This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Personal Deductions in the Federal Income Tax

Volume Author/Editor: C. Harry Kahn

Volume Publisher: UMI

Volume ISBN: 0-870-14122-8

Volume URL: http://www.nber.org/books/kahn60-1

Publication Date: 1960

Chapter Title: Place of Personal Expense Deductions in the Income Tax

Chapter Author: C. Harry Kahn

Chapter URL: http://www.nber.org/chapters/c2418

Chapter pages in book: (p. 1 - 16)

CHAPTER 1

Place of Personal Expense Deductions in the Income Tax

Relation of Deductions to Net Income

DIRECTLY related to that most vexing question of what constitutes personal income, in the context of an income tax, is the question of what expenditures should be allowed as deductions in the computation of a tax base. Under the federal personal income tax law—as indeed under many foreign and most state income tax laws—provision has been made for two kinds of deductions. There are, first, those intended to refine gross income to economic net income by subtraction from gross receipts of the expenses and losses incurred in the pursuit of income. Second, there are the deductions that, at the discretion of Congress, are intended to attain a particular goal of social or economic policy, or to help establish a measure of a person's capacity to pay taxes, which transcends the limits of a strictly economic concept of income. Thus the deduction allowable for philanthropic contributions is commonly regarded as a means of stimulating socially desirable expenditures; the allowance to deduct medical expenses above a certain percentage of income is usually considered a refinement of net income to take account of what are considered differences between the relative capacities of taxpayers to pay taxes.

The question of what deductions are appropriate and desirable in arriving at taxable income has thus depended in part on the concept of income upon which the tax is based, and in part on what particular policy objectives and equity considerations commend themselves to Congress as suitable to be dealt with through tax law adaptations. Consequently, the tax laws need not draw, and indeed have not always drawn, an explicit distinction between deductions stemming from the particular income concept adopted and deductions that serve some independent purpose. Yet such a distinction is valuable as a guide to policy, which is aided by more exact knowledge of identity and size of the deductions presently allowed on grounds other than the derivations of economic personal income.

While neither the Constitution nor successive income tax acts contain definitions that could be said to establish a concept of income

for tax purposes,[1] the statutes, regulations, and judicial rulings have nevertheless resulted in a general, though not very precise, concept of taxable income. Briefly, the tax is based on realized net money income "from whatever source derived," including gains derived from dealings in property and, in some instances, nonmoney receipts that can be readily determined and evaluated.[2] The refinement of gross income

[1] The first federal income tax act did not even stipulate whether gross or net income was to be taxed, although it appears that the taxation of net income was desired. Senator James F. Simmons, author of the bill, remarked that he had thought of putting the word "net" in, "But I could see so many ways of evading it that I thought it better to let the Secretary of the Treasury prescribe his rules, and let the bill cover all incomes" (*Congressional Globe*, July 29, 1861, 37th Cong., 1st Sess., p. 315). The 16th amendment to the Constitution, from which the federal government has since 1913 derived its power to collect income taxes as we know them today, states simply that "Congress shall have power to lay and collect taxes on incomes from whatever sources derived. . . ." Subsequently, income tax laws have used the term "net income" and have enumerated at length some of the sources of "gains, profits and income" to be included, without, however, defining the term "net income" as such. This situation is by no means peculiar to the federal income tax. Great Britain's tax code also contains to this day no general definition of income. Moreover, the majority of the Royal Commission on the Taxation of Profits and Income, in its recent final report (Cmd. 9474, London, 1955), accepted the celebrated principle on which British courts have long based their interpretations, that "income tax is a tax on income." In the Commission's words, "We have not looked to refine upon this principle by producing a more precise definition" (p. 8). Henry C. Simons' characterization is possibly the most trenchant: "Tax laws do not really define income but merely set up rules as to what must be included and what may be deducted; and such rules by no means define income because they are neither exhaustive nor logically coherent." *Personal Income Taxation*, Chicago, 1938, p. 105.

[2] With small exceptions, such as monetary value of food and living quarters received as part of wages or salary, no attempts have been made at the federal level to go beyond money income and to impute income receipts in kind, although the latter clearly have some influence on the individual's relative capacity to pay. Since, at least in the Northern part of the United States, collection of the tax in anything but money form was never contemplated, it can be argued that the tax should also restrict itself to money income as a base. Otherwise, particularly at the time of the Civil War tax, some taxpayers might have been required to give up a very large part of their money income owing to the relative size of their income in kind. It is widely recognized that computation of income taxes has been based predominantly on money income: "Since an estimate of value has an extremely subjective character . . . it is clear . . . that courts and legislatures will tend to avoid such estimates so far as possible. This tendency leads to the limitation of the recognition of income for tax purposes to receipts either in money or susceptible of easy valuation therein." "Since the tax must be paid in money there is a tendency to include in taxable income only those receipts which can readily be measured in money" (Roswell Magill, *Taxable Income*, New York, 1936, pp. 21, 195). Speaking of income taxes, Pigou observed that "in general . . . the tax gatherer has to content himself, for his object of assessment, with money income" (A. C. Pigou, *A Study in Public Finance*, 3rd ed., revised, London, 1952, p. 78). Haig noted that "the net income which our 1918 Act attempts to reach is in the main money income." After offering his classic definition of taxable income from the point of view of "fundamental economics and equity" (see note 7 below), he concludes that "the concept [of taxable income] as it stands in our own law is probably the closest approach to true economic income

to net income has been construed, broadly speaking, as deduction from the taxpayer's receipts of "ordinary and necessary" expenses connected with the creation of his income, and of losses that might be incurred in the course of activity directed toward the acquisition of income or gain. Conceivably, if size of net income were to be the only differentiation between taxpayers, this concept of net income could have constituted the base for the schedule of tax rates.

From the beginning, no such rigorous definition of the tax base was implicit in our tax laws. In fact, they went well beyond that definition in the direction of a narrower base, by two provisions. One, the allowable personal deductions, remained for a long time undefined and concealed; the other, the personal exemption, was at all times explicit in freeing from tax a part of what the statutes defined as income for a given year.[3] The personal exemption has, as a rule, varied in amount with the taxpayer's family status and the number of his dependents. The recent additional exemptions for taxpayers over 65 years of age, and for those wholly or partially blind, introduce some supplementary variation by age and by state of health. The reasons for such personal exemptions of given amounts of net income has been variously presented as the need for keeping untouched by the tax a subsistence amount of income, or a reasonable standard of living, and also the desire to eliminate as taxpayers those whose liability would be too small to warrant the expense of processing such returns.[4] In all the income tax laws from 1913 to 1954, personal exemptions were granted in the form of subtractions from whatever constituted statutory net

yet achieved by any country" (R. M. Haig, "The Concept of Income—Economic and Legal Aspects," in *The Federal Income Tax*, R. M. Haig, ed., 1921, pp. 23, 27).

[3] This view of the personal exemptions was most clearly stated as early as 1896 by Georg Schanz (the generally recognized "father" of the Haig-Simons concept of income, see note 7 below) in "Der Einkommensbegriff und die Einkommensteuergesetze" (The Income Concept and the Income Tax Laws), *Finanz Archiv*, XIII (1896), p. 33: "When the lawmaker leaves a subsistence minimum taxfree, or when he takes into consideration the number of persons in the family dependent on the income by allowing, for example, a deduction for minor children, then this has no connection with the income concept. It is simply that capacity to pay is not determined by size of income alone." (Translation ours.)

[4] The question of the rationale underlying the personal exemptions will be dealt with in more detail by Lawrence H. Seltzer in a later part of our study of the personal income tax. It is enough to note here merely two of many divergent views. "No clear guiding principle can be discerned for the determination of the amount of these allowances other than the revenue need" (Committee on Postwar Tax Policy, *A Tax Program for a Solvent America*, New York, 1945, p. 110). In contrast: "It is almost unanimously agreed that some exemption keyed to at least a minimum subsistence standard of living is desirable" (Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, University of Chicago, 1953, p. 4).

income at the time. Congress thereby made more or less explicit that net income was not considered enough of a refinement of gross income for determining the tax base; alternately, the revenue needs were not large enough to require using all of the tax base available under the net income concept adopted. In 1954, "statutory net income" disappeared from the vocabulary of both the tax return forms and the Revenue code. Personal exemptions are referred to in the new code as deductions, and on the tax return forms they are treated as deductions from adjusted gross income in computing taxable income.

Expense deductions, from the beginning of the modern income tax, have not been restricted to expenses and losses related to the production of taxable income. The income tax law of 1913 allowed deduction of all interest paid, taxes paid, and casualty losses (and bad debts, discussed below) without specific reference to their relation to taxable income. In practice, at that time and later, the personal deductions allowed in computing statutory income were nonbusiness interest, as paid on home mortgages and personal debts; nonbusiness tax payments, as personal income taxes and residential property taxes; and losses of personal property due to fire and storm (later also flood, theft, and accident) not compensated for by insurance.

The 1913 law, as well as later acts, allowed specifically for the deduction of worthless debts charged off during the taxable year. Several writers have included this item among the personal deductions.[5] Its retention (a legacy from the Civil War income tax) among deductions gave rise to some doubt in the Senate about its nature. Senator Albert B. Cummins, discussing the item described in the 1913 bill as "debts due to the taxpayer actually ascertained to be worthless and charged off within the year," spoke of a $100,000 note in his possession, presumably worthless: "I am permitted by this bill to deduct $100,000 from my income . . . although I had just as much income as though the man had remained solvent. I have simply lost a part of my capital or property, and it is proposed here to repair that loss by deducting

[5] "Usually, personal expenses are not deductible, but the federal income tax departs from this general rule by allowing deduction of . . . bad debts not contracted in business transactions. . . ." (Twentieth Century Fund, *Facing the Tax Problem*, New York, 1937, p. 562.) Magill speaks of "a debt ascertained to be worthless and charged off, even though the loan was unconnected with the taxpayer's business or professional activities" as among the deductions that "may be allowable, although they are entirely unconnected with the earning of the income which is the subject of the tax" (*op.cit.*, pp. 319-20). William J. Shultz and C. Lowell Harriss list "uncollectible debts . . . in some cases" among personal expense deductions (*American Public Finance*, 6th ed., New York, 1954, p. 281).

its amount from my income." It was the Senator's contention that the borrower had nothing to do with his income, had not contributed toward it, and was not interested in the source of his income.[6]

Yet it might be argued that this is at best a borderline case. The production of income (in the form of interest), which is usually taxable, may motivate the lender, even if a loan is not made in the ordinary course of business. A loss, in case of default, might have no more validity as a personal expense than losses incurred in the course of other activities directed toward earning income. More doubtful is the status of an interest-free loan to a friend or relative, who declares himself unable to repay—a loan probably more a personal gift than a financial asset. Even in terms of the Haig-Simons concept of taxable income such an unrepaid debt may not be deductible.[7]

Casualty losses on personal property, mentioned above, may also be considered a negative income item within the meaning of the Haig-Simons concept of income, since they may be said to constitute a diminution in the value of a person's "store of property rights." Indeed, the federal income tax law recognizes realized increases in the value of personal possessions and treats them as capital gains, but at the same time it does not allow deductions for realized losses sustained on assets not acquired for a "gainful" purpose.[8] Thus while losses realized through sale of personal possessions are not deductible, although realized gains from sale of such assets are taxable as capital gains, losses from theft, storm, or fire are fully deductible from ordinary income. For this reason the tax law may be said to establish a presumption, widely reflected in the literature, that the allowance for casualty losses on personal possessions is a personal expense deduction.[9] As in the case of bad debts, even the Haig-Simons concept of income does not tell when personal

[6] *Congressional Record*, 63rd Cong., 1st Sess., 1913, p. 3847.

[7] In accordance with what is widely known among students of public finance as the Haig-Simons concept of income, any loan made by a taxpayer—if initially considered as part of the taxpayer's assets—would become an allowable deduction if the debt has become uncollectible. Haig defined taxable income as "the money value of the net accretion to one's economic power between two points of time" (*op.cit.*, p. 7). Simons, similarly, defined personal income as the "algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question" (*op.cit.*, p. 50). This concept, too, leaves open the deductibility of worthless debts whenever the taxpayer's intent in making the loan comes into question.

[8] See Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses*, National Bureau of Economic Research, New York, 1951, p. 4.

[9] Twentieth Century Fund, *op.cit.*, p. 562; Magill, *op.cit.*, p. 320; William Vickrey, *Agenda for Progressive Taxation*, New York, 1947, p. 61; Joseph A. Pechman, "Erosion of the Individual Income Tax," *National Tax Journal*, March, 1957, p. 6.

property losses are essentially capital losses, and when a type of personal consumption. It may be argued that many of the losses allowed are generally anticipated and reckoned with as in the normal course of owning consumer durables.[10] We shall further explore this conceptual problem, as well as the quantitative importance of the casualty loss deduction, in chapter 7.

Brief Legislative History

The roots of the deductions mentioned reach back further than 1913, the beginning of the modern federal individual income tax.[11] Its forerunner, the Civil War income tax of 1861-1872, was in fact somewhat more liberal in this respect. In addition to permitting the deduction of all federal, state, and local taxes, interest, and various non-business losses, beginning with the act of 1863, it also allowed tenants to deduct the annual rent payments on their residences.[12] The rent deduction allowance was an attempt to place renters and homeowners on the same tax basis. It appears that the early law displayed more concern with the renter-debtor-owner problem than our modern income tax laws, although then, in contrast with current practice, the renter was treated more liberally than the owner.[13] The income tax law of 1894, declared unconstitutional before it could go into operation, also permitted deduction of all taxes, interest, and casualty losses, but did not include home rent among the deductions.

In 1917, prompted by the pressures exerted by high wartime revenue requirements, Congress eliminated federal income and profits taxes from the list of allowable deductions but added contributions made

[10] Cf. Vickrey, *op.cit.*, pp. 61-62; Pechman, *op.cit.*, p. 11.

[11] See Roy G. and Gladys C. Blakey, *The Federal Income Tax*, New York, 1940, p. 5.

[12] F. C. Howe goes so far as to state that "the householder was permitted to deduct the annual rental value of his homestead, whether occupied as tenant from another, or held in his own right" (see Charles J. Bullock, *Selected Readings in Public Finance*, Boston, 1906, p. 282). Actually, for the owner occupant, this was true only in the sense that the 1864 act stated specifically that homeowners were not required to include in their income the rental value of any residences occupied for their own use. The act of 1867, specific about another exclusion of income in kind, said that the taxable income of a person should include "the amount of sales of livestock, sugar, wool, butter, cheese, pork, beef, mutton, or other meats, hay and grain, or other vegetable or other productions, being the growth or produce of the estate of such person, not including any part thereof consumed directly by the family."

[13] Under current (1954) tax law, the homeowner's net imputed return on his investment in a home is not included in his income for tax purposes, and he is allowed to deduct property tax and any mortgage interest. But the sum of these falls short of the items covered by gross rent, which equals the explicit rent payments of the tenant.

within the taxable year to religious, charitable, scientific, and educational nonprofit organizations. The unlimited deduction of philanthropic contributions had been proposed, and rejected, in 1913. By 1917 there was much concern that high tax rates might shut off the flow of philanthropy and thus convert privately financed undertakings into public responsibilities. An amendment,[14] passed that year, permitted deduction of philanthropic contributions up to 15 per cent of net income. With some recent liberalizations, it has become a permanent feature of the income tax. The same wartime pressures led shortly afterwards to the disallowance of the deduction from income of federal income taxes paid in the preceding year.

Although in the course of a long Senate debate[15] the question of the relation of previously paid taxes to net income was brought up several times, the matter was apparently disposed of primarily on grounds of expediency.[16] Otherwise, it was argued, the tax rates would have to be commensurately higher to compensate for the revenue loss resulting from the deduction of the federal income tax on the previous year's income. Though one senator persistently raised the issue of the federal, state, and local taxes that remained deductible after 1917,[17] there appeared to be little interest in its solution. In part, this is explained by the fact that the remaining taxes had then relatively little effect on the size of the tax base (evidently the chief concern of Congress at that time). It is also partially explained by the apparent lack of distinction between taxes as a personal and as a business expense.[18] Federal excises and most state and local taxes continued to be deductible.

[14] Senator Henry F. Hollis, sponsor of the amendment, introduced it with the explanation that people usually "contribute to charities and educational objects out of their surplus. . . . Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be tempted to economize. . . . They will say, 'Charity begins at home!' " *Congressional Record*, 65th Cong., 1st Sess., 1917, p. 6728.

[15] *Ibid.*, pp. 6317-6327.

[16] "It seems to me purely a question of expediency as to whether or not we want to raise this amount of taxes by excepting the payments that are made to the government" (Senator John F. Shaffroth, *ibid.*, p. 6323). "Previously to this it has not made very much difference whether they did or not [deduct the federal tax], because the income tax was not very large; but I can not see any matter of morals or justice or principle in it. It is a pure matter of expediency. If you so arrange the income tax this year that you allow those who pay it to take back a third of it next year, you have simply got to put on a bigger tax. . . ." (Senator Hollis, *ibid.*, p. 6324.)

[17] See the remarks of Senator Porter S. McCumber: ". . . there is no more sense in excluding [from net income] taxes paid to a State than excluding those paid to the government. A tax is a tax" (*ibid.*, p. 6320).

[18] Several times during the 1917 debate the question arose whether taxes constitute an "expense." Examples were cited in which taxes were incurred in the

It was not until the beginning of the Second World War that personal deductions were further expanded and modified. In 1942 medical and dental outlays became, to a limited extent, deductible expenses. In the past such expenses had been considered adequately covered by the personal exemptions and dependency credits, but as these were lowered by successive revenue acts, the need for safeguarding unusual expenditures for medical care by special allowances was widely expounded. The medical expense allowance would undoubtedly have constituted a large separate subtraction from taxable net income, had it not been for the almost simultaneous introduction of the simplified tax return,[19] which incorporated a standard deduction.

To make the simplified return applicable to a large number of income recipients, many of whom had become newly liable to the income tax as a result of wartime increases in income and lowered personal exemptions, a new statutory income concept was required. It was this new income concept that at last drew a line between business deductions and personal deductions. In order to include allowance for personal deductions in the simplified tax return without causing extreme inequalities of treatment, it was necessary to place all taxpayers as nearly as possible on an equal before-deductions basis. So long as the standard deduction was granted on the bassis of gross income—as it was from 1941 to 1943 for gross incomes not exceeding $3,000—its application on a grand scale was not possible without considerable inequity. A salaried worker and a storekeeper may have equal net incomes before personal deductions, but the gross income of the storekeeper would in most cases significantly exceed that of the employee. Therefore, the new statutory income concept that evolved to fill the need for simplification came close to being gross income less business deductions. It was closer than any previous definition used in tax legislation to what many economists would consider net income. It placed all taxpayers on a fairly comparable income basis before computation

ordinary course of business, and also in which taxes appeared as a personal expense. Senator Hollis, referring to property taxes deductible by homeowners but not by renters, concluded that the best solution would be to disallow deduction of all taxes, business and nonbusiness (*ibid.*, p. 6325). Senator McCumber cited the tax on a pleasure automobile to arrive at a similar conclusion (p. 6327). But there is no record of a proposal for separate treatment of taxes incurred as business expense and those incurred as a nonbusiness expense.

[19] This device gave taxpayers the option of determining their tax liability by use of a schedule stating the tax due, by size of income and number of exemptions, computed after a blanket allowance covering all personal deductions. The blanket allowance was to be sufficiently high to induce the majority of taxpayers to choose the simplified return rather than itemizing personal deductions.

of personal deductions. But its designation as "adjusted gross income," as if it were an intermediate income concept, was somewhat awkward.[20]

While beginning with 1944 an explicit distinction was attempted between expenses incurred in the creation of income and expenses incurred in its disposition (spending), the distinction is not yet complete. The catch-all category of deductions, miscellaneous, continues to include a substantial amount of business costs, that is, expenses incurred in the course of professional or occupational activity of wage and salary earners and some incurred for the management of property.[21] Apparently for administrative reasons these expenses were not allowed as deductions in arriving at adjusted gross income, but only as deductions from adjusted gross income by taxpayers not self-employed. Therefore, such taxpayers who elect to use the standard deduction cannot also separately deduct these miscellaneous items connected with the production of taxable income.[22]

Some Recent Developments

With the enactment of the 1954 Revenue code, personal deductions have been liberalized and some new ones added.[23] The most recent additions are likely to be important, both quantitatively and with regard to policy. They include expanded deductions for medical expenses, for interest paid on installment plan purchases, and for philanthropic contributions, and an entirely new type of deduction under the heading, "expenses for care of certain dependents."

[20] The meaning of the new income concept might have been better conveyed had it been named statutory net income, and the old net income changed to adjusted net income. Instead, from 1944 until 1954, when the term was abolished, statutory net income was used as in previous years for gross income less all deductions, business and personal. There was considerable confusion about the new term, adjusted gross income, when introduced as part of the tax simplification bill. In the House debate it was referred to as "gross income," "adjusted net income," and even "gross net income" (*ibid.*, p. 4011).

[21] Examples are dues to labor unions and professional societies, tools and supplies, fees to employment agencies and investment counsel, rentals on safe deposit boxes, and amortizable bond premiums.

[22] Some arbitrariness is unavoidable in this type of arrangement. Taxpayers in a position to classify at their discretion part, or all, of their receipts may choose to designate them as business income in order to obtain both the miscellaneous business-type deductions and the standard deduction. Frequently, for example, salaried professional persons who have occasional receipts from professional activities outside their main employment, can, if they wish, declare them in the business schedule of the tax return.

[23] For a fuller discussion of the changes brought on by the 1954 code, see Joseph A. Pechman, "Individual Income Tax Provisions of the 1954 Code," *National Tax Journal*, March, 1955.

Of the expansions, that in the medical and dental allowance is quantitatively the most significant. The previous exclusion of 5 per cent of adjusted gross income, for which no deduction was allowed, was reduced to 3 per cent.[24] There is no evidence that new statistical findings on the pattern of private medical expenditures as such underlay this move. Rather, public concern with medical care and health in the postwar decade, at times as far reaching as the demand of part of the public for some kind of governmental health insurance plan, seems to account for Congress's revision of the original idea of extraordinary medical expenses.[25] In addition, the upper limit on the deductible amount was doubled to allow a married couple filing a joint return to deduct as much as $10,000 for medical expenses, and a single taxpayer (without dependents) as much as $2,500. But, as shown in Chapter 7, the increase in the ceiling has had no immediate significance for the majority of taxpayers.

Until 1954, interest charges on installment purchases were deductible only if the installment contract stated the interest separately from other carrying charges. Under the new law interest is deductible even if not clearly identified as such, but the deduction is limited to 6 per cent of the average unpaid balance due under the installment contract during the taxable year. The respective House and Senate committees parted company on this measure, but the House version as summarized above was eventually enacted. The House Committee was concerned with the inequity resulting from denying a deduction to those whose contracts did not identify interest specifically. The Senate Finance Committee deleted the provision for fear it might "encourage the practice of hiding the interest charge imposed under some other name"; because it might create a presumption that the proper interest charge is 6 per cent; and because most taxpayers who might have such unnamed interest charges are likely to choose the standard deduction, so

[24] For medicines and drugs a new and separate exclusion of 1 per cent of income was established with the intention of eliminating from the deduction most of the routine and ordinary household remedies, such as iodine, aspirins, and so forth. In effect, medical and dental expenses must thus exceed 3 to 4 percent of the taxpayer's income before a deduction can be made. To the extent that taxpayers succeed in having some of their expenses for pharmaceuticals transferred to doctors' and dentists' bills, the floor may be nearer to 3 than to 4 per cent.

[25] Both the House Ways and Means Committee and the Senate Finance Committee reported, in identical sentences: "There is general agreement that limiting the deduction only to expenses in excess of 5 per cent of adjusted gross income does not allow the deduction of all 'extraordinary' medical expenses" (*Internal Revenue Code of 1954*, H. Dept. 1337 to accompany House Report 8300, 83rd Cong., 2nd Sess., March 9, 1954, p. 20).

they would obtain no benefit from the provision.[26] In 1954, for the second time since 1952, Congress raised the ceiling on the amount of philanthropic contributions deductible, but the increase was restricted to gifts to churches, educational institutions, and hospitals. The new law raised the limit from 20 to 30 per cent of the taxpayer's adjusted gross income, provided the extra 10 per cent fell within any of the three categories mentioned. This innovation was "designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds."[27] The additional subsidy thus channelled to those institutions has probably been a modest one, as we shall see in Chapter 4, and the device adopted for it probably quite ineffectual in some cases. The taxpayer who already contributes 10 per cent of his income to his church, university, and a hospital can contribute the additional 20 per cent of his income for any recognized philanthropic purpose. In other words, even if a taxpayer expands his philanthropic contributions from 20 per cent of his income to 30 because of the increased deduction allowance, part or all of his increased gifts may go to other types of philanthropic organizations. The Finance Committee's Report estimated the resulting revenue cost at $25 million for the first year. For 1954 the amount of contributions reported in excess of 20 per cent of income on tax returns came to $67 million, of which $13 million was reported on nontaxable returns. This was a small increase in relation to the $3.9 billion itemized contributions reported on all tax returns for that year.

Beginning with 1954, working mothers were for the first time given an allowance for child-care expenses. The new allowance is carefully drawn to exclude all but those taxpayers whose child-care expenses are genuinely connected with earning a livelihood. A deduction of up to $600 is granted to working widows, widowers, and divorced persons for actual expenses incurred in the care of a child under 12 years of age, or of any dependent, including a working wife's husband, mentally or physically incapable of self care. The deduction may be claimed also by all other working wives provided they file joint returns with their husbands and their combined income does not exceed $4,500 after the deduction.

This new allowance represents a refinement of taxable income to-

[26] *Internal Revenue Code of 1954*, S. Dept. 1622 to accompany House Report 8300, 83rd Cong., 2nd Sess., June 18, 1954, p. 22.

[27] House Report 8300, p. 25.

ward increased interpersonal equity. Child-care expenses are commonly considered part of personal consumption outlays, though the House Ways and Means Committee explained that it had approved the deduction "because it recognizes that a widow or widower with young children must incur these expenses in order to earn a livelihood and that they, therefore, are comparable to an employee's business expenses."[28] If strictly adhered to, the comparison with an employee's business expenses could lead to a multiplicity of deductions covering outlays all of which are necessary in order to earn a livelihood. An alternative explanation is that offered by Pechman,[29] that the child-care deduction "is concerned with the fact that the value of services contributed by the housewife in the home is not included in taxable income." Thus when a housewife accepts employment outside the home and spends part of her earnings for child care, she is now taxed on a part of her income the equivalent of which was formerly untaxed. The situation is similar to that of residential housing, where imputed income from owner-occupied houses is untaxed. The issue can be resolved either by including an imputed amount of income in the taxable income of the housewife, or by allowing a compensating deduction to those who have substituted money income for income in kind. The new child-care allowance constitutes a compensating deduction, though only a very small one, from the substituted money income.

The child care allowance, like all other personal deductions, is available only to those itemizing their deductions. Since the standard deduction was not increased to allow for the additional deduction and the liberalizations of older ones noted above, the trend away from the standard deduction, which we shall observe in Chapters 3 and 8, became intensified from 1954 on.

Three Reasons for Deductions

Even though the tax laws have made it explicit that some personal and consumption expenses are deductible in computing taxable income, the haphazard enactment of these allowances over nearly forty years is more than evident. There has been no systematic legal review of the selection of personal expenses, if any, to be allowed as deductions from taxable income, or of the consistency of such choices with any underlying concepts of income or of social policy.

As we have seen in the foregoing historical sketch of personal deductions, there are three main explanations for their enactment. The first

[28] *Ibid.*, p. 30. [29] *Ibid.*, p. 120.

is simply the lack of distinction between personal expenses on the one hand and business expenses and losses on the other, which appears to have been of significance in drawing up the first income tax laws. It is probably the primary reason that interest payments, various taxes, and casualty losses of property have always been allowable deductions, whether they occur as business or as personal consumption expenses.

The second reason is the desire to encourage certain expenditures, that is, to provide an incentive to expand or maintain private outlays of a specified type. The deduction for philanthropic contributions is usually explained on that ground.[30] From the point of view of the individual taxpayer, the federal government pays part of the cost of his donations. An alternative interpretation sometimes advanced, but not widely accepted, is that the deduction is granted in recognition that the taxpayer has parted with some of his income without any benefit to himself in return, so that gifts require treatment on a par with losses.

The third explanation for personal deductions lies in the desire for greater interpersonal equity than might be obtained with economic net income, however defined, alone. The equity consideration is served by shifting part of the tax load from those who are burdened with "unavoidable" and emergency type expenditures to others who have no such expenses or can "afford" to bear them. In this instance, the redistributive character of the allowance is the primary motive behind its enactment. The medical expense and child-care allowances are cases in point.

Of course the earliest group of deductions, enacted without any explicit considerations of incentive-subsidy or equity, nevertheless exert either or both of these influences. These are the considerations usually emphasized in present-day discussions of their merits. Like the medical expense allowance, those for casualty losses, alimony payments, state and local income, and sales taxes, may be said to serve some interpersonal equity purposes. As with the philanthropic contributions, the

[30] When the question of the deductibility of philanthropic contributions was first raised in 1913, the amendment's author pleaded that "if a man wants to make a gift of charity, he ought to be encouraged so to do and not discouraged" (*Congressional Record*, 63rd Cong., 1st Sess., 1913, p. 1259). And the liberalization of the allowance under the 1954 act in favor of schools, churches, and hospitals was expressly intended "to aid these institutions" (see note 23 above). See also C. Lowell Harriss, "Philanthropy and Federal Tax Exemption," *Journal of Political Economy*, August, 1939, p. 527; Vickrey, *op.cit.*, pp. 130-131; Melvin I. White, "Deductions for Nonbusiness Expenses and an Economic Concept of Net Income," *Federal Tax Policy for Economic Growth and Stability*, Papers submitted by panelists appearing before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report, 84th Cong., 1st Sess., November 9, 1955, pp. 364-65; and Pechman, *op.cit.*, p. 7.

incentive-subsidy element, rather than equity, appears the paramount factor in the allowance of interest paid on personal loans, installment debts,[31] and home mortgages and taxes on owner-occupied residential property.

All the personal deductions have in varying degrees such a privileged expenditure character. They encourage the expansion of the deductible type of expenditures to the extent that the latter has some price elasticity. The deduction allowances for medical expenses, installment interest, and alimony payments[32] thus have some small incentive effect in addition to their equity function. The deductibility on the federal return of state and local income and sales taxes may make them more acceptable to the electorate, but it is difficult to say whether this feature has had any appreciable effect on the extent to which they are imposed.[33]

All the personal deductions also affect the distribution of income after tax. This is implied in the deductions that are intended for more equitable distribution of the tax burden. As they redistribute tax liability they redistribute a portion of after-tax income from the well

[31] Most writers tend to think of the personal interest deduction as lowering the cost of borrowing, viewing it as a subsidy to the borrower. In contrast, Melvin I. White, in examining the interest deductions for their consistency with "a systematically defined economic concept of personal income," assigns to interest on personal and installment loans primarily the characteristics of an equity device (see White, *op.cit.*, pp. 353ff). The deductibility of interest, he reasons, tends to right the balance between those who purchase a durable consumer good outright and those who purchase it with the help of credit. White thinks that the ideal solution would be to impute a return to the user-owner of durable goods, permitting interest payments as a deduction for the borrower-owner, but he acknowledges the difficulty of making such imputations for most durable goods. While imputation would remove inequities to those who purchase or rent their services, White holds that this group is comparatively small in durable goods other than houses. He concludes that a larger measure of equity results if installment and interest payments on consumer durables are allowed as deductions than if disallowed. In the case of housing, however, where renters are a very significant part of the consumer population, he concludes that an interest deduction increases the inequity to the renter, although it puts the debtor-owner on a more equitable footing with the clear owner. (For a more extended treatment of the nature of the interest deduction, see Chapter 6.)

[32] While deductibility is not likely to have affected the divorce rate any more than income-splitting has affected the number of marriages, it may nevertheless have permitted some alimony settlements to be more generous than they would otherwise have been.

[33] State income taxes, next to property taxes the most prominent instance of tax deductibility, have not risen significantly either in number or in rates since the 1930's. Yet since then the value of deductibility has risen steeply. It is particularly noteworthy that rate graduation in state income taxes stops, as a rule, at relatively low income levels. In 1953 over one-half of state income taxes reached their maximum rate at or below $10,000 of taxable income. See U.S. Treasury Department, Tax Analysis Staff, *Overlapping Taxes in the United States*, 1954, Table 12.

to the sick, from the young to the old, and from persons living in low-tax states to those in high-tax states. But redistribution also occurs through those deductions chiefly aimed at encouraging expenditures considered socially desirable. There is redistribution from tenants to homeowner occupants, and from "non-philanthropic" contributors to those who contribute money and property to philanthropies.[34]

If a deduction is primarily designed to stimulate private expenditures in areas of strong public interest, it may, in effect, become an indirect government expenditure. But more than an overlapping of private and public interest in certain expenditures, such as philanthropy and medical care, is necessary to genuinely equate a deduction allowance with indirect public expenditures. For the desired effect, taxpayers claiming the deductions must also expand their deductible expenditures as a result of the tax rebate. In other words, if a deduction is to serve as a tax incentive, the underlying expenditures must have a certain degree of price-elasticity. If taxpayers, despite the deduction, merely spend about the same they would have in any case, then the deduction allowance would in effect, although not by design, become solely a question of equity among taxpayers.

The distinction here between equity motivated deductions and deductions that serve as incentive devices is of more than merely formal significance. If an allowance, by way of refining a person's net income, is considered as part of the attempt to define capacity to pay tax, then a deduction from net income of that expense may be held appropriate. If, on the other hand, the allowance is part of a public policy to advance a given social or economic goal, it may be argued that a tax credit is called for. Reduction in tax resulting from a deduction depends on the size of the taxable income reported. A tax credit, provided it is granted at the same rate (20 or 30 per cent, for example) to everyone, brings, for a given deductible expenditure, a tax reduction that is the same for almost all taxpayers,[35] regardless of income size.

The question of the form allowed for the deduction has been frequently raised concerning the allowance for philanthropic contributions. Recently this has become particularly acute regarding a frequently proposed allowance for educational expenses.[36] Many have

[34] See Robert J. Lampman, "The American Tax System and Equalization of Income," *Proceedings of the 49th Annual Conference on Taxation*, National Tax Association, 1956, p. 277.

[35] An exception occurs when the tax credit to which a taxpayer is entitled exceeds his tax liability before credit.

[36] See, for instance, The President's Committee on Education Beyond the High

favored a tax credit for educational expenses rather than a deduction from taxable income, on the ground that the latter "constitutes an upside down subsidy to education: the larger the income, the greater the subsidy in the form of tax savings. . . ."[37] This reasoning proceeds from the premise that the allowance would be intended to encourage greater private expenditures for education in place of greater budgetary appropriations. Others have favored simple deductions from income of all or selected educational expenses. Indeed, two such deductions connected with education are currently allowed on a limited scale. The 1954 Revenue code eliminates the $600 gross income test for determining the dependency status of children over 19 years of age still attending school, and it provides that scholarship aid need not be reckoned in determining whether a taxpayer provides over half the support of a child. Since 1958, outlays made by a teacher to further his education may be deducted even if such expenses are incurred voluntarily to improve professional status. Previously the latter expenses were deductible only if required to maintain existing salary and status.

Evidently, the kind of broad deduction that might be allowed in the future for educational expenses will depend, in some measure, on the distinctions we have attempted to bring out above. If educational expenses are an appropriate consideration in determining relative capacity to pay, equity among taxpayers being the governing principle, a deduction from income may be called for. In that case the personal investment aspect of education may be cited as the determining factor, and the deduction might take the form of a depreciation allowance. Needless to say, many do not view education as an investment, and many students do not pay their own expenses but receive them as gifts from parents or relatives. On the other hand, if education is to be made increasingly the object of communal investment, and the income tax is to be utilized for that purpose, a tax credit may be held most appropriate.

School, *Second Report to the President*, Washington, D.C., July, 1957, p. 56; National Science Foundation, *Basic Research—A National Resource* (a report to President Eisenhower), Washington, November, 1957, p. 50; and testimony by John F. Meck, on behalf of the American Council on Education, American Alumni Council, Association of American Colleges, and State Universities Association, at hearings before the House Ways and Means Committee on *Federal Revenue Revision*, 85th Cong., 2nd Sess., Part 1, January, 1958, pp. 1061-66.

[37] Walter W. Heller, "U.S. Tax Policy for 1958," *Canadian Tax Journal*, March-April, 1958, p. 95. (But Heller, while giving the edge to a tax credit over an income deduction, appears to favor neither for the purpose under consideration.)