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FEDERAL INCOME TAX ANTHOLOGY

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all forms of imputed income we should put a premium on idleness as a way of employing leisure time. It is probable, therefore, that a considerable amount of imputed-income should remain exempt from tax because it tends to balance the exemption of leisure income and thus to restore in a measure the balance between work and leisure as alternative ways of using one's time.

There is little danger, however, that the taxation of imputed income will become too broad for equity, because other factors set fairly narrow limits to any proposed imputed income tax base. In the first place, the imputed income from a multitude of activities cannot be assessed properly, or, when assessed, it amounts to so little that it is not worth the administrative trouble and expense. For example, shaving oneself instead of going to a barber yields imputed income; so does the use of personal goods such as furniture, clothes, crockery, etc. But, with the possible exception of the larger pieces of furniture, it is unlikely that a tax on imputed income from these items would be worth the trouble, from the point of view either of revenue or of correcting existing inequities. Finally, some rather large items of imputed income may properly be left out of the tax base because most of the recipients are below the exemption level under the income tax even with imputed income added. This would be true in the main of imputed wages from housework. And this category of imputed income is especially competitive with leisure income, so that there is further reason on equity grounds for leaving it alone.

With regard to the eligibility of imputed income for a place in the concept of income proper, we may conclude, then, that all imputed income should be contemplated in an ideal concept, along with income from leisure; but that the necessary exclusion of the latter from any practical concept of taxable income makes the exclusion of some types of imputed income less objectionable on equity grounds. * * *

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NOTE

Is Marsh right that the only reason imputed income is not generally taxed under our system is the practical difficulties of doing so? Is there a theoretical case to be made against taxing imputed income?

Thomas Chancellor, *Imputed Income and the Ideal Income Tax*, 67 Or. L. Rev. 561 (1988)*

A persistent theme in the literature of public finance and tax policy is that an ideal income tax base includes the value of services performed for one's self, the value of leisure, and net rent from consumer durables. That is, in principle, these items constitute income just as much as compensation in cash or in kind.

If such imputed income is not taxed, this received wisdom says, it is only because of the practical difficulties involved * * *.

This Article maintains that this traditional view, bottomed in the concept that income equates to satisfactions, consumption, or well-being, is unwarranted. Rather, the benefits from self-performed services, the value of leisure, or the benefits an owner derives from the use of consumer durables, should not be characterized as income, even in that imaginary world where an ideal income tax is attainable. Imputed income is a misnomer, attributable to an early identification of income with subjective satisfactions, reinforced in modern times by the desire of economists to use the income tax to further their vision of allocative efficiency. This Article argues that individual satisfactions are too idiosyncratic to constitute a tax base. Income must mean something that is measurable and, even in theory, satisfactions are not. This Article also maintains that the economic concept of efficiency, which seeks to avoid or neutralize any disincentives to maximize revenue in the exchange economy, is not an appropriate criterion in defining income for tax purposes.

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Both the politicians and the public have steadfastly remained unconvinced that imputed income is a proper subject of income taxation. The purpose of this Article is to show this intuitive sense is theoretically sound.

I. THE MEANING OF IMPUTED INCOME

A. *What is Included*

In an oft-quoted passage, imputed income is defined as "a flow of satisfactions from durable goods owned and used by the taxpayer or from goods and services arising out of the personal exertions of the taxpayer on his own behalf."[15] To the two accepted components of that definition, benefits from consumer durables and self-performed services, must be made one necessary addition: in the realm where theory reigns and all things can be valued and measured, the definition of imputed income includes a third element, the value of leisure.

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II. THE CONCEPTION OF INCOME

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B. *The Concept of Psychic Satisfactions as Income*

* * * [T]he traditional paradigm among economists has been that income is the flow of satisfactions to an individual. * * * This asserted identity between income and individual psychic satisfactions is the genesis of the view that the imputed benefits of self-performed services, leisure, and consumer assets are income; such sources are just as capable of yielding psychic satisfaction to an individual as are market transactions.

It is also clear that by satisfactions economists mean pleasure, not some objective utility. * * *

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2. *Satisfactions Are Inappropriate as a Tax Base*

Taxation, even at the theoretical level, implies the existence of an objective measuring rod. Accordingly, an indispensable characteristic of income, or any tax base, is that it be capable of measurement, directly or indirectly. Even as a matter of theoretical speculation, the interpersonal comparison of individual satisfactions is not feasible. That is, there is no numerical scale that allows us to quantify the satisfaction derived by one person to allow comparison (for tax purposes) with the satisfaction of another. Therefore, satisfactions as income is an oxymoron: income requires objective measurement, but satisfactions and pleasure cannot be quantified

[15] [Donald B. Marsh, *The Taxation of Imputed Income*, 58 Pol. Sci. Q. 514, 514 (1943).]

even in theory. Economists and fiscal experts routinely acknowledge that taxation based upon individual aggregate satisfactions is not possible in practice. However, some fiscal experts, while acknowledging such practical impossibility, continue to pay homage to the asserted theoretical correctness of defining income in terms of satisfactions. Such fealty is misplaced.

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III. IMPROVING THE DEFINITION OF INCOME

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C. A Revised Definition of Income

I propose the following definition of income for tax purposes:

> Income is the increase, during a given period, in one's power to purchase goods and services from others for preclusive personal use or the receipt of services in exchange transactions during such period. Such purchasing power can be in the form of money (or its equivalent), or property received, or the market value of owned assets.

This is a "command over market resources" conception of income: income is measured by one's power to acquire societal resources. When one earns a wage, human potential is converted into economic purchasing power available for preclusive consumption. Income is obtained at the point purchasing power is acquired. * * *

Wages and fees for services, business profits, dividends, interest and windfalls (prize or found property), increase purchasing power and would be income. The ideal base also includes the receipt of gifts and inheritances as well as the benefit of barter transactions. The recipient's purchasing power (income) is increased by the market value of gifts or inherited property since they may be sold by the recipient to purchase market goods and services. A service received in a barter exchange is also income to the extent of its fair market value. In addition, when there is real appreciation in the market value of an existing asset, there is an increase in the owner's purchasing power. Such unrealized appreciation is available (by selling the asset) to acquire goods and services for consumption.

Self-performed services, leisure, or the use of personal assets provide satisfactions or benefits to the individual. However, they do not increase the individual's purchasing power to acquire goods and services in the market and hence would not generate income. By performing services for oneself, money that would otherwise be paid to a third party for the service is saved and is therefore available for other purposes. This, however, is not an increase in one's purchasing power over market goods and services. It is merely the exercise of choice over the use of purchasing power that otherwise exists. Similarly, the use of a personal asset (a home or other consumer durable) does not increase the user's purchasing power over market goods and services. It merely allows existing income, if any, to be used differently.

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IV. SELF-PERFORMED SERVICES AND LEISURE

Self-performed services and leisure should not be considered income. Such imputed income does not represent a preclusive power over, or use of, society's goods and services.

To argue for the recognition of imputed income in the tax base urges the taxation of services that are rendered for the benefit of oneself or rendered gratuitously for another: the mechanic who repairs her own car or paints her own house; the farmer who consumes vegetables from her own garden; the parent who helps a child with homework rather than hiring a tutor; the spouse who does housework rather than hiring a housekeeper and the man who shaves himself rather then going to the barber. The list could be continued *ad infinitum*. What is the theoretical justification for such a massive creation of income?

If one conceptualizes income as a flow of satisfactions then the taxation of imputed income is understandable: the satisfaction of having a newly painted house occurs whether the repainting is done by a professional painter or by oneself. It is also apparent that self-performed services and leisure compete for an individual's time and attention. A person may fail to repaint the house or make needed repairs because she prefers to listen to music, write poetry, or watch television. If so, then the satisfactions from those leisure activities must be greater than the satisfactions from a repainted or repaired house.

A primary tenet of this Article is that the asserted theoretical equivalence between satisfaction and income (for tax purposes) is incoherent and unacceptable. The arguments against the "satisfactions are income" theory will not be repeated. However, what of the other asserted justifications for including the benefits from self-performed services and leisure in the tax base?

A. Treatment of Self-Performed Services and Leisure Under a "Consumption Is Income" Formulation

Under an unfettered "consumption is income" formula, income becomes anything that can be deemed consumption (including leisure) and is capable of valuation. The latter is not much of a theoretical limitation since, in principle, most things can be valued. There is a market analogue for many self-performed activities. The existence of valets, cooks, chauffeurs, and tutors means that if the concept of imputed income is consistently applied, we have imputed income when we dress ourselves, prepare a meal, drive the automobile, or teach ourselves to play bridge. If an unfettered "consumption is income" theory is accepted, many people have more imputed income than actual income from wages or self-employment.

1. *Measuring Self-Performed Services and Leisure Under the "Consumption Is Income" Formulation*

What standard would be used to measure income from self-performed services or leisure? If *X* mows her own lawn, she would presumably have income equal to the amount she would have had to pay someone else to mow it. * * *

As for leisure, presumably it would generate an amount of income equal to the amount the individual could have earned if the individual had worked rather than engaged in leisure.

* * *

2. *Inherent Potential for Expansion*

The "consumption is income" concept possesses an inherent potential for expansion. If not limited to the preclusive consumption of market goods and services, the "consumption is income" concept would inexorably expand to include other forms of imputed or psychic income. * * *

If a person has income equal to what that person could have earned, then why shouldn't imputed income from services performed solely for oneself also be measured by the cost of the lost opportunity (i.e., income foregone)? * * *

Moreover, imputed income would also tend to expand to the limit of its logic and envelop psychic income. If one is taxed on the value of not working at all (leisure), then a person who takes a job that pays less because it offers more satisfaction (i.e., psychic income) should be taxed on the earnings foregone, imputed income. This taxing of potential outcomes rather than actual economic outcomes would derogate our highly cherished notions of individual and personal autonomy.

Some will seek to avoid these results by relying on the limits of practicality. In other words, since psychic income and gratuitous services to others, as well as leisure, cannot effectively be measured or taxed, the theoretical implications of including it in the ideal tax base can be ignored. This is intellectually dishonest. Among fiscal experts, principle should be important. If the taxation of psychic benefits as income is unacceptable in an imaginary world where an ideal income tax is possible, then economic income for tax purposes should be defined accordingly.

There is no principled way to exclude potential earnings and other psychic benefits from income while including the benefits of self-performed services and leisure. Moreover, a definition of income that requires, for example, an individual to account to society for the time spent reading a book, helping a child with homework, going to church, or acting as a volunteer would introduce notions repugnant to a democratic society. The most appropriate principled response is to define income so that it does not include the benefits of self-performed services, leisure, or psychic income. Such a limited definition is both plausible and coherent.

* * *

B. Income as an Index of Well-Being

Some economists and tax theoreticians seem to view income as a measure of well-being. Under this view, anything which constitutes an enhancement of one's standard of living should, in principle, represent income. While economics is certainly interested in well-being and the good life (as are most fields of human inquiry), that does not warrant equating income with well-being. Even as an ideal, income should not be a measure of all benefits enuring to an individual.

Income as a word, for purposes of taxation, is not infinitely plastic; it has limits that preclude treating all advantages as income. To say that, in principle, income means everything representing an economic advantage expands the word to the point that it could mean anything, and hence means nothing. * * *

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C. Including Imputed Income in the Tax Base to Improve the "Efficiency" of the Income Tax

A theme frequently advanced to justify taxing imputed income is that tax-induced changes in conduct should be minimized under the rubrics of "efficiency" and "minimizing excess burden." Efficiency advocates are concerned that not taxing imputed income (including leisure) provides an incentive for individuals to substitute tax-free self-performed services and leisure in lieu of taxable market transactions. Efficiency advocates assume that over time taxes cause individuals to reduce their work effort.

* * *

Even though efficiency cannot be accepted as the sole or principal criterion in selecting a tax base, this does not mean that it is of no significance. All other things being equal, it is desirable that the selected tax base minimize distortions in economic decision making. Thus, efficiency is one of several criteria that influence the selection of a tax base. For example, one might urge the adoption of consumption as the tax base since consumption (as a tax base) is more efficient than income or wealth as a tax base. However, once income has been selected as the tax base, then efficiency becomes an exogenous factor. Therefore, efficiency should not be injected into the definition of income. That is, income should not be defined in ways that would not otherwise be warranted merely to increase the economic efficiency of the tax. Selecting income as the tax base limits and constrains what can be taxed.

* * *

D. Horizontal Equity

It is frequently argued that the need to tax self-performed services is required by horizontal equity, or fairness. For example, if farmer A sells his wheat and uses after-tax dollars to buy vegetables, this argument asserts that it is not fair to allow farmer B to escape taxation when she consumes vegetables that she has grown. It is tempting to say that farmer B must be treated as having income equal to the market value of the vegetables consumed to avoid giving farmer B an advantage over farmer A. However, this understandable urge should be resisted. One must decide the meaning of income before deciding that two people have equal incomes and are being taxed differently.

* * *

If the line is not based upon a principled distinction it is not likely to endure. The distinction here proposed is that all benefits from self-performed services (such as farmer B's vegetables) or leisure should be excluded from the tax base. Therefore, the distinction between farmer A and B is a principled one.

* * *

V. INCOME FROM CONSUMER ASSETS

It is frequently stated that a comprehensive individual income tax, based on the Haig-Simons definition of income, should tax imputed net rent from home ownership and other consumer assets.

Five different, and somewhat inconsistent, arguments have been advanced for taxing imputed income from home ownership and other consumer assets. First, an owner-occupied home is an asset that will be used up in consumption over a period of years, and thus provides a flow of satisfactions to the owner which is assumed to equal the rental value of the house. The second justification for taxing imputed rent is based on the "consumption is income" formulation: that owner-occupied housing represents consumption, measured by rental value. A third argument, inconsistent with the first two, is that an owner-occupied home is an investment that yields an implicit return—benefits in-kind rather than a cash return. The fourth rationale is based on the concept of potential income: since the owner could have rented the house and received income equal to the going rental value, she should be taxed on potential income although she elected to live in the house rather than rent it. The fifth, and final, argument combines two propositions: that the principles of horizontal equity (for renters) and/or allocative efficiency require taxing the net imputed rental income to the owner-occupier. Are any of these arguments sound?

A. "Satisfactions Are Income"

The first argument is based on the premise that psychic satisfactions are income. As earlier indicated, the definition of income as a flow of individual satisfactions is inappropriate.

B. "Consumption Is Income"

If income is defined as consumption plus accumulation, then, at some point the purchase of a consumer asset is consumption. The purchase of a home or other consumer asset for personal use is a payment in the year of purchase for consumption in that and subsequent years. Under the "consumption is income" formulation the purchase of the consumer durable should be included in the tax base as consumption either when purchased or as it is used up over its useful life. Thus, the purchase price of a house, for example, could be taxed as consumption in the year purchased or over the period that it is used in consumption, *but not both*. Once an item of consumption is included in the tax base, there is no justification for taxing the item again, either as a flow of satisfactions or as providing implicit investment returns.

Those who advocate taxing imputed rent implicitly assume that the income used to purchase a home is included in the tax base. That is, there is no indication that wages or other income used to buy the house would not be taxed. If the asserted justification for taxing imputed rent is that consumption is income, then including in income any amount in addition to the cost of the house would be a second tax on the same consumption. Thus, the "consumption is income" thesis does not justify taxing imputed rent if the funds used to buy the house were included in the tax base.

C. Owner-Occupied Housing and Other Consumer Assets as Investments

Proponents of taxing imputed income often explicitly or implicitly characterize the purchase of owner-occupied housing, and other consumer durables, as an investment rather than consumption. Just as a savings account provides interest which is explicit income, an owner-occupied home provides the benefits of shelter which should be taxed as an implicit return on the investment. This typically leads to an artificial construct—the homeowner as a landlord renting the property to herself as a tenant. Imputed income is the equivalent of what the owner as landlord would receive from herself as tenant. Through this artifice, the asset is shifted from the category of consumption to the category of investment to create additional imputed investment income. To simultaneously treat a consumer asset as both consumption and investment is inappropriate.

D. Potential Rental Revenue Foregone Is Income

Another argument for taxing net imputed rental income is that a homeowner, by electing to live in the house rather than rent it, is voluntarily relinquishing income and hence should be taxed on potential rental income. This is an illustration of taxing economic potential (i.e., income which could be earned) rather than actual economic outcomes.

Taxing potential income often finds favor with economists because it contributes to allocative efficiency. Nevertheless, and independent of administrative feasibility, such taxation is objectionable in a democratic society. The taxation of potential earning power would do violence to our cherished notions of personal autonomy. Individuals should be free to decide how much they will work and how much income they will have. Therefore, any definition of income which permits taxing potential income should not be accepted.

* * *

E. Horizontal Equity and Efficiency

Can the failure to tax net imputed rent be properly viewed as a violation of horizontal equity, discrimination against renters, or a distortion in the efficient allocation of resources?

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The failure to tax imputed rent changes the equilibrium that would otherwise exist between consumer assets and investment assets in a nontax world. Does this justify taxing imputed rent? A desire to remove allocative inefficiencies may be a reason to reject income as the tax base, but once we have accepted income as the tax base, allocative efficiency should cease to be a criterion in the tax base. That is, allocative efficiency should not be a criterion in the definition of income. An acknowledged feature of an income tax is that it encourages consumption over investment. The favorable treatment of home ownership and other consumer asset ownership (as compared to ownership for investment) is merely a manifestation of this difference.

It is frequently asserted that the difference in treatment between homeowners and renters constitutes horizontal inequity. As described above, a system that does not tax imputed rent results in an incentive to own rather than rent housing. Is that fact alone enough to justify including imputed rent in an ideal tax base? I think not. The principle of horizontal equity demands that people with equal income be taxed the same. Proponents of taxing imputed income argue that imputed rent must be treated as income so that renters and owner-occupiers have the same income. The existence of horizontal inequity depends on the fundamental threshold issue: is the benefit of using an owned asset to be treated as income? Only if the answer to that question is "yes" must the imputed benefit be taxed to achieve horizontal equity. It is circular to argue that the answer to that question must be "yes" in order to justify equalizing the incomes of renters and owner-occupiers. In the end, horizontal equity is a question of subjective judgment which should not be allowed to trump the definition of income.

Only if one views owner-occupied housing as an investment is taxing imputed rent mandated. In that case, the tax law would be making one form of investment more favorable than another. Since an investment, if successful, produces new purchasing power, the purchase of a consumer asset is the antithesis of investment; housing and other consumer assets are a form of consumption, not a form of investment. The owner-occupier and the owner-landlord are not similarly situated.

* * *

NOTE

Is Chancellor right that only goods or services purchased in market transactions should be taken into account in determining income? In his article excerpted earlier in this Part, Victor Thuronyi calls Chancellor's position on imputed income from self-performed services and leisure "fallacious," and he disagrees with his position on imputed income from consumer assets. Victor A. Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 79-86 (1990). *See also* David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793, 833 n.118 (1992) (disagreeing with Chancellor's position on imputed income from self-performed services).

D. Gifts, Bequests, and Inheritances

The proper treatment of gifts, bequests, and inheritances has long been debated by tax commentators. There are two aspects to this problem. The first involves § 102, which excludes gifts, bequests, and inheritances from the recipient's gross income. Although a predecessor to § 102 was included in the original income tax enacted in 1913 and has remained in force ever since, Congress has never articulated any ratio-