Federal Income Tax Discrimination between Homeowners and Renters: A Proposed Solution

I. Introduction

The first income tax bill was passed in 1861[1] as a means of financing the Civil War. Since that time, controversy has surrounded this form of taxation. Early debate centered on the justice (or injustice) of an income tax.[2] Later, opponents challenged the constitutionality of a direct tax on income and won.[3] The addition of the sixteenth amendment to the Constitution in 1913[4] settled the constitutional issue and ended, as a practical matter, debate over the existence of the tax itself. More recent controversy has focused upon the inequities of the income tax laws.[5] Internal Revenue Code provisions for deductions, exemptions, and preferential treatment of certain types of income prevent the achievement of what economists call horizontal equality:[6] people with equal income do not pay equal tax.

One of the most frequently criticized inequities in the current Code is the preferential tax treatment granted to homeowners and

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[1]Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 309 (1861) [hereinafter cited as the Civil War income tax]. The income tax was renewed yearly through 1871 and then was allowed to lapse.

[2]For a lively account of the verbal storm raised by the Civil War income tax, see R. Paul, Taxation in the United States 8 (1954). Paul quotes the *New York Tribune*'s description of the tax as "the most odious, vexatious, inquisitional, and unequal of all our taxes," with a tendency to "tax the quality out of existence." *Id.* at 25. Commissioner Pratt's report of 1866 describes the forebearance of the American people:

> We may search in vain in our own history, or that of other nations, for such an example of patience and patriotism as was exhibited by the people of this country in the payment of these extraordinary burdens. They were prosperous and therefore willing to pay. The nations of the Old World regarded us with wonder and affected sorrow.

Id. at 29.

[3]Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, *aff'd on rehearing,* 158 U.S. 601 (1895).

[4]U.S. Const. amend. XVI.

[5]*E.g.*, Bittker, *Income Tax Deductions, Credits and Subsidies for Personal Expenditures*, 16 J.L. & Econ. 193 (1973); Blum, *Federal Tax Reform—Twenty Questions*, 41 Taxes 672 (1963); Frost, *Inequalities of the Federal Income Tax*, 23 Case & Com. 818 (1917); Hackett, *The Constitutionality of the Graduated Income Tax Law*, 25 Yale L.J. 28 (1916); Jensen, *The Historical Discrimination of the Federal Income Tax Rates*, 54 Taxes 445 (1976); Wormser, *Some Reflections on Our Progressive Rate Income Tax System*, 53 A.B.A. J. 28 (1967); Note, *Income Taxation: A Plea for Genuine Reform*, 4 Ind. Legal F. 362 (1970).

[6]White & White, *Horizontal Inequality in the Federal Income Tax Treatment of Homeowners and Tenants*, 18 Nat'l Tax J. 225 (1965).

denied to renters.[7] Two Code provisions account for this discrimination by allowing homeowners to deduct interest on home mortgages[8] and the entire amount of local property taxes.[9] Of all itemized deductions allowable on the individual tax return, these two items are typically the largest.[10] Some economists would add a third discriminatory factor: The failure to tax the imputed net rental value of owner-occupied housing. The following comment is typical of those made by individuals who consider the Code's discriminatory treatment of renters as three-fold:

> The omission of imputed net rent from [adjusted gross income] and the personal deduction for mortgage interest and property taxes discriminate in favor of homeowners compared with renters and with other investors. Homeowners obtain a tax-free return on their investment and at the same time are allowed to deduct important items of housing costs that tenants also pay as part of their rent but without obtaining a tax deduction.[11]

Under the Civil War income tax laws, tenants were allowed to deduct rent,[12] and homeowners were allowed to deduct mortgage interest and property taxes.[13] Congress has not followed this early precedent; no subsequent income tax law has allowed a deduction for rent.[14]

This Note will examine the policies that have resulted in inequitable tax treatment of renters, consider some reforms that have been suggested in the past, and propose a revision of the Code that would provide deductions both for homeowners and renters.

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[7]H. Aaron, Shelter and Subsidies: Who Benefits from Federal Housing Policies (1972); R. Goode, The Individual Income Tax 118 (rev. ed. 1976); J. Pechman, Federal Tax Policy 85 (3d ed. 1977); H. Simons, Personal Income Taxation 112 (1938); White & White, *supra* note 6.

[8]I.R.C. § 163.

[9]*Id.* § 164(a)(1).

[10]Int. Rev. Serv., U.S. Dep't of Treas., Statistics of Income—1975, Individual 50-57 (1978).

[11]R. Goode, *supra* note 7, at 118.

[12]Act of Mar. 3, 1863, ch. 74, § 11, 12 Stat. 713, 723 (1863).

[13]Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223 (1864), *as amended by* Act of Mar. 3, 1865, ch. 78, 13 Stat. 469 (1865).

[14]The state of Indiana, however, recently enacted a provision, effective Jan. 1, 1979, for the deduction from Indiana income tax of rent paid on a dwelling that is subject to property tax. The maximum deduction is $1,500. Act of Mar. 27, 1979, Pub. L. No. 70 (1979), amending Ind. Code § 6-3-1-3.1. A similar provision was effective for the years 1973 to 1975. Renters were allowed a deduction of up to $1,000 of rent paid. Ind. Code § 6-3-1-3.1 (1976).

II. Itemized Deductions: Some Policy Considerations

The reasons for the exclusion of the rent deduction and the inclusion of the deductions for mortgage interest and taxes under present law are not clear. The current Code provisions for deductions of interest[15] and taxes[16] can be traced to the Tariff Act of 1913.[17] Allowable deductions then included the following: business expenses, but not personal, living, or family expenses; all interest; all taxes except assessments against local benefits; casualty losses; worthless debts; and depreciation of business property.[18] Despite the fact that personal expenses were explicitly excluded, important exceptions were made. The deductions for interest, casualty losses, and worthless debts were not restricted to expenses incurred in the production of income.

The current Code provides for itemized deductions of the following personal expenses: medical expenses in excess of three percent of adjusted gross income;[19] real and personal property taxes, state and local income and sales tax, and gasoline tax;[20] interest;[21] charitable contributions;[22] and casualty and theft losses.[23] Other miscellaneous itemized deductions, such as job-related educational expenses[24] and union dues,[25] are characterized as trade or business expenses[26] rather than personal expenses. Worthless debts may also be deducted, but as an adjustment to income rather than as an itemized deduction.[27] Deductions for personal and living expenses other than those expressly provided for are prohibited.[28]

Various attempts have been made to categorize allowable itemized deductions in order to discover some justification for the inclusion of some personal expenses and not others. It has been suggested that at least some personal expenses, such as medical costs, charitable contributions, and alimony, are based entirely upon the ability to pay.[29] This characterization coincides with Professor Simons' concept of income taxation as an "instrument of economic control, a means of

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[15]I.R.C. § 163.
[16]*Id.* § 164.
[17]Tariff Act of 1913, ch. 16, § II, 38 Stat. 114 (1913).
[18]*Id.*
[19]I.R.C. § 213.
[20]*Id.* § 164(a).
[21]*Id.* § 163.
[22]*Id.* § 170.
[23]*Id.* § 165(c)(3).
[24]Treas. Reg. § 1.162-5 (1960).
[25]*Id.* § 1.162-15.
[26]I.R.C. § 162.
[27]*Id.* § 166(d)(1)(B).
[28]*Id.* § 262.
[29]R. Paul, Taxation for Prosperity 264 (1947).

mitigating economic inequality."[30] Of all our taxes, the income tax with its progressive rates is based most nearly on the ability-to-pay principle. Simons considers the defining of income to be the most serious obstacle to the equitable treatment of all taxpayers.[31] If itemized deductions do serve an "income-defining function,"[32] it is difficult to justify the exclusion of certain large personal expenses, such as college tuition, funeral expenses, commuting costs, and for that matter, the cost of food, clothing, and shelter.[33] While some deductions seem to be based upon the ability to pay, itemized deductions taken as a whole do not, in fact, define income.

There is some support for the idea that deductions are a means of implementing social rather than economic policies; that is, that they are a form of indirect government subsidy.[34] At least one court has recognized that the deduction for charitable contributions constitutes a subsidy:

> We think there is little question that the provision of a tax deduction for charitable contributions is a grant of federal financial assistance within the scope of the 1964 Civil Rights Act.
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> . . . Unlike the exemption for nonprofit clubs, it cannot be explained simply as a matter of pure tax policy. Since it is available only to particular groups, it operates in fact as a subsidy in favor of the particular activities these groups are pursuing.[35]

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[30] H. SIMONS, *supra* note 7, at 41.

[31] *Id.* at 41-42.

[32] Bittker, *supra* note 5, at 204.

[33] The zero bracket amount (formerly the standard deduction) serves as a floor below which income is not taxed. Presumably, this floor represents an amount of untaxed income for food, clothing, shelter, and other necessities. In 1977 the zero bracket amount for a single person was $2,200. INT. REV. SERV., U.S. DEP'T OF TREAS., YOUR FEDERAL INCOME TAX 6 (1978). Combined with the personal exemption of $750, *id.* at 14, this amounts to $245.83 per month.

[34] *The Economics of Federal Subsidy Programs: Hearings Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm.*, 92d Cong., 1st Sess. 43 (1972) (statement of Stanley S. Surrey); C. KAHN, PERSONAL DEDUCTIONS IN FEDERAL INCOME TAX (1960); J. PECHMAN, *supra* note 7; Dodyk, *The Tax Reform Act of 1969 and the Poor,* 71 COLUM. L. REV. 758, 780-81; Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures,* 83 HARV. L. REV. 705 (1970). *But see* Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget,* 22 NAT'L TAX J. 244 (1969).

[35] McGlotten v. Connally, 338 F. Supp. 448, 462 (D.D.C. 1972) (class action to enjoin granting of tax benefits to fraternal and nonprofit organizations which exclude nonwhites).

As Secretary of the Department of Housing and Urban Development,[36] George Romney publicly noted that deductions are, in effect, subsidies: "Maybe we ought to repeal part of the right to deduct the interest rate from the income tax return to bring home to middle income and affluent families that they are getting a housing subsidy."[37] If homeowner deductions are a subsidy, the size of the subsidy is substantial. Professor Surrey has emphasized the magnitude of this indirect subsidy by comparing its cost with the cost of direct government subsidies:

> The tax expenditure items for housing—deductions for mortgage interest and property taxes—constitute the largest items in the Government program to assist private housing, far in excess of direct expenditure programs in the housing area. Thus, for 1970, these tax expenditures came to $5.4 billion, and the direct expenditures came to $2.7 billion.[38]

It cannot be said that Congress consciously devised ways of assisting the homeowner at the expense of the renter. The deductions for interest and taxes are general provisions. The interest deduction applies not only to mortgage interest but also to interest on all consumer purchases and investment indebtedness. Deductions for taxes were probably allowed originally as a method of avoiding double taxation. In the original Act of 1913,[39] all taxes were deductible. The deduction of the federal income tax was eliminated in 1917[40] and the deduction for federal excise taxes in 1943.[41] In 1964, deductible taxes were enumerated for the first time.[42] Recognizing that state and local income, property, and sales taxes are the major sources of revenue for state and local governments, Congress continued the deduction of these taxes, not only to ease the burden of multiple taxation but also to allow the federal government to remain properly neutral as to the relative use of these taxes.[43]

It would have been commendable if Congress had also remained neutral on the question of renting or buying a shelter. The House

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[36]Secretary Romney assumed office Jan. 22, 1969, and resigned Nov. 22, 1972. BIOGRAPHICAL DIRECTORY OF THE UNITED STATES EXECUTIVE BRANCH 1774-1977, at 290-91 (R. Sobel ed. 1977).

[37]N.Y. Times, Oct. 24, 1969, at 18, col. 5.

[38]S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 235 (1973).

[39]Tariff Act of 1913, ch. 16, § 11, 38 Stat. 114 (1913).

[40]War Revenue Act, ch. 63, § 1201, 40 Stat. 300 (1917).

[41]Revenue Act of 1943, ch. 63, § 111, 58 Stat. 21 (1944).

[42]Revenue Act of 1964, Pub. L. No. 88-272, § 207, 78 Stat. 19 (1964).

[43]H.R. REP. NO. 749, 88th Cong., 2d Sess., *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1313, 1357.

report contains this rather cryptic statement on the advisability of continuing the deduction for property taxes: "The burden of property taxes varies widely among individuals according to whether or not they are homeowners. Thus, any denial of deductions in such cases would result in an important shift in the distribution of Federal income taxes between homeowners and non-homeowners."[44]

The general provisions for interest and tax deductions have now been adopted retrospectively as one method of achieving the government's goal "to expand homeownership opportunities to as broad a segment of our society as can reasonably afford it . . . ."[45] As a national goal, the fostering of home ownership may be desirable. However, this policy does not consider a large segment of the population—those who, out of choice or necessity, live in rental housing.[46]

III. An Analysis of Some Suggested Reforms

Several remedies have been offered to eliminate the inequities of the present Code. The most popular is the inclusion in income of the imputed net rental value of owner-occupied housing.[47] The homeowner would report as income the gross imputed rent on his residence and then deduct repairs, taxes, interest, depreciation, and other expenses. Although the taxation of imputed rent may seem a novel idea in the United States,[48] it has been employed in many foreign countries.[49] Advocates of this plan stress its obvious fairness in terms of equalizing the tax burden imposed on renters and homeowners. Richard Goode of the Brookings Institution has stated that taxing imputed rent is the *only* way to eliminate tax discrimination between homeowners and persons who choose some other form of investment.[50] The Commission to Revise the Tax Structure noted

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[44]*Id.*

[45]Ninth Annual Report on the National Housing Goal, H.R. Doc. No. 95-53, 95th Cong., 1st Sess. 5 (1977).

[46]In 1975, 25,656,000 (35.4%) of the 72,523,000 housing units in the United States were renter-occupied. U.S. Dep't of Housing and Urban Development, Statistical Yearbook 264 (1975).

[47]H. Aaron, *supra* note 7, at 71; R. Goode, *supra* note 7, at 123-24; H. Simons, *supra* note 7, at 112.

[48]It is interesting that taxation of rental value was specifically *excluded* by the Civil War income tax provisions: "[T]he rental value of any homestead used or occupied by any person or by his family . . . shall not be included and assessed as part of the income of such person." Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281 (1864).

[49]Great Britain terminated the program in 1963. For a brief overview of taxation of imputed rent by foreign countries, see Merz, *Foreign Income Tax Treatment of the Imputed Rental Value of Owner-Occupied Housing: Synopsis and Commentary*, 30 Nat'l Tax J. 435 (1977).

[50]R. Goode, *supra* note 7.

that this revision would place the federal government in an appropriately neutral position regarding the decision by the individual taxpayer to own or rent his dwelling.[51]

One objection to this solution, acknowledged by some of its advocates, is that it poses serious administrative problems.[52] For example, establishment of guidelines for computing imputed rent would be difficult. Several methods have been suggested: a percentage of the owner's equity (market value less debt),[53] gross rental value less cost;[54] and direct estimation by the owner.[55] None of the proposed methods is without disadvantages; each implies a standard upon which rental or market value would be based. The use of the assessed valuation for property tax purposes would be unworkable due to the discrepancies in taxing policy and procedure among local taxing jurisdictions.[56] On the other hand, if the homeowner had to estimate market or rental value based upon his general knowledge of market conditions, the kind of documentation needed to substantiate the estimate is unclear. To avoid this and similar problems, some type of uniform system of value assessment would be necessary, either a system of federal evaluation of residential property, or a federally mandated uniform local system.

Another serious consideration is the cost of administering such a tax program compared to the increased revenue yield. In a 1969 study based on a Brookings Institution sample of 100,000 individual income tax returns filed for 1964, Robert Tinney estimated an increased revenue yield of between \$6,062 and \$6,719 million.[57] However, he did not take into account the cost of establishing a valuation system, and data is lacking for the projection of such cost. Many foreign countries which taxed imputed rental value in the past have abandoned the program.[58] One author has suggested that the reason is the low revenue yield:

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[51]Commission to Revise the Tax Structure, Reforming the Federal Tax Structure 18 (1973).

[52]H. Aaron, *supra* note 7, at 71; R. Goode, *supra* note 7, at 124.

[53]*The Economics of Federal Subsidy Programs: Hearings Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Committee*, 92d Cong., 1st Sess. 43, 96 (1972) (joint statement of Joseph A. Pechman & Benjamin Okner) [hereinafter cited as *The Economics of Federal Subsidy Programs*]; R. Goode, *supra* note 7, at 124.

[54]*The Economics of Federal Subsidy Programs*, *supra* note 53.

[55]R. Goode, *supra* note 7, at 124.

[56]*See* Note, *Inequality in Property Tax Assessments: New Cures for an Old Ill*, 75 Harv. L. Rev. 1374 (1962).

[57]Tinney, *Taxing Imputed Rental Income on Owner-occupied Homes*, in Studies in Substantive Tax Reform 125 (A. Willis ed. 1969).

[58]Merz, *supra* note 49, at 435. In his book on personal income tax published in 1938, Henry Simons commented that the United States and Canada were the only important countries *not* taxing imputed rent. H. Simons, *supra* note 7, at 112 n.3.

> Overall, the experiences with attempts to tax this form of personal income have a distressing similarity, viz., taxes on this form of income have produced (or do produce) negligible amounts of revenue relative to the yield of personal income taxes in general and the administration and enforcement of income taxes on imputed rental income have been and remain a matter of great vexation to the tax authorities.
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> Abnormally low estimates of rental value, either as a product of administrative practice and tradition or as a consequence of statutory enactments setting nominal valuations or freezing valuations for long periods of time are common. Rising costs which may be used to offset this income, particularly mortgage interest, seriously erode the amount of this form of income subject to tax. A negative net value for imputed rent for owners with large mortgages is not uncommon, excess interest in this instance being carried over as an offset to other income.[59]

It has been argued that the taxation of imputed rent can be defended, even if the cost of administration exceeds the revenue, because it is equitable.[60] This view can be adopted only if income taxation is considered exclusively as a means of achieving economic justice, and not as a means of obtaining revenue.

Even if taxation of this form of income were adopted, it is doubtful whether it could withstand a challenge in the courts. The Supreme Court has defined income as gain derived from capital and from labor.[61] It has also specifically held that the rental value of a building is not income within the meaning of the sixteenth amendment.[62]

It is also doubtful that taxation of imputed rent would be acceptable in the United States even apart from the legal issues that could be raised. To suggest such a plan may well be, in Henry Aaron's phrase, "politically unthinkable."[63] Homeowners are accustomed to looking upon their homes as a source of expense rather than income. Furthermore, if the value of housing is to be taxed, why not the value of other durable consumer goods, such as automobiles and appliances? The exchange of one form of tax discrimination for another would be neither fair nor politically acceptable. Finally, this form of taxation would have the unpopular ef-

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[59]Merz, *supra* note 49, at 435-37.

[60]H. SIMMONS, *supra* note 7, at 30-31.

[61]Eisner v. Macomber, 252 U.S. 189, 207 (1920).

[62]Helvering v. Independent Life Ins. Co., 292 U.S. 371, 379 (1934).

[63]H. AARON, *supra* note 7, at 71.

fect of increasing the tax base and further complicating the individual income tax return.

Another feasible solution to the present inequities in the tax treatment of homeowners and renters is disallowance of the mortgage interest and property tax deductions presently available to homeowners. Most proponents of this plan consider it a halfway measure, not as meritorious as taxing imputed rent, but better than no solution at all.[64] Homeowners and renters would be taxed more evenly than at present, and, in this case, no valuation or administrative problems would arise.

There are, however, both economic and equitable problems with this proposal. One economic consequence is the possible effect on lending institutions, a consideration which has led one economist to comment:

> If deductions for mortgage interest were disallowed, homeowners would be encouraged to borrow on assets other than their homes. To the extent that they could substitute other credit instruments, disallowance of deductions for mortgage interest would have no tax consequences. The impact would be massive on markets for financial assets, however. For financial intermediaries, such as savings and loan associatons, which are restricted by law to investing in home mortgages, the result wold be catastrophic.[65]

Following this line of reasoning and assuming that taxing policies influence the consumer's decision of whether to buy or rent a home, one can foresee a recession in the home building industries the effects of which would be felt throughout the economy.[66]

The disallowance of the property tax deduction could cause serious repercussions in those local areas that depend heavily upon revenue from property tax. Moreover, in view of Congress' interest in remaining neutral as to the choice of taxes upon which local governments depend,[67] there is no justification for disallowing the

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[64]Those who advocate taxation of imputed rent obviously consider this an incomplete solution. *E.g.*, R. GOODE, *supra* note 7, at 124 (stating: "The elimination of the interest deduction, for example, would have no effect on persons who own their dwellings free of mortgage debt and hence would do nothing to reduce the discrimination between this group and tenants.").

[65]H. AARON, *supra* note 7, at 72.

[66]The effect would not be limited to owner-occupied housing. For owners of rental property, the result would be equally severe. Property taxes are typically the largest expenditure, next to loan payments, by owners of income producing property. U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, STUDY ON TAX CONSIDERATIONS IN MULTI-FAMILY HOUSING INVESTMENTS 106 (1972).

[67]H.R. REP. NO. 749, *supra* note 43.

property tax deduction while continuing the deductions for local income and sales taxes.

Similarly, the disallowance of the mortgage interest deduction cannot be justified without disallowance of all interest deductions except for interest expenses incurred in the production of income. This in turn raises the problem of defining income-producing debts. Because it is not uncommon to borrow on personal assets to finance a business venture, one would have to ascertain the *motive* of the borrower in order to separate deductible from nondeductible interest.

The two proposals just considered, the taxation of imputed rent and the elimination of the homeowner's deductions, attack the problem of discriminatory taxation by taking away from the homeowner what presently amounts to favorable tax treatment. Equity, however, can be achieved without these drastic measures and the problems which attend them. There are at least two devices for granting tax relief to renters *without* depriving the homeowner of tax concessions traditionally granted him — the tax credit and the itemized deduction.

A tax credit, unlike a deduction, offers tax relief equally to taxpayers in all income brackets. It is a direct subtraction from taxes computed for the taxable year. Tax credits against federal income tax have been suggested as a means of relief from rising local property taxes.[68] "Circuit-breaker" provisions that offer income tax relief for property taxes paid, often in the form of a refundable credit, have been enacted in many states,[69] including Indiana.[70] Many of the circuit-breaker systems offer relief to renters as well, basing the credit on that portion of rental payments attributable to property taxes.[71] This distinctive feature of the circuit-breaker may be one

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[68]*E.g.*, Senate Amend. No. 98, 92nd Cong., 1st Sess., 117 CONG. REC. 42509-15 (1971) (credit for elderly renters adopted by Senate in 1971 Revenue Act, rejected in Conference Committee).

[69]ARIZ. REV. STAT. ANN. § 43.128.01 (Supp. 1978); ARK. STAT. ANN. § 84-2021.10 (Supp. 1975); COLO. REV. STAT. § 39-22-120 (1973); D.C. CODE ENCYCL. § 47-1567g (West Supp. 1978); MICH. COMP. LAWS §§ 206.501-522 (Supp. 1978); MINN. STAT. ANN. §§ 290A.03-04 (West 1978); MO. REV. STAT. §§ 135.010-030 (1979); N.M. STAT. ANN. § 7-2-18 (1978); N.Y. TAX LAW §§ 606, 612 (McKinney Supp. 1977); OKLA. STAT. ANN. tit. 68, §§ 5001-09 (West 1978); R.I. GEN. LAWS § 44-33-9 (1978); VT. STAT. ANN. tit. 32, §§ 5961, 67 (Supp. 1978); WIS. STAT. ANN. § 71.09(7) (West 1969 & Supp. 1978-79). Illinois provides a grant rather than a tax credit. ILL. ANN. STAT. ch. 67½, § 404 (Smith-Hurd Supp. 1978). Three states offer a tax credit for renters only. CAL. REV. & TAX. CODE § 17053.5 (West 1979); HAW. REV. STAT. § 235-55.7 (1978); N.J. STAT. ANN. § 54A:4-3 (West 1978).

[70]IND. CODE § 6-3-3-6 (1976).

[71]*See* the circuit-breaker provisions for Arizona, Colorado, District of Columbia, Indiana, Michigan, Minnesota, Missouri, New Mexico, New York, Rhode Island, Vermont, and Wisconsin in notes 69 & 70 *supra*.

reason for its increasing popularity. In a feasibility study of circuit-breaker systems prior to the enactment of the Indiana circuit-breaker, the Director of the Indiana Commission on State Tax and Financing Policy stated:

> [T]he property tax circuit-breaker . . . has the unique advantage of being able to directly grant relief to renters. If the general level of property tax rates declines, relief does not immediately go to renters. At best, over a period of years competition will force rents to decline, or rise slower than otherwise, to reflect the lower property taxes paid by the landlord. But if the market is not very competitive even this will not occur; rather, the landlord receives a permanent windfall.[72]

The Indiana circuit-breaker, enacted in 1973, is typical. The statute allows a refundable credit to homeowners and renters who are either over sixty-five or disabled, and have an annual income of less than $5,000.[73] The amount of the credit is determined by household income and ranges from ten to seventy-five percent of property taxes paid, the maximum credit allowable being $375.[74] For renters, the credit is based upon that portion of the rent constituting property taxes, calculated at twenty percent of gross rent paid.[75]

Most states which have enacted circuit-breaker legislation limit the credit to families with low incomes; however, in some states the maximum income limitation is considerably higher than in Indiana.[76] In addition, several states limit the tax credit to those who are either over sixty-five or disabled.[77]

A federal tax credit could be modeled after the state circuit-breakers and expanded to include all who pay property taxes directly, or indirectly in the form of rent. If Congress wished to retain the circuit-breaker concept, the percentage of credit could be based upon a graduated income scale, as in the Indiana plan. A credit of this kind would benefit primarily those in the lower income brackets, but it would offer some relief to those in the middle income brackets if the income ceiling were high enough.

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[72]D. KIEFER, THE EFFECTS OF A PROPERTY TAX CIRCUIT-BREAKER IN INDIANA 10 (1972).

[73]IND. CODE § 6-3-3-6 (1976).

[74]*Id.*

[75]*Id.*

[76]The income limitation is $12,000 in New York, 1978 N.Y. LAWS §§ 606, 612, and $20,000 in the District of Columbia, D.C. CODE ENCYCL. § 47-1567g (West Supp. 1977).

[77]Arizona, Arkansas, Missouri, New Mexico, and Rhode Island offer the credit to the elderly only. Colorado, Michigan, and Oklahoma offer the credit to both the elderly and disabled. *See* the circuit-breaker statutes contained in note 69 *supra*.

A tax credit based upon the property tax burden is an incomplete solution, of course. It offers no relief to renters for that portion of the rent representing mortgage interest.

Of all the proposed solutions to the problem of tax discrimination against renters, the simplest is the deduction of rent payments for homesteads, essentially a re-enactment of the Civil War income tax provision previously mentioned.[78] The greatest virtue of the rent deduction, next to its simplicity, is that it is an ability-to-pay deduction; that is, a necessary expenditure that effectively reduces real income. However, if one wishes to adhere to the principle that deductions should serve to define income,[79] there is little justification for allowing a deduction for rent and excluding deductions for other necessary personal expenses. Persuasive arguments can be made for the idea that itemized deductions should be limited to essential expenses such as food, clothing, shelter, and medical costs, and, perhaps, to socially valuable expenditures such as charitable and political contributions. However, a tax reform of this magnitude, which might introduce into the taxying system a hitherto uncontemplated complexity, is outside the scope of this Note. As a solution to unfair taxing policies, a deduction for rent has little merit since it would simply reverse the discrimination which presently exists. Total rent equals more than the sum of interest and taxes now deductible by homeowners.

Perhaps the most logical answer to the problem of unequal taxation of homeowners and renters is to allow the deduction of that portion of rent constituting property taxes and mortgage interest. This proposed deduction would be relatively simple to administer, and it would all but eliminate the tax inequities between homeowners and renters without depriving the homeowner of the tax benefits he presently enjoys.[80] This proposal would, of course, require a revision of the current law, beginning with sections 163[81] and 164[82] of the Internal Revenue Code.

IV. Current Status of the Law

Section 164 of the Code provides that real property taxes shall be allowed as a deduction for the taxable year in which they are paid or or accrued. The Treasury Department and the courts have

[78] *See* note 1 *supra.*

[79] *See* notes 29 & 30 *supra.*

[80] The homeowner would retain the benefit of capital gain treatment upon sale of his residence. I.R.C. § 1202.

[81] This section states in part: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

[82] This section provides for the deduction of taxes "paid or accrued" within the taxable year. For a list of deductible taxes, see text accompanying note 20 *supra.*

interpreted this provision to mean that taxes are deductible only by the person upon whom they are *imposed.*[83] In *Peters v. Commissioner*[84] a property owner whose taxes were paid by a third party was allowed to take the deduction.[85] Thus, actual payment of the tax was not a prerequisite to deductibility. The court in *Peters* stated:

> There [are] no specified statutory requirements that the payment of taxes be an out-of-pocket expenditure of, or directly attributable to, the property owner seeking the benefit of the deduction. . . . Regardless of whether satisfaction of petitioner's obligation is income, a gift, a loan, or repayment of a loan, at least to the extent that it satisfies his obligation it should be deductible by him.[86]

In *Harris v. Commissioner*[87] an owner of mortgaged property was allowed to deduct real estate taxes and interest voluntarily paid by the mortgagee before foreclosing the mortgage.[88] A deduction has been allowed to the mortgagor for mortgage assistance payments made by the Department of Housing and Urban Development to the extent that the payments were for real estate taxes, even though the payments were not income to the mortgagor.[89] The Internal Revenue Service has also ruled that a minister may deduct interest and taxes paid on his personal residence despite the fact that he is entitled to a rental allowance under section 107.[90]

When property taxes are paid by the tenant under the terms of a lease, the landlord takes the deduction. Two lines of reasoning support this result. One is that payments by the tenant to the landlord, even if labelled as a contribution to taxes, are payments for the privilege of occupying the premises and therefore are rent.[91] The other theory is that, even if the lease obligates the tenant to pay the property taxes, the obligation is to the landlord and not to the governmental body imposing the tax.[92] Thus, tax increases paid

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[83]Gilken Corp. v. Commissioner, 176 F.2d 141, 143 (6th Cir. 1949); Willamette Valley Lumber Co. v. United States, 252 F. Supp. 199, 203 (D. Ore. 1966); Treas. Reg. § 1.164-1 (1957).

[84]29 T.C.M. (CCH) 1440 (1970).

[85]*Id.* at 1442.

[86]*Id.*

[87]34 T.C.M. (CCH) 597 (1975).

[88]*Id.* at 600.

[89]Letter from the Internal Revenue Service, Dep't of Treasury, to Mortgage Bankers Association of America (Dec. 10, 1969).

[90]Rev. Rul. 62-212, 1962-2 C.B. 41.

[91]*See* W.T. Grant Co. v. Commissioner, 129 Conn. 663, 666, 30 A.2d 921, 922-23 (1943); Vineland Shopping Center, Inc. v. DeMarco, 35 N.J. 459, 470, 173 A.2d 270, 276 (1961).

[92]*See* Robinson v. Commissioner, 53 F.2d 810, 811 (8th Cir. 1931); W.T. Grant Co. v. Commissioner, 129 Conn. 663, 667, 30 A.2d 921, 923 (1943).

directly by the tenant in the form of a tax surcharge are deductible by the landlord and not the tenant.[93] The Internal Revenue Service stated its position as follows:

> The city ordinance, which permits the landlord to pass on increases in such taxes to a tenant in the form of a surcharge, does not shift liability for the property taxes from the landlord to the tenant. The surcharge is simply, for Federal income tax purposes, an additional rental payment by the tenant.[94]

Similarly, taxes designated as "renters" tax[95] or "rates"[96] tax that are assessed against the renter and based upon the rental value of the dwelling are not deductible. In a 1973 revenue ruling, a United States citizen living in the United Kingdom was not permitted to deduct a local tax based on the rental value of the rented premises.[97] The ruling stated that the tax was not deductible as a foreign property tax under section 164(a)(1) of the Code because it was a tax levied on the occupation or use of, rather than on an interest in, real property.[98] In a later ruling, a tax levied by Prince George's County, Maryland, based upon a percentage of rent paid, was held to be not deductible for the reason that the tax was based upon occupancy rather than ownership of the property, for which tax there is only personal liability.[99]

The rule that taxes are deductible only by the one upon whom they are imposed is perhaps best illustrated by the provision of the Code that requires apportionment of taxes between buyer and seller if the sales transaction occurs in the middle of the taxable year.[100] The tax allocable to that part of the year ending on the day before the sale is treated as imposed upon the seller, whereas the tax allocable to the part of the year beginning on the date of sale is treated as imposed upon the buyer. This provision does not require an actual proration insofar as the payment of the tax is concerned. The buyer gets an automatic deduction of the tax allocable to him, regardless of whether he or the seller paid the tax.[101]

Construction of section 163[102] has also been quite restrictive. For interest to be deductible, three factors are essential: (1) In-

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[93]Rev. Rul. 75-301, 1975-2 C.B. 66.

[94]*Id.*

[95]Rev. Rul. 75-558, 1975-2 C.B. 67.

[96]Rev. Rul. 73-600, 1973-2 C.B. 47.

[97]*Id.* at 49.

[98]*Id.* at 48-49.

[99]Rev. Rul. 75-558, 1975-2 C.B. at 68.

[100]I.R.C. § 164(d).

[101]Cramer v. Commissioner, 55 T.C. 1125, 1131 (1971).

[102]*See* note 81 *supra.*

debtedness, (2) interest on indebtedness, and (3) the payment or accrual of interest within the tax year.[103] Indebtedness has been defined as "something owed in money which one is unconditionally obligated or bound to pay, the payment of which is enforceable."[104] Furthermore, the interest must be specifically and separately stated. One court refused to imply an obligation to pay interest from an agreement merely to pay an agreed price in installments due at a future date.[105]

From the foregoing discussion it can be concluded that in order for tax on real property to be deductible it must be: (1) Imposed on the property at issue, and (2) imposed on the legal owner. In addition, deductible interest apparently must be on an actual indebtedness owed by the person taking the deduction. In some instances, however, these requirements have been waived, either by statute or by court decisions.

In *Offutt Housing Co. v. County of Sarpy,*[106] the Supreme Court held that a lessee was subject to state property taxes on improvements erected by the lessee on land leased from the federal government.[107] This decision has not been broadly applied due to the very particular and atypical facts giving rise to the ligitation: The improvements had a useful life of thirty-five years while the lease ran for seventy-five years, the lessee paid only nominal rent for the land, and the lessee was required by the terms of the lease to pay all state and local property taxes. The court held that, although the government had title to the land, it was only a "paper title" and lessee's interest in the improvements encompassed the entire worth of the improvements.[108] By implication the decision entitles the lessee upon whom the property taxes are imposed to deduct the amount of taxes paid from income. The Internal Revenue Service, however, has carefully limited the *Offutt* precedent to permit deduction of property taxes paid by the lessee only in cases in which the lessee is entitled to the sole enjoyment of the entire interest in the improvements.[109]

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[103]Tomlinson v. 1661 Corp., 377 F.2d 291, 295 (5th Cir. 1967); *accord*, United States v. Norton, 250 F.2d 902, 905 (5th Cir. 1958).

[104]Commissioner v. Wilson, 163 F.2d 680, 682 (9th Cir. 1947).

[105]Daniel Bros. Co. v. Commissioner, 28 F.2d 761 (5th Cir. 1928).

[106]351 U.S. 253 (1956).

[107]*Id.* at 262.

[108]*Id.* at 261-62.

[109]*See, e.g.*, Rev. Rul. 62-177, 1962-2 C.B. 89. The Internal Revenue Service refused to allow a deduction for real estate taxes to a corporation that had leased land with an existing building, the useful life of which was shorter than the term of the lease. The ruling stated that the lessee was not entitled to the sole enjoyment of the improvements since the lessor received a substantial benefit in the form of rent. Payment of taxes by the lessee corporation was deemed to be the equivalent of rent. *Id.*

Under the Code, taxes, interest, and depreciation deductible by cooperative housing corporations are passed through to the tenant-shareholder, each deducting his proportionate share according to the number of shares he owns.[110] If the criteria set out in *Offutt* are met, these deductions may be taken even though the corporation leases rather than owns the building in which the tenant resides. This was demonstrated by a situation in which a corporation leased land and constructed thereon an apartment building with an estimated useful life shorter than the term of the lease.[111] Even though legal title to the building was vested in the lessor, real estate taxes paid on the building and interest paid to finance construction were deductible to the corporation, and thus also to the tenant-shareholder.[112]

In other instances the possession of legal title to the property has not been a prerequisite to deduction of property taxes. An owner of a beneficial interest may, in some cases, qualify for the deduction. In one case, a taxpayer who conveyed property subject to a reserved term of five years for his own use and possession and also subject to an agreement that he would pay the taxes during the reserved term was allowed to deduct the taxes paid.[113] The tax court has also allowed beneficiaries of trusts to deduct property taxes assessed to the trustee because payment by the beneficiary was necessary to protect the beneficial interest.[114]

The foregoing examples are illustrative of two related propositions, either of which would provide rational support for the proposal that renters should be allowed to deduct interest and taxes. The first proposition is that in many cases the entity against whom taxes are imposed, or against whom interest is charged, is a mere

[110]I.R.C. § 216.

[111]Rev. Rul. 62-178, 1962-2 C.B. 91.

[112]*Id.*

[113]Rev. Rul. 67-21, 1967-1 C.B. 45.

[114]Estate of Movius v. Commissioner, 22 T.C. 391 (1954) (holding taxes assessed on properties of the estate and paid by the trustees from funds designated by the beneficiaries for that purpose to be the equivalent of payment by the beneficiaries); Horsford v. Commissioner, 2 T.C. 826 (1943) (determining that taxpayer holding property in trust was required by the will to pay all taxes even though taxes were assessed to the trustee); *cf.* Harrison v. Commissioner, 17 T.C. 1350 (1952) (holding that in computing gift tax, donor may exclude from the value of the gift the gift taxes paid by the trustee); Gruen v. Commissioner, 1 T.C. 130 (1942) (holding that because donor was insolvent at the time of the transfer and the income tax liability shifted to the donees, the value of the gifts was decreased by the income tax paid by donees as transferees of the donor); Rev. Rul. 75-72, 1975-1 C.B. 310 (advising that if a gift is made subject to the condition that the gift tax be paid by the donee, the tax is deducted from the value of the gift in computing donor's gift tax). *See also* Corliss v. Bowers, 281 U.S. 376 (1930) (holding income from trust taxable to taxpayer who retained power over the funds, on the theory that taxation is concerned less with refinements of title than with command over the property and the benefit for whom the tax is paid).

conduit through which the deductible expenses flow. Whether the conduit is a corporation,[115] a trust,[116] or a landlord, the one in possession of the property has actually borne the expense. The following analysis by economist Henry Aaron explains that, sooner or later, the renter pays the property tax:

> [U]sers of real property eventually must pay property taxes on structures through higher sales prices or rents . . . . After sufficient time, an increase in property taxes will shrink the stock of structures and force up their rental prices. . . . A rise in taxes would initially fall on owners, reducing their net income. Either of two sets of events might ensue. In the first, owners, now denied their former rates of return on investment in structures, may curtail investment in new structures, rehabilitation, and maintenance. As a result, the stock of structures will become less valuable than the stock that would have prevailed in the absence of the tax; and users will pay higher rents for the restricted stock. This process will continue until the rental income per dollar of new construction, *net of tax*, is as high as it was before taxes were increased. Rents will therefore be increased by the amount of tax. Alternatively, owners may short-circuit this process by raising rents directly when taxes increase. This course is more likely if demand for structures is rising independently—for example, because of population growth. . . . The end result is the same as in the first case.[117]

In the same way, any fluctuation in the interest rate will be reflected, in the short or long run, in prices and rents.

The second proposition is that the one who bears the expense should receive the tax benefit. This principle was apparently recognized by Congress in 1864 when it amended the income tax statutes to provide for the deduction of taxes by the one who paid them,[118] and more recently by the tax court in allowing a deduction for taxes by the beneficial owner.[119] Since principles of equity have in some instances prevailed over technical construction of the Code, there is at least some precedent for the idea that those who actually

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[115]I.R.C. § 216.

[116]Estate of Movius v. Commissioner, 22 T.C. 391 (1954); Horsford v. Commissioner, 2 T.C. 826 (1943).

[117]H. Aaron, Who Pays the Property Tax? 24 (1975).

[118]"[N]ational, state, and local taxes, lawfully assessed upon the property or other sources of income of any persons . . . shall be first deducted from the gains, profits, or income of the person or persons who actually pay the same, whether owner or tenant . . . ." Act of July 1, 1862, ch. 119, § 91, 12 Stat. 432, 473-74 (1862).

[119]Estate of Movius v. Commissioner, 22 T.C. 391, 394-95 (1954); Horsford v. Commissioner, 2 T.C. 826 (1943).

bear the expense of deductible items, even though indirectly in the form of rent, should be allowed the deduction.

V. The Proposed Deduction for Renters

The relative simplicity of the renters' deduction; has already been mentioned. It would merely require a revision of Code sections 163 and 164, and the corresponding regulations, to include the deduction of that portion of rent constituting property taxes and mortgage interest. It would require no major overhaul of the existing tax structure. Unlike the taxation of imputed rent, or the disallowance of the interest and tax deductions for homeowners, there would be no appreciable economic repercussions. In addition, this proposal is more likely to be accepted politically.

As a practical matter, the amount of the deduction should be a flat percentage of rent paid. To require each landlord to keep records of the actual deductible expenses for each rental unit and dissemniate this information to each tenant would be unwieldly and probably unworkable.[120] The flat percentage method is used uniformly by those states that have enacted tax credits for renters, the amount of rent constituting property tax ranging from six to twenty-five percent.[121]

There are, of course, a great variety of methods for arriving at a fair percentage of deductible rent. The simplest method is the use of medians and averages. For example, the average monthly payment of real estate taxes by homeowners in 1976 was $47.[122] The median monthly rent paid in 1975 was $150.[123] Assuming that those who rent paid the same taxes indirectly via the landlord, 30.5% of rent represented property taxes. Since the average mortgage interest rate on new houses in 1975 was 9.01%,[124] it is a safe assumption that at least 40% of rent payments represent the renter's share of real

[120]Similar objections were made during hearings on the Revenue Act of 1913, which provided for collection of income tax at the source. A lessor or mortgagee was faced with the prospect of turning over to the lessee or mortgagor a statement of annual profits and income as well as an accounting of all deductions and expenses, thus "disclosing his entire private business to his debtors." *Hearings on the Revenue Act of 1913 Before the House Committee on Finance*, 63d Cong., 1st Sess. 1959-61 (1913) (statement by Mass. Real Estate Exchange).

[121]New York allows a credit based upon 25% of rent paid. N.Y. Tax Law §§ 606, 612 (McKinney Supp. 1978). New Mexico allows six percent. N.M. Stat. Ann. § 7-2-18 (1978).

[122]Bureau of the Census, U.S. Dep't of Commerce, Statistical Abstract of the United States 790 (98th annual ed. 1977).

[123]*Id.* at 779. Statistics on the median monthly rent for 1976 are not yet available, since the statistics are only compiled at five-year intervals.

[124]U.S. Dep't of Housing and Urban Development, 1976 Statistical Yearbook 238 (1977).

estate taxes and mortgage interest.[125] Allowing a deduction from income of 40% of rent paid would go far toward equalizing the tax burden of homeowners and renters.

One argument against the percentage-of-rent deduction is that it does not accurately reflect the actual property tax expense since the rate varies widely throughout the country, nor does it reflect actual interest expenses. An alternative method is to tie the property tax deduction to the current local rate, with the percentage changing as property taxes rise and fall. The corresponding interest deduction could be based on the current prime interest rate, or an average bank interest rate for the taxable year. However, the introduction of so many variables into the computation of the deductions would likely result in a complexity that would far outweigh the advantages. If a flat percentage is used, Congress could periodically adjust the percentage to reflect current average interest and property tax rates.

Another objection likely to be raised is that this proposal calls for a double deduction, with both landlord and tenant being entitled to the same deduction. The concept of a double deduction did not, however, preclude the enactment of the rent deduction during the Civil War.[126] The landlord's right to deduct property tax on the rental homestead was not affected.[127] Moreover, a similar situation already exists under the current law. Under the tenant-stockholder provision of the Code, the corporation and the individual tenant deduct the same expenses.[128]

VI. Conclusion

Despite the fact that there may be objections to the idea of a double deduction, the renters' deduction seems to be the best possible solution to the tax inequities between homeowners and renters. It can be justified in light of the suggested rationale for deductions generally as a means of defining income.[129] Also, with the virtual

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[125]Mortgage interest is normally computed on the unpaid balance. The interest rate on new or recent mortgages is currently much higher than 9% per annum. The 40% figure constitutes a compromise between those who pay a higher interest rate and those whose dwelling is not subject to a mortgage.

[126]Act of Mar. 3, 1863, ch. 74, § 11, 12 Stat. 713, 723 (1863).

[127]Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223 (1864), *as amended by* Act of Mar. 3, 1865, ch. 78, 13 Stat. 469 (1865). Neither is the landlord's deduction affected by state circuit breakers.

[128]*See* notes 110-12 *supra* and accompanying text. Rep. Edward I. Koch made this argument when he introduced a bill in Congress to allow renters to deduct that portion of rent attributable to interest and taxes. *General Tax Reform: Public Hearings Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 6817, 6818 (1973) (statement of Hon. Edward I. Koch).

[129]*See* notes 29-33 *supra* and accompanying text.

elimination of differences in the tax consequences of owning or renting a shelter,[130] the government would have assumed a neutral position and the individual could make his choice based on other, more pertinent, considerations.

Finally, this deduction would benefit a large group of taxpayers in the lower-middle and middle income ranges. In 1963, a family with a minimum annual income of $6,820, or 44.3% of all American families, could afford to buy a new median-priced house.[131] In 1975, a minimum of $19,250 annual income was required and the percentage of families in this group had fallen to 31.5%.[132] Of those families with an annual income in 1975 of $25,000 or more, only about 12% live in rental housing, compared to approximately 35% of those in the $10,000 to $15,000 bracket, and 51% of those in the $3,000 to $5,000 bracket.[133] The renters' deduction would have little effect on the last group since very few itemize deductions.[134] As is true of any deduction, the benefit rises with the income. In 1976, 11% of those with an annual income of between $5,000 and $10,000 filed returns claiming deductions for mortgage interest and property taxes, compared with 32% of those in the $10,000 to $15,000 bracket, and 44% of those in the $15,000 to $20,000 bracket.[135] The average tax savings for all returns itemizing these deductions was $391.[136] Obviously, the percentage of those in the lower and middle income brackets who were able to lower their taxable income by itemizing deductions would be much larger if renters were included.

If the cost of housing continues to rise, it is especially important not only that homeowners continue to deduct a portion of their housing costs, but also that renters be allowed similar deductions. Although it has been held that "perfect equality or absolute logical consistency between persons subject to the Internal Revenue Code has [not] been, at least since the adoption of the sixteenth amendment, a constitutional *sine qua non*,"[137] any legislative change aimed in the direction of equality and consistency is surely desirable.

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[130] *See* note 80 *supra*.

[131] U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, 1976 STATISTICAL YEARBOOK 238 (1977).

[132] *Id.*

[133] *Id.* at 264.

[134] Less than one percent of those in the $3,000 to $5,000 income bracket itemized deductions in 1975. INT. REV. SERVICE, U.S. DEP'T OF TREAS., STATISTICS OF INCOME 16 (1975).

[135] U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, *supra* note 131, at 233.

[136] *Id.*

[137] Barter v. United States, 550 F.2d 1239, 1240 (7th Cir. 1977) (appeal of an adverse judgment in a tax refund suit wherein plaintiffs unsuccessfully contended that the tax rate schedules violated the due process clause of the fifth amendment, the free exercise clause of the first amendment, and the right to associate in marriage protected by the first, fourth, fifth, ninth, and tenth amendments).