Worshipful Company of
Tax • Advisers

HISTORY OF TAX

A HISTORY OF US TAXES - 10 KEY DATES

Our next History of Tax Lecture will focus on overseas taxes. We are delighted that Don Korb, former Chief Counsel for the Internal Revenue Service, will present a history of US taxes from 1861 to the current day (and beyond). While Chief Counsel, Don became well known in the UK as a speaker at HMRC public meetings and other events and he played a vital role in bringing together US and UK tax administrators and practitioners. Subsequently he practiced at Sullivan & Cromwell LLP and continued to speak at international events such as the Congress of the International Fiscal Association.

Don will describe some of the key steps in the development of US taxes from the earliest days until recent tax reform, including a fascinating look at the era of tax shelters and the role he played in the IRS approach to challenging them. Questions and discussion will be very welcome and there will be an opportunity to speculate about the possibilities for US tax policy after the election in November and as the world recovers from the economic effects of Covid-19.

Unfortunately, wine and nibbles will not be served on this occasion although please provide those for yourself (provided that the mute button is on in case of any loud crunching).

If you wish to attend, please use https://cvent.me/E5OYel to register before the closing date of Monday 26th of October 2020.

DATE

Tuesday 27th October 2020

TIME

6pm – 7pm

PRICE

No charge but you are invited to make a voluntary donation to the Tax Advisers Charitable Trust via the link below:

https://www.justgiving.com/campaign/History-of-Tax

£20 suggested but no obligation!

VENUE ADDRESS

Online log in details will be provided to registrants.

CLOSING DATE

Monday 26th October 2020

This event is open to everyone with an interest in the history of tax

Please note that in view of the temporary closure of the CIOT office registration can only be accepted online (preferably) or, if necessary, by email to: iliepina@ciot.org.uk

TEN KEY DATES IN U.S. TAX HISTORY

Speech
The Worshipful Company of Tax Advisors
on
October 27, 2020

Donald L. Korb
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Sullivan & Cromwell LLP
and
Former
Chief Counsel
For the Internal Revenue Service
(2004-2008)

I. Introduction.

A. Greetings from the Colonies!

B. Thanks Paul, for that very nice introduction. And I also want to thank you for inviting me to speak to your Company tonight. Everyone else should know that I have attended several of your Company's dinners as Paul's guest, and have enjoyed them immensely.

1. I have been a tax lawyer now for almost 48 years and have worked both in the private sector (at two different corporate law firms and one Big 6 accounting firm) as well as in the public sector (with three different stints at the U.S. Internal Revenue Service) over that time-period.

2. And I was fortunate to be able to cap off my career, first as the Chief Counsel for the Internal Revenue Service, the federal government's top tax lawyer, and following that, as a tax partner in the law firm of Sullivan & Cromwell LLP.

C. Throughout my life, I have always enjoyed reading and studying history. And because I am a tax lawyer, I have taken a particular interest in the history of tax.

1. A high point in my study of tax history came when Paul took me to the Archives in the House of Lords to see the statute which enacted the first modern income tax, your Income Tax Act of 1799. There we were, holding the actual, physical document in our hands and scrolling it out so we could read it. Don't worry, we had on gloves, so we didn't damage it.

2. In any event, I was particularly fascinated to see that even in 1799, there were not only "technical corrections" made by interlineations between the lines of the text and the law in the document, but also there were what we refer to today as "transitional rules", which, in the case of the 1799 Act, dealt with issues raised by moving from a tax system with no income tax to one which had such a tax.

D. Consequently, I was delighted when Paul asked me to prepare remarks for your Company on some aspect of the history of taxation in the United States. And I decided that the best way to give you a sense of the history of our income tax law is to focus on ten key dates in the history of U.S. taxation.

E. But before I start, I want to clarify one interesting feature about taxation in the U.S. Because of our country's federal structure, there are actually three levels of taxation: there are taxes at the *national* or *federal* level (primarily income, estate, gift, and excise taxes) to finance the national government; at the *state* level and in the District of Columbia where Washington is located (primarily income, sales, inheritance taxes, and in the case of D.C., real estate taxes as well) to finance each of the 50 state governments and the District of Columbia; and at the *local* level – literally thousands of counties, townships, villages, and cities throughout the U.S. – (primarily real estate taxes and fees, but also often including income taxes). However, in this talk, I will be focusing only on taxes at the federal level.

F. So let's begin with our first date, **August 5, 1861**, which is almost four months after the Confederates (the South) fired on the U.S. Ft. Sumter (located in the Charleston, S.C. harbor) to start our country's Civil War.

II. The first federal income tax was enacted in 1861 during the Civil War **(8/5/61)**.

A. Prior to 1861, the federal government had been financed almost exclusively by receipts from customs duties, even though its total revenues were also supplemented by proceeds from sales of public lands plus a few excise and other internal taxes.

B. However, the Civil War forced the Union (the North) to undertake spending on an unprecedented scale.

1. So in order to raise the necessary funds, the North turned to three methods of financing the cost of the war:

a. First, various types of government bonds (66%).

b. Second, Treasury Notes, essentially fiat money, called "greenbacks" (13%).

c. And third, the internal revenue system, including excise taxes, license fees, and the federal government's first individual income tax (21%).

2. Forced into action, mainly because the Confederate Army had just won a surprisingly easy victory in a battle over the Union army in Northern Virginia near Washington, D.C., by a river called Bull Run, President Abraham Lincoln signed the Omnibus Revenue Act of 1861 on August 5. This Act included a 3 percent income tax on residents of the U.S. on amounts over a personal exemption of $800. Because in 1861, the average American citizen had an annual income of about $900, the new income tax was initially imposed on what we would today call "upper-income" households.

a. The first income tax law was very simple and short; in fact, it did not even specify whether the tax was to be assessed with respect to gross or net income.

b. It also contained the first income tax "loophole," a special 1.5 percent rate on government securities.

c. But there was one big problem with the new income tax law: the Congress in its haste to act had not bothered to include provisions in the new law for collecting the tax. Thus, it should come as no surprise to anyone that no taxes were ever assessed and collected under the new law.

C. Consequently, in the Spring of 1862, Congress had to go back to the drawing board, and on July 1, 1862, a second income tax act was signed into law by President Lincoln.

1. This time, the law included a progressive rate structure – the tax rate was 3 percent on incomes between $600 and $10,000 and increased to 5 percent on incomes over $10,000.

2. More important, this time the law contained provisions for the assessment and collection of the tax, including the establishment of the Bureau of Internal Revenue (the forerunner of today's Internal Revenue Service).

a. The Bureau was up and running within two weeks; in addition to a Commissioner of Internal Revenue, it had only two employees, a secretary and a clerk.

b. Within a year, however, the Bureau would grow to 149 employees, and by the end of the war, it would expand to 3,882 employees.

c. To aid taxpayers with compliance with the new law, the Commissioner, George Boutwell, a politician from Massachusetts, published a *Manual of the Direct and Excise Tax System of the United States*, which explained the new law. Each day, Boutwell personally spent several hours responding in writing to letters from both taxpayers and his workforce of assessors and collectors answering their questions on the new law. Think about that for a minute. It would be like the head of HMRC taking time each day to respond personally to taxpayers' requests for guidance.

3. Interestingly, one feature of the 1862 Act was the partial adoption of the British "stoppage-at-the-source" method of collecting the tax (first used by the British government in 1803 and eventually adopted by the United States for three years beginning in 1913 and, as we will see, eventually for good during World War II). However, during the Civil War, this method of collecting the tax only applied to U.S. government employees, both civilian and military.

D. After the war ended, the income tax still continued for an additional 6 years. However, eventually, Congress came under pressure to repeal the tax, which ultimately it did when it let the law expire at the end of 1871.

III. Enactment (8/27/94) and Repeal **(4/8/95)** of the Income Tax of 1894.

A. Repeal of the Civil War income tax meant that tariffs once again became the primary source of revenue for the federal government. That would change almost 25 years later, when, on August 27, 1894, Congress passed the Wilson-Gorman Tariff Act of 1894 which significantly lowered tariff rates. As a result, Congress had to make up for some of the lost revenue, and to do so, they introduced taxes on individual income, corporate profits, gifts, and inheritances.

B. But, the income tax was not destined to last for long. That is, because the very next year on **April 8, 1895**, our second date, in the U.S. Supreme Court case of *Pollock* v. *Farmers' Loan & Trust Company*, the Supreme Court, in a narrow 5-to-4 decision, struck down the income tax imposed by the 1894 Act for the reason that it was, in the view of the majority of justices, a constitutionally impermissible unapportioned direct tax.

C. More specifically, in the majority opinion written by the Chief Justice, he explained that a federal tax on income derived from property was unconstitutional where it was not apportioned among the states in proportion to population as required by the U.S. Constitution.

D. The Court's *Pollock* decision was actually generally unpopular, certainly among the Populists who supported the new income tax law (remember this was the Era of Robber Barons), but because the constitutional apportionment requirements were widely regarded as unworkable, it effectively prevented the Congress from implementing another income tax law over the next 18 years.

IV. Enactment of Sixteenth Amendment to the U.S. Constitution **(2/3/13)**.

A. Consequently, in the years between 1895 and 1909, interest in the income tax waned considerably.

1. During that time, the Populists, led by William Jennings Bryan, a three-time unsuccessful candidate for President, took up other causes, and although they did briefly try to resurrect the income tax as a means of financing the 1898 Spanish-American War. However, firm Republican control of the Congress and the difficulty of writing legislation within the confines of the 1895 Supreme Court's ruling defeated the effort.

2. But in 1908, the issue became credible again when President Theodore Roosevelt, a progressive Republican, made a radical proposal for both an inheritance tax and an income tax.

B. Thus, in the next year, 1909, the issue came to life in Congress.

1. While there had been some support in the House of Representatives among the Democrats (who were in the minority there), in the Senate (also controlled by the Republicans), Republican leadership had consistently resisted the income tax in favor of very high protective tariffs.

2. In the Spring of 1909, however, a new group of liberal Republican Senators joined with Democratic Senators to fight diligently but still unsuccessfully against extension of the high tariff rates. But during the proceedings, they were able to introduce two income tax proposals that directly challenged the 1895 Supreme Court ruling.

3. When it looked like one of these proposals might actually pass the Senate, several key Republicans appealed to Roosevelt's Republican successor, President Howard Taft, for intervention.

4. Taft suggested a compromise, ostensibly to defuse the potential constitutional crisis between Congress and the Supreme Court. He proposed:

   a. a constitutional amendment that would specifically allow an income tax without apportionment among the states; and

   b. immediate passage of an "excise" tax of 1 percent on corporate profits -- not technically an income tax but practically, it amounted to the same thing.

5. Both houses of Congress accepted Taft's proposals by almost unanimous votes. Thus, a very modest but what became a permanent corporate income tax was born, and unappreciated at the time, the path to the individual income tax was set.

6. In truth, most observers at the time thought that Taft's proposal for the constitutional amendment was a "harmless gesture", and many on both sides of the issue thought that it would effectively put off the enactment of an individual income tax for many years to come.

C. But such thinking was a good example of "be careful what you wish for."

1. While progress on ratification of the constitutional amendment began slowly, the timing for a major political transformation started to take shape in the very next year, in the 1910 midterm elections, which transformation subsequently, two years later, culminated in the sweeping Democratic victories in the election of 1912.

2. Woodrow Wilson, a Democrat, was elected President in November 1912, and the Democrats took control of both houses of Congress.

3. And on our third date, **February 3, 1913**, Massachusetts became the thirty-sixth state to ratify (approve) the Sixteenth Amendment to the Constitution, which meant that the 1895 Supreme Court case would no longer stand in the way of an income tax, either on individuals or corporations.

4. As a result of the enactment of the Sixteenth Amendment, in President Wilson's inaugural address, given on March 4, 1913, he called for tariff reform and reduction and also called for an income tax to be enacted in order to make up for the lost revenue. Congress responded by enacting the Individual Income Tax of 1913 later that year (10/3/13).

   a. The 1913 federal income tax law consisted of only 16 pages.

b. The 1913 Act imposed a 1 percent tax upon all persons with a net income over and above $3,000. There was also a surtax on individual incomes over $20,000, with six progressively higher brackets, starting with 1 percent on incomes between $20,000 and $50,000 and increasing to 6 percent on incomes over $500,000.

i. Because the average American's annual income from wages in 1913 was $1,300, less than the $3,000 personal exemption, the new tax was clearly a "class tax" rather than a "mass tax".

ii. In fact, less than one percent of the population was subject to the first year of the new tax regime.

c. In addition, the Act included a flat 1 percent tax on corporate income.

V. Enactment of the Social Security Act **(8/14/35)**.

A. Let's step away from the income tax for our next historical date.

B. In 1935, the U.S. was deep in the throes of the Great Depression. At that time, poverty rates among the country's senior citizens exceeded 50 percent. Consequently, Franklin Roosevelt, who had become president in March 1933, decided that he would take a social insurance approach as the "cornerstone" of his attempts to deal with the problem of economic security for the elderly.

C. So, as part of the New Deal, the Social Security Act was enacted **August 14, 1935**, the fourth historical date in our journey.

1. The Act was an attempt to limit what were seen as the dangers in the modern American life, including old age, poverty, unemployment, and the burdens of widows and fatherless children.

2. The Act provided benefits to retirees and the unemployed, and a lump-sum benefit at the death of a worker for his widow and children.

D. The reason I am including this date as one of my talk's historical dates, is to focus on the way the benefits were financed.

1. Benefits were based on payroll taxes on workers and their employers, with participants (and their families) reaping benefits related to their contributions. Hence, the name "payroll taxes", but also called "employment taxes", was born. (Note that if you were self-employed, you were responsible for both the employee and employer taxes)

2. The financing mechanism and approach to calculating pension benefits together gave Social Security the outward appearance of a publicly run insurance system not unlike private-sector models. By making the funding dependent on worker and employer contributions, rather than general federal tax revenues, Social Security cleverly gave people a sense that all they were getting back in old age were their own contributions, plus accrued interest. Thus, to the average person, Social Security represented nothing more than a new form of saving, mandated by the federal government.

3. Today, the payroll tax on employees is 6.2 percent of his or her wages and an equal payroll tax is paid by the employer. Wages subject to this tax are now capped at $137,700. But there is also now an additional 1.45 percent tax on both employees and their employers to pay for Medicare (healthcare for Americans 65 and older), and there is no limit on wages subject to the Medicare tax. For self-employed people, the tax rate is 12.4 percent up to the $137,700 limit and 2.9 percent for Medicare (with no limit). Finally, the employee's portion of the Medicare component of the payroll taxes is increased by an additional 0.9 percent on wages in excess of $200,000; the same rate applies to the self-employed.

VI. Let's return to the income tax/income tax becomes mass tax during World War II.

A. As I said earlier, the modern U.S. income tax started out as a "class tax" – only about 1 percent of Americans were subject to the tax in 1913, and except for the years 1917 and 1918, when revenue needs of the U.S. government skyrocketed due to the need to finance the cost of World War I, the tax remained a tax primarily on the wealthiest of Americans.

1. But, in order to raise such vast sums of money, the maximum marginal tax rate of the individual income tax, which was 7 percent during the years 1913-1915, was increased to 77 percent by 1918. The corporate income rate also rose sharply during the war, rising from an initial level of 1 percent in 1913-1915 to 12 percent by 1918. Plus there was a whopping 80 percent excess profits tax on corporations as well.

2. Consequently, during the war the income tax soon became the government's most significant source of revenue, and by 1917, income tax collections surpassed customs revenues.

3. Because the traditional 19th century revenue sources were inadequate to finance the greatly expanded federal defense and war expenditures needs of the period, the fiscal lesson learned from the First World War was that the income tax could be an important source of revenue during a future national emergency.

4. But subsequently, during the 1920's, with the Republicans back in charge, income taxes were cut substantially for both individuals and corporations, and once again, the individual income tax reverted to being a "class tax", basically paid only by upper income people.

B. However, 20 years later, the extraordinary revenue needs of World War II changed that forever. It was during the Second World War that the income tax became a permanent "mass tax" for good covering a large portion of the population.

1. In 1939, the individual income tax applied to only a small slice of the population: only one of 14 Americans paid federal income tax in that year.

2. But increasing demands for additional revenues to finance World War II programs established the overriding importance of both the individual and corporate income taxes in our federal structure.

3. And by the end of the war in 1945, the income tax was levied on most of the population. By then, the marginal individual income rates ranged from 23 percent to 94 percent -- the highest rates ever imposed in the entire history of the federal income tax.

C. With the tax applying to the masses on **June 9, 1943**, our fifth historical date, a withholding system was introduced by the Current Tax Payment Act of 1943. This Act compelled employers to withhold federal income taxes from workers' paychecks and pay them directly to the U.S. government on their workers' behalf. For those who were self-employed, quarterly estimated tax payments were required instead.

1. The Current Tax Payment Act of 1943 re-introduced the requirement for an employer to withhold income taxes from its employees' wages (tax withholding had been introduced in 1913 but repealed in 1916).

2. Interestingly, the idea of withholding did not originate in the U.S. Treasury Department but instead was the brainchild of an executive of Macy's Department Store in New York City. His name was Beardsley Ruml.

a. In the summer of 1942, Ruml proposed that the U.S. Treasury start collecting income taxes through a withholding, pay-as-you-go system.

b. He also proposed an abatement of the previous year's taxes, making up the revenue by immediately collecting on the current year's taxes.

c. And in 1943, the Congress adopted this withholding system.

3. The new withholding regime began for payroll periods on or after July 1, 1943, which meant that 1943 was a transition year because under the old system, payment of the 1942 tax would be due in 1943, while under the new system, 1943 payments would be made currently by the new wage withholding mechanism for the last half of the year.

a. But this created a problem – if taxes for both years were to be collected in 1943, the overall tax bill for 1943 could actually exceed a particular taxpayer's entire income for that year.

b. To solve this problem, an amazing thing happened: 75 percent of the 1942 tax liability was forgiven – technically, there was a 75 percent forgiveness of tax for the lower of 1942 or 1943.

4. And due to the need to maintain a strong national defense in the post-World War II years, income tax rates remained high for almost 20 years after the end of the war. For example, in the 1950s, the maximum marginal individual income tax rate was still as high as 92 percent. And the maximum corporate tax rate was 52 percent.

5. It was not until 1964, in what was called the "Kennedy tax cuts", that the top marginal tax rate for individuals was reduced to 70 percent and the corporate tax rate to 48 percent. But at least the wartime excess profits tax which had taxed 85 percent of corporate profits above a peacetime norm, had been repealed in 1946.

VII. Employee Retirement Income Security Act **(9/2/74)**.

A. Beginning in 1969 and continuing in 1974, 1976, and 1978, the Congress made a number of changes to the tax code. For example, beginning in the 1960's and continuing into the early 1970's, Congress held a number of hearings on pension reform, particularly because of reports regarding the misuse and diversion of labor union benefits.

B. This work eventually led to the enactment of the Employee Retirement Income Security Act of 1974, which was signed into law by President Gerald Ford on **September 2, 1974**, our sixth historical date.

C. ERISA, as it was called, was a comprehensive rewrite of the tax and labor law rules for retirement plans that established minimum standards for pension plans in private industry. ERISA was enacted to protect the interests of employee benefit plan participants and their beneficiaries by:

1. Requiring the disclosure of financial and other information concerning the plan to beneficiaries;

2. Establishing standards of conduct for plan fiduciaries; and

3. Providing for appropriate remedies and access to the federal courts.

VIII. Era of Tax Shelters (mid-1970s through early 2000s with hiatus from 1987 through about 1995).

A. Our next historical date is actually dates – plural – starting in the **mid-1970s** and running through the **early 2000s** with a brief hiatus from **1987** through about **1995.** I call this the Era of Tax Shelters.

1. Tax advisors have been figuring out ways to reduce taxpayers' tax liabilities forever.

2. In fact, while IRS Chief Counsel, I was able to document examples of "tax sheltering activities" as far back as Ancient Rome and also during the Middle Ages in areas of the Islamic world, the 15th Century in Russia, and the 19th Century in the Antebellum South in the U.S.

B. And the modern day U.S. is no exception. Beginning in the mid-1970s and continuing until the mid-1980s, there was a significant tax shelter syndication industry in the United States which promoted all kinds of tax shelters to individuals, and not just to wealthy individuals, but to middle class taxpayers as well. Included were tax shelters involving such thing as cattle breeding, master recordings, equipment leasing, movie production and distribution, oil well drilling ventures, development of orchards and vineyards, and rental real estate.

1. However, as we shall see in a moment, when Congress enacted in the Tax Reform Act of 1986, the new law contained an extremely broad-based attack on tax shelters by limiting the deduction of losses from "passive activities". This change resulted in the syndicated individual taxpayer shelter business as it existed prior to 1986 being basically wiped out.

2. And the tax sheltering even disappeared for a while (between 1986 and about 1995). But the widespread use of computers and the exotica of modern corporate finance combined with the desire of the Big 6 accounting firms, investment bankers and some law firms to generate revenues, not based on the traditional billable hours, but instead based on contingency or premium fees, led to a new phenomenon, commonly called Corporate Tax Shelters.

   a. In turn, emboldened by the perceived weakness of the IRS in discovering these new forms of tax shelters, a whole new breed of tax shelter promoters emerged to peddle questionable tax shelter schemes—that oftentimes were unsolicited by any client—to corporations and to individuals who became newly wealthy during the booming economy of the 1990s.

   b. The hallmark of these new tax shelters was to develop a transaction which involved exploitation of not-well-known imperfections in specialized parts of the tax law to produce results that everyone knows would not have been intended if they had been foreseen, and which are likely to be corrected soon after they are discovered. Rather than providing tax planning advice to individual clients based on their particular circumstances, these transactions were developed in a way that made them easy to replicate and promote to a variety of clients and non-clients alike.

   c. Most of these new tax shelters were not publicly syndicated, partly to keep them secret from competitors, but largely to keep them secret from the IRS as long as possible. Indeed until about 2004, many of these schemes were shown to prospective customers subject to confidentiality agreements committing the prospects not to reveal anything about the tax shelter to anyone else. Sometimes the prospect was not even permitted to share the deal with his or her lawyer in order to obtain legal advice unless the lawyer subscribed to the confidentiality agreement too.

C. Beginning in 2002, however, the situation began to change dramatically.

1. The IRS made changes to its internal audit procedures which allowed it to quickly identify these types of transactions. After I became Chief Counsel in 2004, the Service began implementing a litigation strategy where the IRS would identify specific cases which could then be sent on to the courts in order to test the application of the law with respect to the specific facts of those cases, and just as important, to refine the law for the future based on the outcome of these cases.

2. This litigation strategy was a valuable tool in the resolution of industry-wide or tax shelter issues, and at the same time, helped to establish judicial precedent which led to resolution of the majority of cases involving a particular issue without the need for further litigation.

3. As Chief Counsel, I often referred to this strategic litigation strategy as the "three and out" strategy because the idea was to "order" the cases in litigation involving significant recurring issues in a way that that those cases with the most favorable facts for the IRS were the ones which were tried first. Then after litigating and winning the first three such cases with basically the same transaction or issue, the IRS would then offer to settle all of the other taxpayers' cases which were the same or substantially the same on very favorable terms for the IRS and very unfavorable terms for the taxpayer.

4. Such settlements were possible because by that time, taxpayers knew that if they pursued their particular cases in court, they were likely to lose based on the precedents which were set by the first three decided cases.

D. But we're getting a little ahead of ourselves—let's backtrack to the year 1981.

IX. Economic Recovery Tax Act of 1981 **(8/13/81)**.

A. When Ronald Reagan was sworn in as President in January of 1981, a major tax cut was at the very top of his "to do" list.

1. By 1981, the top marginal tax rate for individuals had dropped from the high of 92 percent in the 1950s to 70 percent, the rate since 1964.

2. And the corporate tax rate for the largest corporations had fallen to 48 percent from the post-World War II high of 52 percent, also in the 1950s.

B. To encourage economic growth, Reagan proposed and the Congress enacted the Economic Recovery Tax Act of 1981 which he signed into law on **August 13, 1981**, the eighth historical date in our journey.

1. The new tax law, called ERTA, was one of the largest tax cuts in U.S. history. (ERTA and the Tax Reform Act of 1986 are known together as the Reagan tax cuts.) Along with spending cuts, Reagan's tax cuts were the centerpiece of what some contemporaries described as the conservative "Reagan Revolution."

2. Included in ERTA was an across-the-board decrease in federal income tax rates. The top marginal individual income tax rate fell from 70 percent to 50 percent. Meanwhile, the lowest rate was lowered from 14 percent to 11 percent.

3. ERTA also slashed capital gains taxes and corporate taxes.

4. Importantly, for the first time in the history of the income tax, the new tax rates were indexed for inflation in order to prevent future "bracket creep", which occurs, as you know, when taxpayers are pushed into a higher tax bracket merely because of inflation.

C. Critics of the act claim that it worsened federal budget deficits, while supporters credit it for bolstering the economy during the 1980's. In fact, however, tax revenues declined (relative to baseline without the cuts) due to the tax cuts and the deficit ballooned during Reagan's term in office.

D. Consequently, much of the 1981 ERTA was reversed in 1982 by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), sometimes called the largest tax increase of the post-war period.

X. Tax Reform Act of 1986 **(10/22/86)**.

A. Our next historical date, **August 22, 1986**, was when the landmark Tax Reform Act of 1986 was signed into law.

1. During the Reagan Administration, I served as the Assistant to the Commissioner of Internal Revenue from May 1984 to September 1986, when the tax bill was being developed by the U.S. Treasury Department and then enacted by Congress.

2. My job was to be the overall coordinator of the IRS's involvement in that legislative process. In essence, I had a front-row seat to not only watch, but more important, to participate in the process as a player in this significant event in U.S. tax history.

B. The Tax Reform Act of 1986 was the most comprehensive overhaul of the federal income tax system since 1913. Among the many changes:

1. It dramatically reduced individual rates; there were only two tax brackets – 15 percent and 28 percent. The Act also lowered the corporate rate from 46 percent to 34 percent, and for the first time ever, the corporate tax rate was higher than the individual tax rate, which eventually led to an explosion in the use of pass-through entities for tax planning purposes.

2. To make up for lost revenue due to the rate reductions, the Act repealed or restricted scores of tax incentives written into the tax code over the years to encourage activities deemed economically or socially beneficial. This was known as "broadening the tax base".

3. And it made such fundamental changes to the law as eliminating (for the first time since 1921) the tax rate differential for capital gains.

C. Another very significant change was the addition of the so-called "passive activity loss" rules that I mentioned earlier, which meant the death knell for almost all individual tax shelters.

D. Finally, the tax code itself was renamed the Internal Revenue Code of 1986, which remains its title today.

E. In my view, now with hindsight, of course, the 1986 Act resulted in the simplest income tax law that may ever exist in the U.S. – at least the simplest since the very early years of the modern U.S. income tax.

XI. Tax Cuts and Jobs Act of 2017 **(12/22/17)**.

A. Other than in 2004, there were no comprehensive tax bills between 1986 and 2017. Over that time period, there were tax increases (generally when the Democrats were in control) and tax cuts (generally when the Republicans were in control) and of course some other tinkering with the tax code, but except for some of the provisions in the American Jobs Creation Act of 2004 (such as creating a business deduction for U.S. production activities and changing the interest expense allocation rules), the tax code stayed pretty much the same over that 30-year period.

B. Such stability in the tax code (the longest since 1913) came to an end in 2017, when the Republican controlled Congress did a major rewrite called the Tax Cuts and Jobs Act, which was enacted **December 22, 2017**, the tenth and last historical date in our journey.

C. On the individual income side, tax rates were lowered, at least through 2025; also through 2025, the so-called standard deduction was doubled (resulting in about 85 percent of families being better off taking the standard deduction rather than itemizing their personal deductions); also through 2025, for those who could still itemize, the deduction of state and local taxes was capped at $10,000; and also through 2025, the child tax credit was doubled.

D. But the big news involved the corporate income tax.

1. The corporate tax rate was lowered from 35 percent to 21 percent, bringing the corporate tax rate down to a comparable level of most other developed countries.

2. However, the real headline at the time, was that the Act changed the U.S. from a global tax system to a territorial one.

    a. Ostensibly, under the latter, instead of a U.S. corporation paying the U.S. corporate tax rate for income earned in any particular country (less taxes paid to that country), each of its subsidiaries would pay the tax rate of the country in which it is legally established, even if it is less than in the U.S.

    b. However, interestingly, in practice we understand that it has not quite worked out the way the Congress intended.

        i. Before the change, the U.S. technically had a global system of taxation. But because of the deferral rules – that is, the U.S. tax code would not tax overseas earnings of U.S. multinationals until the profits were repatriated to the U.S. – in effect, the implementation of the U.S. tax law resulted in an "ad hoc" territorial system.

        ii. However, after the enactment of the 2017 Act, the reverse is true: while technically the U.S. now has a "territorial" system, practically it has become a "global" system due to such new provisions as the GILTI rules (Global Intangible Low-Taxed Income) and others.

    c. Finally, the 2017 Act also contained a one-time repatriation tax of profits in overseas subsidiaries where they would be taxed at 8 percent, 15.5 percent for cash. This change permitted U.S. multinationals who had accumulated nearly $3 trillion offshore, much of it in subsidiaries in tax-haven countries, the choice to bring the money back to the U.S. at these much lower rates.

E. One feature of the 2017 Act, which was necessary in order to meet Congressional parliamentary rules that are designed to keep potential increases in the federal government's budget deficit to a minimum, is that, while the Act's corporate tax cuts are permanent, the individual tax cuts disappear over time and actually become net tax increases starting in 2026. That is, of course, unless the Congress decides to change the rules between now and then, a real likelihood if the Democrats win control of the White House and both houses of Congress.

XII. Conclusion.

A. Let me conclude my remarks by summarizing where things basically stand today.

1. Since 1980, the federal income tax in the U.S. has actually grown increasingly progressive, even as top marginal tax rates have been significantly reduced.

a. In 2017, the top 50 percent of all taxpayers paid 97 percent of all individual income taxes, while the bottom 50 percent paid the remaining 3 percent.

b. And the top 1 percent paid a greater share of individual income taxes (38.5 percent) than the bottom 90 percent combined (29.9 percent).

2. Another trend since 1980 is that the percentage of nontaxable returns (meaning that even though no tax is due, returns are still filed so that the individual can recover a refund of the "pay as you go" payments withheld by his or her employer) increased from approximately 20 percent in 1980 to approximately 35 percent today.

3. However, in contrast to "withheld" taxes, which are refunded to an individual if in fact no income tax is actually due, payroll taxes—those taxes withheld by employers for payment into the Social Security system on behalf of the employee – are not refundable.

a. So, for all of those low income people who are no longer taxpayers in the income tax system, they still must pay payroll taxes.

b. And, even for those lower-income people who make enough to be required to pay some income tax, the payroll taxes they pay are often much, much higher than their income tax.

B. I believe that these figures show that, notwithstanding hysteria on the Left, when you look at the tax burden on the upper income people, it is not so simple to argue that the tax law is stacked heavily in favor of those taxpayers.

C. However, having said that, should the Democrats win the White House and both houses of Congress next month, income taxes could be significantly higher than they are today, and notwithstanding the Democrats' claim that taxes will only be higher for the upper bracket taxpayers, it is hard to see them keeping that campaign promise, which means the middle class could suffer much higher taxes as well.