts that merely kept pace with inflation. The Democratic majority in Congress rejected the proposal. The House Ways and Means Committee report argued that Congress' periodic adjustments of the rates and other Code provisions took account of inflation and operated more appropriately than automatic adjustments would. Discretionary adjustments focus tax cuts where policy makers deem them appropriate. They allow for selective cuts in the rates. Automatic indexing, on the other hand, would

⁴⁵ See discussion *infra* p. X; see also KIEFER *supra* note 29 at 5.

⁴⁶ See KIEFER *supra* note 6 at 5.

⁴⁷ See *id.* at 11 (table 2 shows effective tax rate in inflation adjusted dollars in terms of revenue).

⁴⁸ See *e.g.*, H.R. REP. NO. 5829, at 11, 23 (1980).

⁴⁹ Indexation of Certain Provisions of the Tax Laws: Hearing on S. 2738 Before the Subcommittee on Taxation and Debt Management Generally of the S. Committee on Finance, 95th Cong. 22-29 (1978) (statement of Rep. Bill Gradison- R, OH); ~~[Anti-Inflation tax Reduction and Reform Act, H.R. 11413, 95th Cong. (1978) (would have placed automatic inflation adjustments to the personal income tax brackets but died in committee).].

make it harder for Congress to engage in “responsible fiscal policy” and provide timely tax changes. The benefits of automatic indexing, it concluded, could be achieved better with occasional legislative tax cuts.

In 1981, however, after Republican electoral victories, Congress reversed course. Public concern about “bracket creep” doubtless contributed pressure to change. Inflation ran at 13.5% in 1980 and 10.3% in 1981. The income tax rate schedule contained fifteen brackets above zero, from 14% to 70%. Perhaps the misperception by some constituents, that when a taxpayer moved to a higher bracket all the income, not just the marginal dollars, suffered tax at the higher rate, deepened the anxiety surrounding bracket creep and increased pressure on Congress to act. Congress enacted a partial solution.

The 1981 Economic Recovery Tax Act included automatic inflation adjustments for the rate schedule, including the zero bracket amount (later reincarnated as the standard deduction), and the personal exemption, to begin in 1985.⁵⁰ Congress subsequently extended automatic inflation adjustments to many other fixed dollar amounts in the Code.⁵¹ The automatic adjustments have survived into an era of much lower inflation rates as well as a smaller number of tax brackets.⁵² Congress mandated calculation of the adjustments with reference to the consumer price index.⁵³ But that index, as already noted, may overstate the effects of inflation.

The 1981 Joint Committee report offered a number of rationales for the change to automatic indexing. It characterized the “automatic tax increases” caused by inflation as unfair to taxpayers “since their tax burden as a percentage of income could increase during intervals between tax reduction legislation, with an adverse effect on incentives to work and invest.” The increased taxes would provide the Federal government with an automatic increase in dollars of revenue, creating pressure for further spending. It viewed inflationary increases in real tax burdens as inconsistent with the rate reductions ERTA enacted. Indexing, it said, will “avoid the past pattern of inequitable, unlegislated tax increases and induced spending.”

Leaving aside the effects of inflation on the income tax base, discussed below, its precise effect on a taxpayer’s tax burden depends on where in the rate table the income falls. As an illustration, suppose a married taxpayer filing jointly, at the midpoint of the 15% bracket, earns taxable income of \$43,000 and incurs tax of \$5,600. The tax amounts to 13.02% of taxable income. Suppose inflation of 20%

⁵⁰ Pub. L. 97-34 sec. 104(f). Adjustments for the zero bracket amount and the personal exemption cross-refer to this section. P.L. 97-34, Secs. 62(b) and (c).

⁵¹ Lawrence Axelrod, of the Office of Chief Counsel of the Internal Revenue Service, has listed 47 current provisions indexed for inflation. See Axelrod, Chain, Chain, Chain: Taxes and Chained CPI, 139 Tax Notes, 461 (April 22, 2013)

⁵² Inflation in 2011 and 2012 ran at the rate of 3.2% and 2.1% respectively. The rate schedule for 2013 contains six brackets.

⁵³ Specifically, the CPI-u.

over five years. If income rises at the rate of inflation, taxable income will grow to \$50,304 in year 5. The unadjusted tax on it amounts to \$6,696. The percentage of income paid in tax comes to 13.31%. The taxpayer has incurred an additional tax of 0.29% on all of the taxable income, amounting to an additional \$146.

For income at the midpoint of the 25% bracket, the taxpayer earns taxable income of \$104,175 and incurs tax of \$18,293. The tax amounts to 17.56% of taxable income. If the income rises exactly at the rate of inflation, 20% over five years, it will rise to \$121,870 in year 5. The unadjusted tax on it amounts to \$22,717. The percentage of income paid in taxes comes to 18.64%. The taxpayer has incurred an additional tax of 1.08% on all of the taxable income, amounting to \$1,125 in real dollar terms.

At the bottom of the income range, a taxpayer whose income in year 5 falls below the sum of the unadjusted standard deduction and personal exemptions incurs no tax liability and suffers no increase in tax as a result of inflation. At the top of the income range, the percentage effects of inflation on the rate brackets decline as income increases. Thus, the effects of unadjusted progressive rates fall most heavily on the broad middle range of taxpayers.

Adjustment of the tax rates automatically eliminates increases in real tax, preserving the prior allocation of tax burdens.⁵⁴ In the absence of automatic inflation adjustments, Congress would have several choices: do nothing and affirm a silent increase in the level of income taxation; change rates periodically, and act to maintain the prior order in real dollar terms; change rates but enact a reallocation of the tax burden. Given that Congress generally finds it easier to reduce taxes than to raise them, automatic inflation adjustments help to foreclose the first and third possibilities. Thus, automatic adjustments have implications for legislative action. Unadjusted inflation raises the real tax burden without Congressional action.⁵⁵ Congress then can respond and adjust the results if necessary. Given the political barriers to raising taxes as compared with the ease with which Congress can reduce taxes, inflation can provide a political “cushion” to enable Congress to change the level of taxation. Automatic adjustments eliminate the cushion and make it harder to increase effective rates.

On the other hand, from a public choice perspective, we should applaud the automatic adjustments. Discretionary adjustments enhance the ability of powerful legislators to provide targeted benefits for supporters and friends. Automatic adjustments take this power out of their hands and eliminate the potential pool of government funds for distribution.

Corporate Income Tax

⁵⁴ Adjustment of the personal exemption and standard deduction amounts contributes to this effect, see p. *infra*.

⁵⁵ See discussion of bracket creep, *infra*. p.

The corporate income tax also applies progressive rates.⁵⁶ The Code taxes the first \$75,000 at rates significantly lower than the stated top rate of 35%.⁵⁷ It phases out the benefit of the lower rates in a range of income from \$100,000 to \$339,000. It imposes a nominal 34% rate on income from \$75,000 to \$10,000,000, but phases out that 1% benefit for income over \$15,000,000. It is unclear what the rationale may be for any progressivity in corporate rates, apart from congressional generosity for small business. The Code does not index these rates for inflation. As a consequence the real value of any graduation in corporate rates has declined. Perhaps the availability of pass-through treatment for unincorporated entities, some corporate entities and limited liability companies has rendered this effect less significant.

Alternative Minimum Tax

Until recently the alternative minimum tax (AMT) contained no automatic inflation adjustments. The AMT calculates tax on a broader base but at a lower rate than the regular income tax. It provides a two-bracket rate schedule and a substantial exemption amount, stated in dollars, which varies with marital status and phases out with income level. In order to prevent the expansion of the AMT to taxpayers with lower real incomes, Congress “patched” the AMT annually. When Congress reduced income tax rates in 2001 and 2003, it did not cut the AMT rates. Since the AMT consists of the excess of the tentative AMT over the regular tax, reduction in the regular tax increased the number of taxpayers subject to AMT. Congress responded by increasing the exemption amounts annually to limit expansion of the AMT and take account of year-to-year inflation. In 2012 Congress permanently increased the fixed dollar amounts in the AMT and introduced automatic inflation adjustments, effective beginning in 2013. The bracket amount in the AMT rate schedule, the exemption levels and the phaseout of the exemption amounts, all now receive annual inflation adjustments.

These changes dissipate the annual pressure to mitigate the effects of the AMT and appear to cement the AMT’s position as a permanent supplement to the regular income tax. Critics continue to advocate repeal of the AMT. Rep. Camp’s tax reform proposals included a recommendation for its repeal.

The proponents of an AMT initially sought to limit a taxpayer’s ability to reduce tax liability unduly through combinations of different deductions and credits. The current structure of the AMT generally fails to do so, while adding a complex parallel calculation to the regular individual income tax. Repeal would lose substantial revenue, but that shortfall could be made up more directly through the regular income tax. Unfortunately, that change would require engaging in a political battle that elected officials have little incentive to conduct. Inertia carries the AMT forward.

Deductions and credits

⁵⁶ IRC section 11.

⁵⁷ Code sections 1561 and 1551 limit the ability of a single enterprise to obtain multiple benefits from the lower rates through several incorporations.

While the dollar amounts in the rate schedule represent the most obvious subject for adjustment, inflation also affects many other parts of the tax calculation. The value of deductions stated as dollar amounts declines with inflation, leading to increased tax burdens unless adjusted.⁵⁸ Limits on benefits stated as dollar amounts likewise decline and thereby increase tax burdens unless adjusted.

The Standard Deduction

Automatic inflation adjustments for the rates have been closely linked to similar adjustments for the standard deduction. The present-day standard deduction serves two somewhat distinct functions in the income tax.⁵⁹ Congress originally created the standard deduction to ease the expansion of the income tax during World War II. Previously, only a small percentage of Americans paid any income tax.⁶⁰ By 1945, more than 70% of households filed returns. The prospect of the new tens of millions of taxpayers keeping records of itemized deductions, followed by government audits of small amounts, presented an administrative nightmare. Congress accordingly crafted the standard deduction as a simplifying alternative to itemization of certain deductions from gross income, such as state and local taxes. The standard deduction initially consisted of a percentage of adjusted gross income up to a ceiling amount. The standard deduction has undergone several structural changes over time. In its present form it allows a taxpayer to deduct a fixed dollar amount in lieu of claiming the itemized deductions.⁶¹

Congress later endorsed a second function for the standard deduction. Along with the personal exemption, it excludes from the tax base an amount of income sufficient for subsistence, generally identified with the official poverty level. This

⁵⁸ See e.g., numerical illustrations *infra* p. (illustrating effect inflation real value of fixed dollar amounts)

⁵⁹ See generally, John H. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203 (2011). See also Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 Tax L. Rev. 1 (1994); Allan J. Samansky, *Nonstandard Thoughts About the Standard Deduction*, 1991 UTAH L. REV. 531; Glenn E. Coven, *The Decline and Fall of Taxable Income*, 79 MICH. L. REV. 1525, 1556-64 (1981); Alan L. Feld, *Fairness in Rate Cuts in the Individual Income Tax*, 69 CORNELL L. REV. 429, 441 (1983); and Theodore P. Seto and Sande L. Buhai, *Tax and Disability: Ability to Pay and the Taxation of Difference*, 154 U. PA L. REV. 1053, 1088-93 (2006).

⁶⁰ See Eric M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes"*, 33 Ariz St. L. J. 1057, 1103 (only 1% of the population were initially subject to income taxes).

⁶¹ Code section 63(c). For 2015 the standard deduction amount for a married couple filing jointly is \$12,600, half that amount for a single individual or a married person filing separately, and \$9,250 for a head of household. Rev. Proc. 2014-61, 2014-47 I.R.B.

exclusion of income from the tax base adds to the progressivity expressed in the tax rates.⁶²

The simplification objective gives only very rough guidance as to how high or low to set the amount of the standard deduction. Different taxpayers incur varied amounts of the expenses that give rise to itemized deductions. In general, a taxpayer will claim the standard deduction when it exceeds the total of the itemized deductions that the taxpayer otherwise could claim. In recent years about two-thirds of tax return filers have claimed the standard deduction.⁶³ A larger dollar amount would reduce the number of itemizers, but also would increase the number of taxpayers whose standard deduction will exceed the actual itemized deductions for which it supposedly substitutes. A smaller standard deduction would tend to increase the number of itemizers and reduce the extent of the simplification, both for individual taxpayers and for the IRS.⁶⁴

The standard deduction as currently structured confers on many taxpayers with no or modest itemizable deductions a significantly larger deduction than simple substitution for the actual expenses. Compare the Smiths, a married couple who rent their home, with the Joneses, a couple who own their home, each couple earning wages income in 2015 of \$50,000. The Joneses incur and deduct mortgage interest expense and real property taxes.⁶⁵ Assume these amount to \$15,000 and that neither couple has any other itemized deductions. The Smiths will claim the standard deduction of \$12,600, which, in their case, “substitutes” for their itemized deductions of zero. They receive the full standard deduction benefit without any inquiry as to whether they have any itemized expenses.⁶⁶ Since the Jones’ itemized deductions exceed the standard deduction, they will itemize their deductions. But setting the standard deduction at a high level dilutes the value and incentive effects of their itemized deductions. The Joneses in the example will be able to deduct \$15,000 as itemized deductions, but that amount is only \$2,400 more than the Smiths’ deduction. At a marginal tax rate of 15%, the Joneses save \$360 in federal income tax as compared with the Smiths. This amount is far less than the \$2,250 benefit the Joneses might expect to receive when they simply multiply their

⁶² The standard deduction removes a portion of income from the tax base; the percentage of taxable income eliminated by the standard deduction decreases as income rises.

⁶³ See I.R.S. Table 1.2, Stat. Income Pub. 1304 (2010) Rev. 08-2012. (In 2010, out of 142,892,051 total returns filed, 93,678,175 claimed the standard deduction (65.6%)); I.R.S. Table 1.2, Stat Income Pub. 1304 (2011) Rev. 08-2013 (In 2011, out of 145,370,240 total returns filed, 96,619,312 claimed the standard deduction (66.5%)); I.R.S. Table 1.2 Stat Income Pub. 1304 (2012) Rev. 08-214 (In 2012, out of 144,928,472 total returns filed, 97,208,513 claimed the standard deduction (67.1%).

⁶⁴ See also John H. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203 (2011).

⁶⁵ I.R.C. § 163 allows taxpayers with mortgages on a their residences to deduct interest in computing taxable income. I.R.C. § 164 allows a deduction for certain state and local taxes, including real property taxes.

⁶⁶ See Rev. Proc *supra* note 61.

deductible expenses by their marginal tax rate. In this example, the Smiths enjoy a substitute deduction for nonexistent expenses, while the Joneses receive a limited marginal benefit for their actual expenses.

As currently in effect, the standard deduction in fact may serve as an implicit offset, especially for taxpayers in lower tax brackets, for itemized deductions untouchable directly through the political process. The package of homeowner benefits, including the deductions for mortgage interest and taxes, has been criticized as an inefficient incentive to invest in homeownership.⁶⁷ Nevertheless, these deductions enjoy strong political support. By providing a large standard deduction, the Code implicitly reduces the attractiveness of the itemized deductions. Assume the Smiths in the earlier example pay rent expense of \$15,000 and cannot deduct that expense. Without the standard deduction the disparate tax treatment between them and the Joneses would be far greater. Note that the benefit of the itemized deductions grows more than proportionately with the size of those deductions. If the Joneses had double the interest and real property tax expense, \$30,000, the excess over the standard deduction amount would rise to \$17,800.⁶⁸

An excessively large standard deduction available to renters dilutes the incentive effects of the tax deductions for homeownership. If every potential taxpayer receives one or another tax break, the benefit targeted to homeownership is mitigated. When Rep. David Camp, Chairman of the House Ways and Means Committee, published his proposals for income tax reform as the 2014 Chairman's mark, they included a significant increase in the standard deduction and elimination of the personal exemption. The change, the proposal said, would help to simplify tax return filing. The larger standard deduction would have done so by increasing the percentage of nonitemizers to an estimated 95% of all taxpayers. As a corollary, the incentive effects of the mortgage interest and real property tax deductions would have disappeared for the new standard deduction filers and would have been reduced for taxpayers who continued to itemize.

Some evidence points to an increase over time in the proportion of itemized deductions represented by the standard deduction. Since taxpayers claiming the standard deduction do not report the itemized deductions they otherwise would have claimed, we can make no direct comparison of the effects of inflation on both. Instead, I have used as a surrogate for comparison purposes, the average itemized deductions claimed by taxpayers in the same adjusted gross income range who did not take the standard deduction. The IRS reports itemized deductions by income

⁶⁷ See e.g., Rebecca N. [Morrow](#), *Billions Of Tax Dollars Spent Inflating The Housing Bubble: How and Why the Mortgage Interest Deduction Failed*, 17 FORDHAM J. CORP. & FIN. L. 751; Benjamin H. [Harris](#), C. Eugene Steuerle, Amanda Eng, *New Perspectives on Homeownership Tax Incentives*, 141 TAX NOTES 1315 (2013); Eric Toder, et al. *Reforming the Mortgage Interest Deduction*, [Urban Institute](#) (2010)

⁶⁸ At high levels of adjusted gross income (\$300,000 in the case of a couple filing a joint return), the Code imposes direct reductions on the allowable itemized deductions, IRC Section 68.

intervals. A change over time in the ratio of the standard deduction to the average itemized deduction for that income interval would suggest the extent to which the inflation adjustments to the standard deduction under or over compensate. For joint return filers in 1990 with adjusted gross income of \$40,000 - \$50,000 the standard deduction amounted to 50.2% of the average itemized deduction. For the same dollar interval in 2010 the percentage was 57.8%. In the \$50,000- \$75,000 range, the respective numbers were 41.66% and 56.2%. While the comparison is not definitive, since the dollar intervals themselves are not adjusted for inflation, the increase is suggestive.⁶⁹

Substitution of the c-CPI for the CPI-u as the adjuster for the standard deduction would slow or reverse any increase in its relative coverage. If that occurred, more taxpayers likely would itemize, with some increased administrative costs in record keeping, reporting and auditing burdens.

The standard deduction serves another function in the individual income tax.⁷⁰ Together with the personal exemption, the standard deduction operates to exempt from taxation an amount of income representing an individual or household level of subsistence. By placing the minimum amount needed for food, clothing and shelter beyond the reach of the income tax, these allowances leave an amount roughly equivalent to discretionary income subject to tax. The Code currently adjusts both the standard deduction and the personal exemption for inflation.⁷¹ Taxpayers whose incomes fall below this exclusion amount do not benefit from any inflation adjustment. The increase in dollar amount created by an inflation adjustment affects only those with incomes near to or larger than the poverty level.⁷²

In setting the appropriate subsistence level for income measurement purposes, analysts ordinarily look to the standard “poverty level.” The poverty level, calculated by the U.S. Department of Health and Human Services, consists of an estimate of the cost of a basket of goods and services, adjusted annually for inflation. The poverty level calculation and the tax adjustments for inflation currently employ the same index, the CPI-u, as the measure of their respective adjustments. Once established, the combined personal exemption and standard deduction accordingly should maintain a consistent relationship to the official poverty level.

⁶⁹ For single individuals the comparable ratios were as follows:

Adjusted gross income	1990	2010
40,000-50,000	34.5	39.2
50,000-75,000	23.5	35.6

⁷⁰ Some scholars have questioned whether the provision can perform these two functions efficiently See *supra*. note

⁷¹ I.R.C. §§ 63(c)(4), 151(d)(4)

⁷² Taxpayers with low and moderate incomes may also benefit from the earned income tax credit. See *infra*.

Two observations modify this simple connection. First, the calculation of the poverty level itself has received significant criticism. The poverty level counts only cash income. It does not count in-kind government aid such as food stamps. Nor does it include assistance in the form of an income tax refund under the earned income credit.⁷³ Also, although the basket of goods and services on which the calculation is based has remained constant, the relative costs of subsistence consumption have shifted over time. Food has become less expensive, housing more so. Efforts to modify the basket have failed lest the new measure create political difficulty: either it will show that the number of poor people has grown, an embarrassment to the party in power, or it will show that the number has declined, diminishing the arguments of those advocating for more aid to the poor. Moreover, change could impair comparability across time periods. For these and other reasons, the measure of the poverty level continues in its inexact state. Since 2011 the US Census Bureau has calculated a Supplementary Poverty Level, which seeks to measure poverty by consumption rather than income. This measure reports slightly fewer children in poverty and slightly more older folks, findings which could generate political consequences. The standard deduction and the personal exemption together were supposed to exclude income below the poverty level, but that measure that has become increasingly inexact as a measure of minimum well-being.

The proposed change to c-CPI in the President's 2014 budget excluded non-means tested benefit programs. Apparently, the poverty level would have continued make its adjustments using the CPI-u. A change to the c-CPI for income tax adjustments but not for calculation of the poverty level would create a greater divergence between the standard deduction and the poverty level.⁷⁴

Second, the combined personal exemption/standard deduction amount approximates but fails to hit the existing poverty level numbers accurately. The total provides a higher exemption amount for families and a lower exemption for individuals. For a family of four, the poverty level amount for 2015 was \$24,250, while the standard deduction for a married couple with two children plus four personal exemptions amounted to \$28,600. For a single parent with three children, the standard deduction plus four personal exemptions amounted to \$25,250, closer to the poverty level.⁷⁵ The poverty level for a single individual came to \$11,490, but the sum of the standard deduction and one personal exemption amounted to only \$10,300. The numbers would hit their target more accurately if the personal exemption increased by more than the current inflation adjustment and the standard deduction by less

Two tax credits further complicate consideration of the standard deduction's role in excluding taxpayers below the poverty level from paying income tax, the

⁷³ See *infra*. p.

⁷⁴ See discussion *supra*, p. 21.

⁷⁵ The standard deduction used is for head of household, \$9,250 for 2015.

child tax credit⁷⁶ and the earned income credit.⁷⁷ The child credit currently grants a taxpayer a \$1,000 credit against tax for every qualifying child dependent. The credit phases out above stated modified adjusted gross income levels and accordingly applies only to low and middle income families.⁷⁸ Like the personal exemption, the child credit takes family size into account to determine tax liability. A married couple with two children and income of \$28,600 (the sum of the standard deduction and four personal exemptions) would have a refundable \$2,000 credit.⁷⁹

The credit amount and its income level limitations have no automatic adjustment for inflation and the real value of the dollar amounts thus erodes over time. Congress has varied the amount of the credit from \$500 to the current \$1,000 per child.⁸⁰ But it has not changed the income levels at which the credit phases out. For a married couple filing jointly, the credit declines as modified adjusted gross income exceeds \$110,000. The credit phases out completely at \$130,000. The failure to adjust this “threshold amount” for inflation means that the value of the credit declines in real terms for some middle-income families.

The EIC provides a refundable credit to individuals based on earnings. The credit consists of a percentage of earned income up to a dollar limit. As earnings increase further, the credit levels off and then begins to phase out. A taxpayer couple with two children who had earned income of \$28,600 (the sum of the standard deduction and the personal exemptions) would receive a refundable credit of \$4,330. Indeed, the credit would not phase out completely until the couple’s income reached \$49,150. But as income increased some amount of the credit would be used to offset the couple’s tentative tax liability, reducing the refundable amount.

The Code adjusts for inflation all the dollar elements of the earned income credit, including the threshold for the phaseout percentage. Assuming the earned income increases by the amount of inflation, the result for the taxpayer is the same real income under an inflation-adjusted tax system. For a couple whose earned income does not increase with inflation, the structure of the EIC creates varied results. If the income lies below the earned income amount in the EIC, the amount of the credit will remain the same in dollars, but will lose buying power. When income equals or exceeds the earned income amount, the credit will remain the same. At higher income levels, of tentative tax before EITC will kick in at later points by reason of the increases in the standard deduction and the personal exemption, the phaseout of EITC will start later and the taxpayer will receive a larger credit.

⁷⁶ IRC §24.

⁷⁷ IRC §32.

⁷⁸ The threshold amount for phasing out the credit consists of \$110,000 for a married couple filing a joint return, half that amount for separate returns and \$75,000 for individuals.

⁷⁹ If the couple have many qualifying children, the maximum refundable credit is \$3,000. Rev. Proc. 2013-35, 2013-2 C.B. 537.

⁸⁰ Economic Growth and Tax Relief Reconciliation Act of 2001, 107 Pub. L. No. 16, §201(a), 115 Stat 38, 45.

At lower incomes, inflation adjustment pushes up the maximum credit, so that the unadjusted income would get more dollars. A change from the CPI-u to c-CPI would reduce the adjustment and the amount of the dollars at most income levels eligible for the EIC.

III Effects of failing to adjust for inflation

The Code states the value of certain credit, deduction and exclusion provisions as dollar amounts, but provides no adjustment for inflation. As time passes, these amounts lose their real value for the taxpayers who claim them. Inflation thus operates as a slow repeal of the benefit, reducing but never completely eliminating it. The decline in the benefit has the reciprocal effect of increasing real tax revenue.

Slow repeal by cumulative inflation has the political virtue of stealth. The benefit to the disfavored class declines without public announcement, discussion or vote. No political actor carries the burden of reducing the benefit. Small reductions caused by low or moderate inflation tend to escape public notice. Only in periods of unusually high inflation do taxpayers voice enough concern over the erosion of particular tax benefits to move their representatives to act.⁸¹ Without an automatic inflation adjustment, the proponents of a tax provision bear the burden of justifying any increase in the dollar amount and its attendant revenue loss. In contrast, the taxpayers who benefit from provisions that provide for automatic adjustments do not have to explain why their benefits should increase every year to match the rate of inflation.

⁸¹ The relatively high levels of inflation in the mid to late 1970s provides an example. See, e.g., *Indexation of Certain Provisions of the Tax Laws: Hearing Before the Sen. Subcommittee on Tax, Debt Mgmt'n*, 95th Cong. 2d Sess. 103 (1978) (statement of Dennis Jacobson on behalf of the U.S. League of Savings Associations).

Social security benefits

Millions of taxpayers receive social security benefits. The Code allows them to exclude varying amounts of the benefits from gross income, but does not index the exclusion levels for inflation.

Before 1983, administrative practice excluded social security benefits entirely from gross income, treating them as a species of nontaxable welfare benefits.⁸² As part of a larger reform of the social security system, Congress changed that treatment. In reimagining social security benefits as a kind of income, at least two characterizations are possible. First, many understand the program as akin to an insurance system, as its formal name, the Federal Insurance Contribution Act, implies. Workers and employers make payments in the form of FICA taxes as they earn or pay wages. Self-employed workers pay FICA tax on their self-employment income. Upon retirement or disability, beneficiaries receive benefit payments. Like beneficiaries of a private retirement plan, the employee participants make their payments into the system out of after-tax income. When a retiree receives private benefit payments, part consists of a return of the previously taxed amount, not subject to a second tax, while the excess constitutes income subject to tax.⁸³ Similarly, by analogy to a private annuity, social security benefits could be understood as in part a return of the amounts previously paid in and only in part as taxable income. An alternative view of the social security system severs the link between payment of payroll taxes and entitlement to retirement or disability benefits. This view regards the two flows of cash as separate elements within a unitary federal budget. The system creates transfer payments from today's workers to retirees, with benefits to be treated for income tax purposes like any other income. As a concession to the fact that many recipients of social security benefits have little or no other income, an exclusion of some amount tied to income level nevertheless may make good policy.⁸⁴

During its first decades, the payroll tax that financed social security imposed a relatively low rate and applied to a limited amount of earnings.⁸⁵ Beginning in 1950 Congress increased individual benefits periodically to account for inflation. Congress introduced automatic cost of living adjustments effective in 1975.⁸⁶ By the end of the 1970s, however, social security benefits were projected to rapidly

⁸² IT 3447, 1941-1 C. B. 191.

⁸³ See generally I.R.C. § 72, which specifies the tax treatment of annuities.

⁸⁴ Any exclusion would come in addition to the standard deduction and personal exemptions otherwise available.

⁸⁵ At the beginning, the tax rate was 1%, applied to the first \$3,000 of earned income. The maximum tax was \$30.

⁸⁶ *Public debt limit; disaster losses; Social Security Act*, Pub.L. 92-336 §202, 86 Stat. 406 (enacted in 1972, provided for automatic cost of living adjustments beginning in 1975)

outstrip funding.⁸⁷ Many individuals received benefits far in excess of the annuitized value of the social security taxes they had paid. Concern for the financial security of social security had led the President to create an Advisory Council on Social Security.⁸⁸ As part of its mandate the Advisory Council considered whether the Code should tax social security benefits like annuities. Employment taxes paid would constitute the beneficiary's contribution and the benefits in excess of that amount would constitute income, spread out as the beneficiaries received the payments. The Council rejected the full annuity approach because lack of the necessary data would make the process difficult and it would result in taxing more of the benefit "than most people would consider appropriate." It recommended instead that half of the benefits be taxed. Congress followed the Council's report with the establishment of a bipartisan commission, the National Commission on Social Security Reform.⁸⁹ This Commission, building its proposals in part on the recommendations of the Advisory Council, adopted the half-the-benefits approach in principle, but inserted an income floor, below which no benefits would be taxed. It also specified that the tax collected would go into the OASDI trust funds rather than into general revenues in order to help shore up the financial stability of the trust funds..

Congress enacted most of the Commission's social security reform recommendations. As to the income taxation of benefits, it included as income an amount up to half the social security benefits, if modified adjusted gross income plus one half of social security benefits exceed a threshold amount (\$25,000 for a single individual, \$32,000 for a married couple).⁹⁰ It also directed that the revenue generated by the new inclusion flow into Social Security's two trust funds, Old Age and Survivors Insurance (OASI) and Disability Insurance ("DI"), rather than the Treasury's general revenues.

In 1993, as part of a larger deficit reduction plan, Congress added a second tier to the taxation of social security benefits, modeled on the first.⁹¹ It created an inclusion for up to 85% of social security benefits if modified adjusted gross income plus half the social security benefits exceeds the second tier amount (\$34,000 for a single individual and \$44,000 for a joint return).⁹² The statute credited the proceeds from this second tier of tax to the Medicare Hospital Insurance program.

⁸⁷ See *National Pension Policies: Private Pension Plans: Hearing before the Subcomm. On Retirement Income and Employment, of the House Select Comm. On Aging*, 95th Cong., 2d Sess. (1978)

⁸⁸ Executive Order No. 12335, Dec. 16, 1981 46 Fed. Reg. 61633.

⁸⁹ The Commission was informally known as the Greenspan Commission, after its Chair, Alan Greenspan.

⁹⁰ I.R.C. section 86(c)(1). Modified adjusted gross income makes several changes to adjusted gross income, most significantly adding tax exempt interest. I.R.C. section 86(b)(2).

⁹¹ I.R.C. section 86(c)(2).

⁹² I.R.C. section 86(a)(2).

The Code does not adjust the threshold or second-tier dollar amounts for inflation. Nor has Congress seen fit to increase either the threshold amounts or the second tier amounts in order to take account of inflation. In real terms, therefore, the floors in the section have dropped. The social security benefits themselves, however, continue to increase with inflation as required by statute.⁹³ As a result, increasing amounts of the real value of social security benefits have been subjected to income taxation. Only 8% of social security beneficiaries paid income tax in 1993 with respect to their benefits. By 2005, 39% of beneficiaries (16.9 million people) were affected by the income taxation of social security benefits.⁹⁴ In 2014 the proportion had increased to 49%, 25.5 million out of 51.9 million social security beneficiaries.⁹⁵ As another measure of the magnitude of the taxation of social security benefits, in 1984, the first year of the tax, its proceeds accounted for 1.67% of receipts for the social security funds. In 2013 the OASI and DI trust funds were credited with \$21.1 billion from taxation of benefits, representing 2.5% of their income. The HI fund received \$14.3 billion or 5.7% of its total income.⁹⁶

The failure to adjust the threshold amounts for inclusion of social security benefits in gross income pushes taxpayers more quickly into the “transition range” that the provision establishes to phase out the earlier exclusions. Like many provisions that phase out favorable tax treatments, the transition formulas for including 50% or 85% of social security benefits in income increase the taxpayer’s marginal tax rate. As an example, suppose a married couple had modified adjusted gross income in 2014 of \$37,000 and social security benefits of \$14,000. After inclusion of part of the social security benefits, and subtraction of the standard deduction and two personal exemptions, their income tax liability amounts to \$2,655. If they earn an additional \$1,000 of income, their tax increases to \$2,932.50. Their nominal marginal tax rate is 15%. But the extra \$1,000 has cost them \$277.50 in additional income tax, for an actual marginal rate of 27.8%. We do not know what specific effects this may have on conduct, but a rational actor would take the higher marginal rate into account in deciding whether to earn the additional \$1,000.

At least some of the architects of the 1983 social security reform omitted indexation of the social security income tax floors with the express intention of reducing the floor’s value. Robert J. Myers, former Chief Actuary of the Social Security Administration and Staff Director for the Commission, testified in 1993 that the thresholds were not indexed in 1983 so that over time they “would gradually

⁹³ 42 U.S.C. 430.

⁹⁴ Christine Scott and Janemarie Mulvey, *Social Security: Calculation and History of Taxing Benefits*, Cong. Rsch. Serv. Report (Aug. 2011).

⁹⁵ Noah P. Meyerson, *Social Security: Calculation and History of Taxing Benefits*, Cong. Rsch. Serv. Report (Jan. 2015).

⁹⁶ *Id.* at 9.

wither on the vine.”⁹⁷ Myers viewed the limited income tax exclusion as undesirable, and agreed to include it only as a political necessity. He welcomed the erosion of the floor amounts in real value terms as a painless way to repeal them. Myers agreed with the principle that an employee’s benefits reflecting previously-taxed income should not be subjected to tax, but calculated that the previously taxed portion contributed by a social security beneficiary averaged less than 15% of the benefits to be received. Myers, however, foresaw that over time, as the burden of FICA taxes increased relative to benefits, the 15% estimate would understate the previously taxed contribution. He argued for gradually increasing the exclusion percentage from 15%. Congress did not make this change.

The shrinking value of the second-level threshold amount subjects more beneficiaries to inclusion of 85% of benefits. Today the ratio of tax payments made by a worker into the system out of after-tax income to benefits received from the system is higher on average than 15% and thus provides a justification for an enhanced exclusion of benefits from current income tax. To bring the exclusion amount in line with the previously taxed amount, Congress should reduce the 85% rate.

Surprisingly, the gradual increase in tax of social security benefits has attracted little political activity. Perhaps the funding mechanism that transfers the tax receipts directly to the social security and Medicare trust funds complicates the prospect for inflation relief for social security beneficiaries. Any increase in the floor amounts would reduce tax receipts currently directed to the trust funds. The reduction would weaken the trust fund’s financial position unless some other sources made up the missing revenue.

Dependent care services

The credit for dependent care services provides a prime illustration of the way in which the failure to index dollar amounts reduces benefits. Code section 21 created a nonrefundable credit for household and dependent care expenses necessary for gainful employment. The credit aims primarily at relieving working couples or single parents with children from some of the burden of day care expenses.⁹⁸ The provision has a long history. The Board of Tax Appeals held in 1939 that a taxpayer could not deduct the costs of child care as ordinary and necessary expenses of carrying on a trade or business.⁹⁹ It rejected the argument that but for the child care the parents would have been unable to work and that the expenses accordingly should be deductible.

⁹⁷ *Hearing before the Committee on Finance, US Senate, Taxation of Social Security Benefits*, 103d Cong. 1st Sess., May 4, 1993 (Statement of Robert J. Myers).

⁹⁸ It also applies with respect to a spouse or dependent incapable of caring for him or herself.

⁹⁹ *Henry C. Smith*, 40 BTA 1038 (1939), *affd. per curiam*, 113 F.2d 114 (2d Cir. 1940).

Congress created a separate child care deduction in 1954, limited to the most dire of circumstances.¹⁰⁰ Congress enlarged the scope of the deduction substantially in 1971¹⁰¹ and converted the deduction to the current credit in 1976.¹⁰² By 1971 policy analysts and legislators had recognized that the limited deductibility of child care expenses created perverse incentives that tended to discriminate against women joining the workforce.¹⁰³ Wives often were regarded as the second earners in the family. In making the decision whether to move into the market economy, income taxes provided a significant disincentive. The second earner's earned income would be added to that of their spouse and taxed in a joint return at high marginal rates, starting from the first dollar of earnings. Paying child care costs out of after-tax income often left little net increase when the wife joined the market economy. By comparison, the value created in the home through household services was not subject to tax. The tax rules thus created disincentives for wives to enter the market economy. The deduction and then the credit provided a compromise response.

To qualify for the credit, a taxpayer must incur expenses that enable the individual to work when one or more "qualifying individuals" share the taxpayer's principal place of abode.¹⁰⁴ A qualifying individual includes a dependent aged twelve years or less, or a dependent or spouse unable to care for him or her self.¹⁰⁵ The credit consists of a percentage of the employment related expenses, up to a maximum of \$3,000 of expenses for one qualifying individual or \$6,000 for two or more qualifying individuals.¹⁰⁶ The percentage ranges from 35 percent, declining to 20 percent as adjusted gross income exceeds \$15,000.¹⁰⁷ Employment related expenses include expenses for household services and for care of a qualifying individual. Congress increased the maximum dollar amounts of expenses to their current levels in 2001, effective in 2003, but did not include an inflation adjustment.¹⁰⁸ As a consequence, the real value of the maximum credit has declined since 2001; the \$15,000 threshold has declined in value to \$11,221 in 2001 dollars.

¹⁰⁰ *Internal Revenue Code of 1954*, Pub. L. 83-591 §214, 68 Stat 730 (IRC §214 (1954)).

¹⁰¹ Revenue Act of 1971, Pub. L. 92-178 §210, 85 Stat 497, 518.

¹⁰² Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat 1520 (IRC §21).

¹⁰³ Alan Feld, *Deductibility of Expenses for Child Care and Household Services: New Section 214*, 27 Tax L. Rev. 415 (1972); Grace Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 Buffalo L. Rev. 49-98 (1971).

¹⁰⁴ I.R.C. §21(b)(1).

¹⁰⁵ I.R.C. §21(c).

¹⁰⁶ I.R.C. §21(a)(2).

¹⁰⁷ I.R.C. §21(b)(2).

¹⁰⁸ Before 2001, the dollar amounts were \$2,400 and \$4,800. The adjustment in 2001 did not restore the dollar amounts to their real value in 1976.

The 2001 Act also increased the maximum percentage credit from 30% to 35%. The maximum percentage declines to 20% as adjusted gross income rises from a

The maximum expense allotments generally fall well short of the costs needed to provide child care coverage for full-time employment. At the conservative rate of \$10 per hour, \$3,000 buys 300 hours of coverage, enough for seven and one half weeks.¹⁰⁹ At the 20% credit rate, the amount of the credit, \$600, pays for child care for a week and a half. The modest relief provided by the credit has become more symbolic than real.

It is not clear whether failure to adjust these numbers for inflation derives from oversight or an affirmative desire to reduce the real benefit of the credit over time. As some evidence of Congressional disfavor, Section 129, which provides an exclusion from income for employer-provided dependent care assistance, contains different dollar limitations but also does not adjust for inflation.¹¹⁰ A third provision, the credit for employer provided child care facilities, likewise lacks an inflation adjustment.¹¹¹

The absence of either automatic inflation adjustments or more regular direct adjustment of the numbers has produced an anomaly in section 21. Virtually no one in the target population actually can use the stated maximum 35% rate for the credit.¹¹² The credit is nonrefundable, so it can benefit the taxpayer only by offsetting income tax liability. While the credit nominally applies at the 35% rate for AGI of \$15,000 or less, it can have effect only if the taxpayer owes some tax. But in the years since 2003 when the AGI cutoff increased from \$10,000 to \$15,000, the standard deduction and personal exemption amounts have increased with inflation adjustments. A single working parent with one child who earns \$15,000 can claim a standard deduction in 2015 of \$9,250¹¹³ and two personal exemptions of \$4,000, for a total of \$17,250. At \$15,000 of adjusted gross income the parent thus will have no taxable income and no tentative tax. The parent will have no use for the credit, so that the nominal 35% rate is meaningless in this circumstance. The nontaxed portion of AGI runs even higher for taxpayers who file a joint return or parents with more children.¹¹⁴ Only in the unusual case of a parent, married but filing a separate

specified dollar amount. The 2001 Act increased this amount from \$10,000 to \$15,000. Economic Tax and Reconciliation Act of 2001, Pub. L. 107-16, §204, 115 Stat. 38.

¹⁰⁹ Assumes full-time forty hour per week employment. At part time, twenty hour per week employment, the sum covers fifteen weeks.

¹¹⁰ The maximum exclusion amount is \$5,000, \$2,500 for a separate return filed by a married individual. I.R.C. §129(a)(2)(A).

¹¹¹ I.R.C. §45F.

¹¹² The credit consists of a percentage of employment related expenses calculated on a sliding scale, from 35% to 20%. The percentage declines from 35% by one percentage point for every \$2,000 (or fraction) by which adjusted gross income exceeds \$15,000. I.R.C. §21(a)(2).

¹¹³ The standard deduction amount is for a head of household.

¹¹⁴ The standard deduction amount for a couple filing jointly is \$12,600, which when added to three personal exemptions, totals \$24,600.

return and claiming a dependent, could a \$15,000 adjusted gross income produce even a small amount of tentative tax, in the amount of \$70.¹¹⁵ The difference between a 35% credit and a 20% credit shrinks to the vanishing point when applied to a small amount of tentative tax of a tiny segment in the target group. No stated reason favors this group over other low-income earners. For most individuals who claim the credit, the 35% rate is simply illusory.

The failure to adjust for inflation has thus changed the value of the child and dependent care credit in two ways. It has reduced the effective ceiling on the amount of employment-related expenses taken into account in computing the credit and therefore the value of the maximum credit. It has distorted the sliding percentage used to calculate the credit, rendering portions of its range effectively useless. Congress should adjust the \$3,000 and \$6,000 maximums on employment related expenses in order to restore the value lost to inflation and index them to prevent future erosion. Congress could increase the \$15,000 cutoff point to correct for inflation. Further, the structure of the credit remains unduly complicated. Congress could eliminate the cumbersome sliding scale credit percentage altogether and substitute a flat percentage. It could increase the credit percentage slightly to compensate for the change. These changes would not only simplify the calculation of the credit, but would render the credit a more meaningful aid to working families

President Obama's 2015 State of the Union message proposed a major expansion of the credit. According to the White House "Fact Sheet" the proposal would provide a 50% credit with respect to children under age five, increasing the maximum credit amount to \$3,000.¹¹⁶ The phaseout point would increase to adjusted gross income of \$120,000 .

¹¹⁵ .10 (15,000-(6,300 + 8.000)).

¹¹⁶ *FACT SHEET: A Simpler, Fairer Tax Code That Responsibly Invests in Middle Class Families*, Office of Press Secy (Jan. 17, 2015), available at <https://www.whitehouse.gov/th-press-fice/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami>

Limitation on the Use of Capital Losses

The Code generally restricts the deduction of capital losses to the amount of capital gains included in income.¹¹⁷ The restriction prevents taxpayers from taking advantage of the tax law's realization requirement to include losses but not gains. Since the Code does not take gains and losses into account until recognized, a taxpayer whose investments include some unrealized gains and some unrealized losses might seek to cull the portfolio, sell the losing investments and recognize the losses for use against ordinary income, while deferring recognition of the investment gains. The restriction limits the ability to exploit the realization requirement in this way.

As an exception, after offsetting recognized capital losses against recognized capital gains, the Code allows an individual to deduct a small amount of capital loss against ordinary income.¹¹⁸ The Code currently limits this deduction to a maximum of \$3,000. Perhaps the exception reflects less concern that the owners of small portfolios might engage in tax-motivated selling of losing investments. Congress has not indexed the \$3,000 limit for inflation and has allowed it to remain the same since the 1976 Tax Reform Act increased it from \$1,000, effective for 1978.¹¹⁹ The Committee Report then had cited as the reason for the change the reduced value of the deduction by reason of the increase in consumer prices since 1942 when the \$1,000 maximum was enacted .

Subsequent inflation has failed to elicit a comparable legislative response. More recent proposals to increase the limit have met with rejection. In 2002 the House Ways and Means Committee voted to increase the limit to \$20,000 and to adjust the limit going forward for inflation. The House did not act on the proposal. To maintain the real value of the 1978 amount, the current exclusion should be \$10,893. The failure either to increase the amount or to index it for inflation may reflect a desire to phase out the exception.

Unlike their more optimistic cousins, who hope for large gains and support lower taxes on long-term capital gains, small investors have not rallied to increase the deduction for capital losses. Taxpayers may carry forward their unused capital losses, which may provide some consolation for bad investments. Even in periods of stock market decline little political pressure has arisen for change. Accordingly, the \$3,000 maximum remains unadjusted.

Residential housing

The Internal Revenue Code provides generous tax support for owner-occupied housing. Here we will consider the absence of inflation adjustments in two

¹¹⁷ I.R.C. §1211.

¹¹⁸ IRC section 1211(b).

¹¹⁹ Tax Reform Act of 1976, Pub. L. 94-455 §1401(a), 90 Stat 1520.

expensive provisions, the deduction for mortgage interest and the exclusion of capital gains on home sales.¹²⁰

Although the Code generally does not allow a taxpayer to deduct personal interest expenses, it carves out an important exception for home mortgage interest. In 2013, the deduction for home mortgage interest reduced tax revenues by an estimated \$70 billion.¹²¹ The deduction applies to qualified residence interest, defined as interest paid on acquisition indebtedness on a qualified residence up to \$1 million of debt, and an additional \$100,000 of debt secured by the residence even if not acquisition debt.¹²² The deduction has been justified as an incentive to increase home ownership. Critics of the provision challenge both the premise, that the federal government should subsidize middle and upper class homeownership, and the means, finding the interest deduction an inefficient and poorly designed subsidy.¹²³ In 2012, the most recent year for which statistics are available, almost 34.5 million tax returns claimed the deduction for qualified residence interest.¹²⁴ Perhaps because so many deduction itemizers claim it, the deduction has achieved the political status of a “third rail”, a provision touched at great peril.

The dollar limits on the amount of qualifying indebtedness cap the subsidy for investment in extravagant homes. The average price of a single family home in the United States was \$245,700 in 2013.¹²⁵ Assuming 80% financing of the

¹²⁰ Homeowners and homeownership also receive a number of other tax benefits that do not refer to specific dollar amounts and so do not require any adjustment for inflation. The benefits (with their 2013 estimated costs) include: the deduction for state and local property taxes on owner-occupied homes (\$20.3 billion); the exclusion of net imputed rental income (\$74 billion); and the exclusion of interest on owner-occupied mortgage subsidy bonds (\$1,170 billion). The Code subsidizes rental housing construction to a more limited extent, e.g. exclusion of interest on rental housing bonds (\$0.990 billion).

¹²¹ CONG. BUDG. OFFICE, *The Distribution of Major Tax Expenditures in the Individual Income Tax System* 6 (Table 1) (2013).

¹²² Acquisition indebtedness includes debt incurred for construction and substantial improvement of a residence. The statute extends the term “qualified residence” to include a second home. I.R.C. §163(h)(3). The residence must secure the loan.

¹²³ For recent discussions see Benjamin Harris, Eugene Steuerle and Amanda Eng, New Perspectives on Homeownership Incentives, Tax Notes (12/2014) Reason Foundation, [Unmasking the Mortgage Interest Deduction: Who Benefits and by How Much?](#) (2011), Rebecca N. Morrow, [Billions of Tax Dollars Spent Inflating the Housing Bubble: How and Why the Mortgage Interest Deduction Failed](#), 17 *Fordham J L & Fin L* 751 (2012)

¹²⁴ I.R.S., Table 2.1 STAT. INCOME Pub. 1304 (2012) Rev. 08-2014.

¹²⁵ NAT'L ASSOC. REALTORS, *Sales Price of Exsrtng Family Homes* (Feb. 23, 2015). available at

<http://www.realtor.org/sites/default/files/reports/2015/embargoes/ehs-02->

purchase price, the statutory limits may be criticized as unduly generous in their support of residential housing at quadruple the average price. While low and moderate income individuals may need some tax relief to aid them in buying and carrying a home, many of these taxpayers claim the standard deduction and get no benefit from the interest deduction. As noted earlier, the availability of the standard deduction means that the net benefit of the interest deduction amounts to the sum of itemized deductions less the standard deduction multiplied by the marginal tax rate. For many moderate income homeowners the net benefit is quite small. At the other end of the income scale, mortgage amounts in the seven figures strongly imply that the purchasers do not require federal assistance in housing their families. The extension of the tax subsidy to its current levels proceeds more from political rather than humanitarian justifications. Mortgage limits at their current level benefit primarily upper middle class homeowners. Further, since home prices vary significantly by region, a \$1 million mortgage seems less extraordinary in New York City or Hollywood, where political clout may be particularly strong, than in Omaha or Texarkana.

The Code does not adjust the limiting numbers for inflation. As a consequence, the ceiling numbers lose real buying power on a gradual but cumulative basis. The value of the \$1 million limit, enacted in 1986, has declined since then to the equivalent of \$ 462,963. Inflation acts in an unobtrusive way to reduce the real value of the mortgage ceiling and to curb the more extravagant aspects of the interest deduction.

Homeowners receive an added tax benefit when they sell a home. Upon the sale of a principal residence owned and occupied for a stated minimum period,¹²⁶ a single individual may exclude from income gain up to \$250,000; a husband and wife filing a joint return may exclude up to \$500,000. Any excess gain incurs tax at long term capital gain rates.¹²⁷ For 2013 the exclusion reduced estimated tax revenue by \$18 billion.¹²⁸ The maximum dollar exclusions are unadjusted for inflation and the cap on benefits conferred by the provision slowly declines.

The current exclusion provision enlarged upon and replaced two earlier provisions. One provided for nonrecognition of gain on the sale of a principal residence if the taxpayer reinvested an amount at least equal to the proceeds of sale in a new residence. A taxpayer thus could move to successively more expensive homes without incurring tax. The other created an exclusion for older homeowners' sales of their homes. The policy sought to mitigate the lock-in effect for their

23/ehs-01-2015-single-family-only-2015-02-23.pdf (for existing single family homes)

¹²⁶ The taxpayer must have owned and used the property as the principal residence for at least a two-years out of the preceding five years.

¹²⁷ A homeowner may not deduct any loss on sale of a personal residence, Reg. sec. 1.165-9(a).

¹²⁸

housing. An elderly couple contemplating sale of their home might be deterred from selling by the potentially large capital gain, while instead holding the property until death would give the heirs a step-up in basis and eliminate any tax on the gain. The current provision enlarged the exclusion and eliminated the “rollover”.

Alimony and property settlements

The Code applies different tax rules to three elements of divorce settlements. A spouse who pays alimony as defined in the statute can deduct that amount and the recipient spouse includes it in income.¹²⁹ The payor of child support payments or property settlements, however, cannot deduct them and the recipient does not include them in income.¹³⁰ Congress sought to limit the ability of divorcing couples to disguise property settlements as alimony by making large initial payments labeled as alimony. To do so, the Code includes “excess alimony payments” in the income of the payor spouse in the third year after the separation and allows a comparable deduction to the recipient spouse.¹³¹ The computation formula allows a fixed amount, \$15,000, to avoid excess alimony treatment. This amount has remained unchanged since its adoption in 1986. In the interim, its real value has declined in real terms to \$ 6,944. As a result, the recomputation potentially affects divorce settlements to a greater extent in real terms than originally intended.

Group term life insurance

The Code includes in the income of an employee the cost of group term life insurance purchased by an employer.¹³² It excludes the cost of \$50,000 of the insurance. The amount of the exclusion has not changed since 1964 when the provision entered the Code.¹³³ The real value of the insurance benefit covered by the exclusion has declined by 87%.¹³⁴ This provision may confer a tax benefit that would receive little support if proposed today, but any effort to repeal the provision likely would generate political opposition. A slow repeal by inflation serves a similar goal without fuss.

Casualty loss deduction

The Code allows individuals to deduct losses from fire, storm, shipwreck or other casualty subject to two limitations.¹³⁵ One limitation reduces the deductible loss from a casualty by \$100.¹³⁶ Originally intended to prevent claims for fender bender accidents, the dollar amount has remained at the same level, except for a brief period, and has not been adjusted for inflation. The effect of the \$100

¹²⁹ I.R.C. §§ 71(a) and 215(a).

¹³⁰ I.R.C. §71(c).

¹³¹ I.R.C. §71(f).

¹³² I.R.C. §79(a).

¹³³ *Revenue Act of 1964*, Pub L. 88-272, §204(a)(1), 78 Stat. 19.

¹³⁴ \$50,000 in 2014 was the equivalent of \$6,547 in 1964.

¹³⁵ I.R.C. §165(c)(3) and (h).

¹³⁶ I.R.C. §165(h)(1).

reduction has been overshadowed as a practical matter by the second limitation, 10% of the taxpayer's adjusted gross income, which radically reduces the number of eligible claims.¹³⁷ The \$100 limitation serves little purpose and Congress should repeal it. In the interim, its value slowly declines with inflation.

Administrative provisions

Inflation can affect administrative provisions of the Code. Often, however, they avoid the need for direct adjustments. As an example, the six-year statute of limitations for a substantial omission from gross income applies to a more than 25% omission, not to a fixed dollar amount.¹³⁸ Less obviously, the requirement to file an income tax return applies when gross income equals or exceeds the personal exemption plus the standard deduction.¹³⁹ Both adjust annually for inflation, so the filing threshold requires no further adjustment. Occasionally an administrative level appears as a fixed dollar amount. The rules for reporting charitable contributions provide an example.

The Code ordinarily accounts for property transactions by looking to the adjusted basis of the property.¹⁴⁰ The charitable contribution deduction provides an important exception. It measures the amount of a contribution by its fair market value.¹⁴¹ Any appreciation over adjusted basis goes untaxed but increases the amount of the contribution deduction. While many gifts of property can be readily valued in publicly-traded markets, many cannot. To prevent overstatement of value Congress has enacted a series of stepped requirements for taxpayers to describe the property in filing the tax return or obtain a formal appraisal. The Code defines thresholds for these steps in fixed dollar amounts. A taxpayer who claims a deduction of more than \$500 for a gift of property must describe the nature of the property.¹⁴² With certain exceptions, including publicly traded securities, for a claimed deduction over \$5,000, the taxpayer generally must obtain a qualified appraisal and report the results on the tax return. For a claim over \$500,000 the taxpayer must attach the appraisal to the return. Failure to comply with applicable requirements can result in denial of the deduction. These amounts are not adjusted for inflation. As the nominal values of property increase over time, these administrative provisions will apply to an increasing number of charitable gifts.

A separate provision imposes verification requirements on contributions of vehicles with a claimed value in excess of \$500. Another provision requires a qualified appraisal for a single gift of clothing or a household item over \$500. No inflation adjustment applies to any of these dollar amounts. Over time, as these dollar amounts lose real value, we would anticipate that more taxpayers would become subject to the requirements.

¹³⁷ I.R.C. §165(h)(2).

¹³⁸ Section 6501(e).

¹³⁹ Section 6012(a)(1)(A).

¹⁴⁰ I.R.C. §1011(a).

¹⁴¹ Treas Reg §1.170A-1(c)(1).

¹⁴² I.R.C. §170(f)(11)(A)

Individuals who use their cars for the benefit of exempt charities may deduct an amount based on mileage. The deduction excludes depreciation but does account for out-of-pocket expenses such as gasoline. The Code currently fixes the applicable rate at 14 cents per mile.¹⁴³ No inflation adjustment applies.

No policy comes to mind to justify the slow decline in dollar boundaries that govern verification for charitable gifts in kind. Inflation adjustments seem as appropriate for these administrative limitations as for more substantive rules. Nor should the 14-cent rule remain at the same level in the face of rising out-of-pocket costs.

¹⁴³ I.R.C. §170(i).

Conclusion

Taxation invariably involves a political process to determine who pays and how much. Even an apparently technical matter, adjusting for inflation, becomes an arena in which one group or another may seek advantage. The indexing rules currently built into the tax law reflect this process.

The provisions for automatic inflation adjustments in the income tax raise a number of issues. First, the choice of the proper measure of inflation for this purpose has been called into question. The chained CPI has gained acceptance by scholars in the field as a more accurate measure of consumer inflation than the CPI-u. Continued use of the CPI-u to make tax adjustments raises the prospect that it overshoots the mark and provides hidden tax cuts as measured in real value terms for some taxpayers. Second, the application of widespread indexation effectively limits the political choices open to legislators. Without indexation, income taxes slowly creep up and the legislature more easily can provide selective relief through tax reductions. Readjustments become more difficult when inflation adjustment occurs automatically. On the other hand, some observers support automatic adjustments precisely because the system limits Congressional discretion to give selective relief. Third, the application of indexing to dollar amounts does not occur uniformly for all tax provisions. The failure to index all dollar amounts in the Code subjects some provisions to gradual reduction in real value without the political cost that an effort to repeal the provision would incur. In effect, it shifts the burden of action from those who would reduce or eliminate the provision to those who would preserve it. Perhaps in the future, foes of new or renewed deductions or credits involving dollar amounts, unable to defeat the proposed benefit, may learn to use inflation as a functional limitation.