

# TAXING LUCK

*Peter A. Prescott\**

|   |     |
|---|-----|
| INTRODUCTION .....                                      | 117 |
| I. CURRENT AND HISTORICAL TAX TREATMENT OF LUCK         | 121 |
| A. <i>Luck and Income Taxes</i> .....                   | 122 |
| 1. Lucky Income.....                                    | 122 |
| 2. Unlucky Expenditures and Losses.....                 | 126 |
| B. <i>Luck and Other Taxes</i> .....                    | 127 |
| 1. Excess Profits and War Profits Taxes.....            | 128 |
| 2. Oil Windfall Profit Tax.....                         | 134 |
| 3. Land Value Tax .....                                 | 137 |
| II. LUCK INCOME DEFINED .....                           | 142 |
| A. <i>The Nature of Luck</i> .....                      | 143 |
| B. <i>Luck Income</i> .....                             | 148 |
| III. TAX POLICY CONSIDERATIONS .....                    | 156 |
| A. <i>Economic Efficiency</i> .....                     | 156 |
| 1. The Inelasticity of Luck.....                        | 157 |
| 2. Optimal Income Tax Theory.....                       | 160 |
| B. <i>Distributive Justice Considerations</i> .....     | 163 |
| C. <i>Complexity and Practical Administration</i> ..... | 169 |
| IV. TAXING LUCK INCOME .....                            | 175 |
| A. <i>A Proposal for Taxing Luck Income</i> .....       | 177 |
| B. <i>Some Simple Examples</i> .....                    | 183 |
| 1. Lottery Winnings and Gambling.....                   | 184 |
| 2. Treasure Trove/Found Money .....                     | 184 |
| 3. Punitive Damages .....                               | 185 |
| CONCLUSION.....   | 187 |

## INTRODUCTION

Larry King once said, “Those who have succeeded at anything and don’t mention luck are kidding themselves.”<sup>1</sup> While some

---

\*Assistant Professor of Business Law, Butler University College of Business. The Author would like to thank William Rieber, Robert S. Main, and Robert B. Bennett, Jr.

might quibble over luck's relative importance, most people would probably agree with Larry that it contributes to success—including economic success.<sup>2</sup> His remark is certainly consistent with my personal observations about the economically-successful entrepreneurs and business executives that I helped advise before entering academia.<sup>3</sup> Those entrepreneurs and business executives possessed wealth ranging from relatively modest (i.e., between \$1 million and \$10 million), to moderate (i.e., between \$10 million and \$100 million), to vast (i.e., more than \$1 billion). At each wealth level, my clients possessed considerable natural ability that they had cultivated through hard work. To a great extent, those characteristics explained why they were successful. But talent and effort did little to explain why some were merely modestly successful and others were wildly successful.<sup>4</sup> Instead, those two attributes seemed to be a prerequisite for vast wealth accumulation that was more akin to a lottery ticket—albeit one that few had the ability and drive to purchase. Non-winners

---

at Butler University's College of Business; Michael J. Pitts, Lloyd T. Wilson, Jr., and Max Huffman at Indiana University McKinney School of Law; and the participants in the Indiana University Maurer School of Law's Tax Policy Colloquium for their contributions to this Article.

<sup>1</sup> Larry L. King Quotes, THINKEXIST.COM, [http://thinkexist.com/quotation/those\\_who\\_have\\_succeeded\\_at\\_anything\\_and\\_don-t/213538.html](http://thinkexist.com/quotation/those_who_have_succeeded_at_anything_and_don-t/213538.html) (last visited Nov. 3, 2013).

<sup>2</sup> One psychologist, who has made a career of studying luck, went so far as to observe that luck can “make the difference between life and death, reward and ruin, happiness and despair.” RICHARD WISEMAN, *THE LUCK FACTOR* 3 (2003).

<sup>3</sup> Ed Bradley, of 60 Minutes fame, similarly advised us to “[b]e prepared, work hard, and hope for a little luck. Recognize that the harder you work and the better prepared you are, the more luck you might have.” Ed Bradley Quotes, BRAINYQUOTE.COM, [http://www.brainyquote.com/quotes/authors/e/ed\\_bradley.html](http://www.brainyquote.com/quotes/authors/e/ed_bradley.html) (last visited Oct. 15, 2013). Others have made similar observations. *See, e.g.*, Hal R. Varian, *In the Debate Over Tax Policy, the Power of Luck Shouldn't Be Overlooked*, N.Y. TIMES, May 3, 2001, at C2.

<sup>4</sup> It is possible that these apparently disproportionate outcomes could have resulted from small differences in my clients' abilities and efforts. That would be plausible if they were competing in a “winner-take-all” market. The dominant characteristics of such markets are that “payoffs are determined by relative rather than (or in addition to) absolute performance” and that “rewards tend to be concentrated in the hands of a few top performers, with small differences in talent or effort often giving rise to enormous difference in incomes.” ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY* 23–24 (1995). Given the varied paths that my clients followed to attain their wealth, a winner-take-all market explanation seems inadequate.

earned modest wealth. “Lucky” winners attained considerably greater economic success.<sup>5</sup>

Like just about everything else in life, that luck-generated economic success has federal income tax consequences for the lucky recipient. Under the current system, the Internal Revenue Code (the “Code”) does not distinguish between income resulting from luck and other types of income. Thus, unless the lucky income is realized through the sale or exchange of a capital asset,<sup>6</sup> it is taxed as ordinary income along with other types of income (e.g., trade or business income, wage income).<sup>7</sup>

But does that fairly uncontroversial tax treatment hold up under scrutiny? If not, then how should the federal government tax “lucky” income? And, how should Congress and the Internal Revenue Service (the “Service”) decide which income is “lucky” and which is not?<sup>8</sup> This Article wrestles with those thorny questions before concluding that taxable income attributable to luck should be segregated from other types of income and subjected to a fixed tax rate that exceeds the top marginal tax rates on ordinary income earned by individuals.<sup>9</sup> Note that this

---

<sup>5</sup> I am certainly not the only one to make this type of observation. *See, e.g.*, FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 283 (Augustus M. Kelley 1964) (1921) (observing that (1) leadership capacity may be the “chief limitation” on business enterprise size, (2) “[i]f this is true the ability to handle large enterprises successfully, when it is met with, must tend to secure very large rewards,” and (3) “[t]he income of any particular entrepreneur will in general tend to be larger . . . as he himself has ability, and good luck”). When discussing the relationship between education and income inequality, N. Gregory Mankiw observed that “[a] good education is not a guarantee of great riches, but for many highly paid career paths it may be a prerequisite. Perhaps, advanced degrees are like Willie Wonka’s famous chocolate bars. A few of them come with golden tickets that give you opportunities almost beyond imagination. . . . But even if you aren’t lucky enough to get a golden ticket, you can still enjoy the chocolate, which by itself is well worth the price.” N. Gregory Mankiw, *Spreading the Wealth Around: Reflections Inspired by Joe the Plumber*, 36 E. ECON. J. 285, 288 (2010).

<sup>6</sup> I.R.C. § 1222. (2006 & Supp. V 2006). Net capital gain income of individuals may be taxed at a variety of fixed tax rates depending on factors like the nature of the capital asset sold or exchanged and the duration that it is held prior to sale. *See id.* § 1(h).

<sup>7</sup> *See id.* § 64 (“For purposes of this subtitle, the term ‘ordinary income’ includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).”).

<sup>8</sup> This last question poses a number of practical problems and thus far has largely been considered in the abstract by legal philosophers. *See infra* Part II.

<sup>9</sup> Currently, this top marginal tax rate is 39.6%. I.R.C. § 1(i)(3) (2006).

proposed recharacterization of luck-related income is just that—a recharacterization within the existing federal income tax structure. It is not a call for creation of a parallel tax on such income. Nor does it necessitate creation of new rules governing when income is taxed or to whom it is taxed. Instead, the proposed tax structure for luck-related income is comparable to the existing tax treatment of income that is characterized as net capital gain and subjected to a fixed tax rate that differs from the marginal ordinary income tax rates for individuals.<sup>10</sup>

Part I of this Article provides some context that is helpful when addressing the issues highlighted in the preceding paragraph. Specifically, it briefly reviews how federal tax law has handled luck-related income and expenditures in the past and today. Part II turns to the difficult issue of defining what constitutes “luck” for purposes of identifying the luck-related income—referred to in this Article as “luck income”—that would receive the special tax treatment proposed here. Recent scientific and philosophical scholarship on the nature of luck helps inform that definitional exercise. The result is a broad luck income definition encompassing economic outcomes (1) that the recipient cannot control and (2) either (i) that the recipient did not choose or (ii) that are “zero-sum” in nature. In Part III, tax policy considerations such as economic efficiency, equity/distributive justice concerns, and practical administrative issues related to increasing legal complexity are employed to evaluate the desirability of singling out luck income for special tax treatment. The results of that evaluation are used in Part IV to develop and support an initial luck income taxation system that would subject luck income to tax at a fixed tax rate set between 80 and 90 percent. Unfortunately, that system is not currently politically viable. So, it is best viewed as a good place to start thinking about how to successfully tax luck income. To that end, the initial system is designed to be simple and flexible, while capturing as many of the tax policy benefits identified in Part III as possible without incurring too many of the costs found there. After

---

<sup>10</sup> Compare *id.* § 1(h) (capping the income tax rate at 15% for most net capital gains), with Rev. Proc. 2013–15, 2013–5 I.R.B. 444, 445–46 (containing the 2013 tax rate tables applicable to ordinary income, which include rates ranging from 10% to 39.6%).

discussing a few simple examples of luck income, this Article concludes by summarizing the rationale and justifications for specially taxing luck income.

### I. CURRENT AND HISTORICAL TAX TREATMENT OF LUCK

Luck, income, wealth, and taxation have always been, and still are, inexorably intertwined. The connection between the latter three is obvious and driven by practical necessity—one cannot collect a tax from someone who has nothing to pay it with.<sup>11</sup> Previously-acquired wealth or current income solves the collectability problem.<sup>12</sup> Luck enters the picture as one of a handful of important factors contributing to acquiring wealth and to earning income.<sup>13</sup>

Over the years, the federal government has intermittently factored the luck component of income and wealth generation into its tax system. This Part explores some of the ways that accounting for luck has influenced the tax system over the years and still influences it today. It is not intended to be a comprehensive review of the relationship between luck and taxation. Instead, the review's purpose is to demonstrate that luck is relevant to taxation in the real world and to provide some context that should be helpful when turning to the difficult issues addressed in the succeeding Parts. After examining luck and the federal income tax system, the focus shifts to several other situations where the United States and other governments have attempted to isolate and tax luck.

---

<sup>11</sup> This fact of life underpins the “ability to pay” rationale for distributing the tax burden briefly discussed in Part III.B’s distributive justice analysis. *See infra* Part III.B.

<sup>12</sup> Even if one supports consumption-based taxation over income-based taxation, wealth and income are critical because they provide the means for generating sustainable consumption, and therefore sustainable tax collection.

<sup>13</sup> Varian, *supra* note 3. As will be discussed in Part II.A, the other important contributing factors are generally thought to be innate ability and effort. *See infra* Part II.A. Arguably, innate ability is more than a little dependent on luck as well. Lawrence Zelenak, *Taxing Endowment*, 55 DUKE L.J. 1145, 1154 (2006) (“[T]he most significant differences in brute luck are differences in human endowments—that is, differences in abilities based on the morally arbitrary distribution of genetic inheritances and the benefits of parental care and attention.”).

### A. *Luck and Income Taxes*

Luck income has never been identified as a separate class of income and taxed at special tax rates. In fact, the initial tax disputes involving luck income dealt with whether some types of luck income were part of a taxpayer's taxable income at all. Strangely enough, from the very beginning of the modern income tax, Congress *has* specifically identified certain types of bad luck and has afforded preferential tax treatment to the resulting adverse economic consequences. A brief discussion of the income taxation of luck income and unlucky events follows.

#### 1. Lucky Income

The first net income definition, adopted at the advent of the modern income tax in 1913, stated that

[T]he net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, . . . or from dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever . . .<sup>14</sup>

While luck income was not explicitly addressed, to the extent it was connected to the provision of services, ownership of property, and business activity it was part of net income. Presumably, "pure" luck income (e.g., found money and other windfalls) could fit under "gains or profits and income from any source whatever."<sup>15</sup> Given the incubational state of the income tax law, it is not surprising that the accompanying Treasury regulation did not mention luck income, either.<sup>16</sup> Thus, from the very beginning of the modern income tax one would expect that all luck income would be taxable.

---

<sup>14</sup> Tariff Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167.

<sup>15</sup> *Id.*

<sup>16</sup> See T.D. 1944, 16 Treas. Dec. Int. Rev. 28, 29–30 (1914). The regulation did distinguish between net income and gross income, but did little more than pull the statute's net income definition into its component parts. *Id.*

The dispute over whether luck income was taxable at all begins and ends with the Supreme Court. *Eisner v. Macomber* got things rolling when the Court decided that Myrtle Macomber's 1916 stock dividend was not "income" under the 16th Amendment of the Constitution.<sup>17</sup> Although the stock dividend in question had nothing to do with luck,<sup>18</sup> the Court's definition that appeared to limit "income" to "the gain derived from capital, from labor, or from both combined" did.<sup>19</sup> Such a definition would seem to exclude the "pure" luck income mentioned above because neither capital nor labor created it. In fact, the Third Circuit adopted that reasoning when it relied on *Macomber* to hold that a taxpayer's litigation settlement received from an allegedly fraudulent employee was not part of the taxpayer's income.<sup>20</sup> The court characterized that settlement as a "windfall" to the taxpayer that was "granted gratuitously because of the necessity of keeping persons in positions of trust beyond the temptation of double dealing."<sup>21</sup> Similarly, the Tax Court concluded in a separate case that punitive damages were "[a] penalty imposed by law [that] does not meet the test of taxable income set forth in *Eisner v. Macomber* . . . ."<sup>22</sup> In both cases, the taxpayer simply got lucky that a penalty required to deter harmful behavior for the greater good of society was bestowed exclusively upon the taxpayer.<sup>23</sup>

---

<sup>17</sup> *Eisner v. Macomber*, 252 U.S. 189, 219 (1920). Of course, the 16th Amendment does not concern itself with mundane tasks like defining "income." Instead, it gives Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI. For more on *Macomber* and its continuing significance see Marjorie E. Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization*, in TAX STORIES 93 (Paul L. Caron ed., 2d ed. 2009).

<sup>18</sup> Economically, Mrs. Macomber's stock dividend from the Standard Oil Company of California did not help her at all. Before and after, she had the same claim to the same percentage of the company's assets. *Macomber*, 252 U.S. at 200–01. Clearly, she was not thanking her lucky stars!

<sup>19</sup> *Id.* at 207 (quoting *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918)).

<sup>20</sup> *Cent. R.R. Co. of N.J. v. Comm'r*, 79 F.2d 697, 699 (3d Cir. 1935).

<sup>21</sup> *Id.*

<sup>22</sup> *Highland Farms Corp. v. Comm'r*, 42 B.T.A. 1314, 1322 (1940).

<sup>23</sup> This statement demonstrates some of the difficulties inherent in defining "luck." Despite their windfalls, most likely the taxpayers in *Central Railroad* and *Highland Farms* did not consider themselves lucky to have been abused by their respective antagonists. Of course, "lucky people have an uncanny way of transforming their misfortune into amazing good fortune," in part by learning to "see the positive side of their bad luck." WISEMAN, *supra* note 2, at 128–29.

The Supreme Court resolved the dispute over taxability of punitive damage windfalls, and pretty much all other types of luck income, in the seminal case *Commissioner v. Glenshaw Glass Company*.<sup>24</sup> Again faced with punitive damages—this time for fraud and anti-trust violations—the Court noted that the labor/capital language in *Macomber* was “useful” for “distinguishing gain from capital” but that it was “not meant to provide a touchstone to all future gross income questions.”<sup>25</sup> Instead, the Court formulated a new gross income touchstone that has survived to this day.<sup>26</sup> Gross income became “instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”<sup>27</sup> Clearly, that broad definition should encompass all types of luck income regardless of whether connected to labor, capital, both, or neither.

The post-*Glenshaw Glass* gross income situation continues today.<sup>28</sup> The critical statutory language considered in that case—that “gross income means all income from whatever source derived”—lives on in the current Code.<sup>29</sup> Furthermore, Congress, the Treasury Department, and the courts have specifically addressed certain types of luck income. Examples include (1) punitive damages “on account of personal physical injuries or physical sickness,”<sup>30</sup> (2) treasure trove,<sup>31</sup> (3) found money,<sup>32</sup> and (4) lottery winnings.<sup>33</sup>

---

<sup>24</sup> *Comm’r. v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

<sup>25</sup> *Id.* at 431. Previously, the Supreme Court signaled that the *Macomber* labor/capital language was not the complete income test when it held that a lessor’s windfall from “receiv[ing] back his land with a new building on it,” constructed by his former tenant who had unexpectedly forfeited the lease, was includable in the lessor/taxpayer’s gross income. *Helvering v. Bruun*, 309 U.S. 461, 469 (1940). Congress later overturned the specific result in *Bruun*. See I.R.C. § 109 (2006) (“Gross income does not include income (other than rent) derived from a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.”).

<sup>26</sup> See Joseph M. Dodge, *The Story of Glenshaw Glass: Towards a Modern Concept of Gross Income*, in *TAX STORIES* 17, 46–53 (Paul L. Caron ed., 2d ed. 2009) (exploring the case’s continuing importance today).

<sup>27</sup> *Glenshaw Glass*, 348 U.S. at 431.

<sup>28</sup> See, e.g., *Nathel v. Comm’r*, 615 F.3d 83, 88–89 (2d Cir. 2010) (recounting *Glenshaw Glass*’s role in setting the current gross income definition).

<sup>29</sup> I.R.C. § 61 (2006).

<sup>30</sup> *Id.* § 104(a)(2). This provision indirectly addresses punitive damages by excluding them from the rest of a taxpayer’s damages received on account of such injuries or sickness. The non-punitive damages are actually excluded from the

Once luck income is folded into gross income and taxed, the question of how it should be taxed becomes relevant. To date, classification of luck income within the Code's existing gross income character classifications—ordinary income/loss and capital gain/loss—has not been a source of significant dispute. Because the Code does not distinguish between income resulting from luck and other types of income, the normal classification rules apply and luck income is taxed as ordinary income along with other types of income (e.g., trade or business income, wage income) unless it is realized through the sale or exchange of a capital asset.<sup>34</sup> The most notable disputes in this area dealt with the character of gross income realized through the sale of winning lottery tickets.<sup>35</sup> Although the lottery cases involve luck income, the nature of the income as luck-related has not been particularly important to their resolution.<sup>36</sup> Thus, within the existing income tax system the character of income arising from good luck has not been a particularly troublesome issue.

---

taxpayer's gross income. *Id.*; see also Treas. Reg. § 1.61-14 (“[P]unitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income . . . to the taxpayer unless excluded by law.”).

<sup>31</sup> Treas. Reg. § 1.61-14 (2012) (“Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.”).

<sup>32</sup> *Cesarini v. United States*, 296 F. Supp. 3, 4-5 (N.D. Ohio 1969) (including money found in a piano in the taxpayer's gross income), *aff'd*, 428 F.2d 812 (6th Cir. 1970).

<sup>33</sup> *Paul v. Comm'r*, 64 T.C.M. (CCH) 955, 956 (1992) (“Generally, ‘gross income’ means all income from whatever source derived. Lottery proceeds are clearly within the purview of this general definition.” (citations omitted)).

<sup>34</sup> See I.R.C. § 64 (2006) (“For purposes of this subtitle, the term ‘ordinary income’ includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).”). Net capital gain income of individuals may be taxed at a variety of fixed tax rates depending on factors like the nature of the capital asset sold or exchanged and the duration that it is held prior to sale. See *id.* §§ 1(h), 1222.

<sup>35</sup> See, e.g., *Watkins v. Comm'r*, 447 F.3d 1269, 1273-74 (10th Cir. 2006) (classifying the gross income as ordinary income); *United States v. Maginnis*, 356 F.3d 1179, 1187 (9th Cir. 2004) (same).

<sup>36</sup> See *Lattera v. Comm'r*, 437 F.3d 399, 401, 409-10 (3d Cir. 2006) (starting from the position that the lottery proceeds, if paid directly, would be ordinary income and applying the substitute for ordinary income doctrine to conclude that their indirect receipt through sale of the right to future lottery payments did not change that result).

## 2. Unlucky Expenditures and Losses

Of course, bad luck can have economic and income tax consequences, too. Most commonly, a taxpayer may be able to deduct losses and expenditures resulting from bad luck events against the taxpayer's other gross income, whether luck-related or not. As with the characterization of luck income discussed above, the Code's deduction provisions usually do not distinguish between unlucky expenditures and losses, and those that have no connection to bad luck.<sup>37</sup> Therefore, unlucky expenditures and losses are generally deductible when incurred in connection to a trade or business or profit-making activity and not deductible when they are personal in nature.<sup>38</sup>

From the beginning of the modern federal income tax, Congress has given preferential treatment to certain—otherwise nondeductible—unlucky expenditures and losses. In the Tariff Act of 1913, which installed the modern income tax for individuals, Congress approved a deduction for “losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise.”<sup>39</sup> Under this provision, personal losses (i.e., losses not “incurred in [a] trade”) were not deductible unless inflicted by an unlucky catastrophic event.<sup>40</sup> Although the legislative history accompanying that first income tax law did not discuss the rationale for this deduction, presumably Congress felt it was appropriate because such a loss, while personal in nature, represented a real decline in the taxpayer's wealth without any

---

<sup>37</sup> See, e.g., I.R.C. § 162(a) (2006) (“There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .”); see also *id.* § 262(a) (denying a deduction for most “personal, living, or family expenses” without mention of whether such expenses arose from bad luck); but see *id.* § 165(d) (“Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.”).

<sup>38</sup> See I.R.C. § 165(c) (making losses experienced by individuals deductible when connected to a trade or business or any other “transaction entered into for profit” and denying a deduction for most other losses).

<sup>39</sup> Tariff Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167.

<sup>40</sup> *Id.* Admittedly, fires and shipwrecks can be intentional and the statute does not appear to differentiate between an unlucky fire and self-inflicted arson; but one assumes most self-inflicted arson is intended to recover insurance money, which would make the fire loss non-deductible. See *id.*

corresponding consumption benefit/enjoyment.<sup>41</sup> This special tax treatment for unlucky personal losses continues today<sup>42</sup> and is joined by other preferentially-treated bad luck expenditures and losses (e.g., losses from gambling for fun).<sup>43</sup> While the special treatment extended to these unlucky expenditures and losses does not directly support the new tax treatment of luck income proposed in this Article, it does demonstrate that luck-based distinctions are not without precedent within federal income tax law.

### B. Luck and Other Taxes

Income taxes are not the only mechanism for reaching the economic rewards resulting from luck. Congress has periodically employed various excise taxes to capture lucky economic returns<sup>44</sup>—most commonly war-generated returns that are taxed

---

<sup>41</sup> Brian Lester, *The “Casualty” to Taxpayers From a Misapplied Application of Internal Revenue Code Section 165(C)(3): The Need For an Objective Approach*, 48 S.D. L. REV. 52, 54 (2003) (observing that the successor to the language in the 1913 tax law was intended to “protect the taxpayer from incurring heavy losses caused by an intervening event that ultimately deprives the taxpayer of full enjoyment from [the taxpayer’s property’s] use”).

<sup>42</sup> See I.R.C. § 165(c)(3) (2006) (“[T]he deduction . . . shall be limited to . . . losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.”).

<sup>43</sup> See *id.* § 165(d) (allowing a deduction for gambling losses regardless of whether the gambler engages in the activity to make a profit or for fun).

<sup>44</sup> The excise tax on medical device manufacturers that was one of the revenue-generating provisions accompanying the Patient Protection and Affordable Care Act may be one of Congress’s most recent attempts to capture and tax windfall profits. See Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111–152, § 1405, 124 Stat. 1029, 1064–65 (replacing provisions of the Patient Protection and Affordable Care Act with the medical device tax); OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATIVE POLICY: H.R. 436 – HEALTH CARE COST REDUCTION ACT OF 2012 (June 6, 2012) (“The medical device industry, like others, will benefit from an additional 30 million potential consumers who will gain health coverage under the Affordable Care Act starting in 2014. [The medical device] excise tax is one of several designed so that industries that gain from the coverage expansion will help offset the cost of that expansion.”), [http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr436r\\_20120606.pdf](http://www.whitehouse.gov/sites/default/files/omb/legislative/sap/112/saphr436r_20120606.pdf) (last visited on Oct. 22, 2013). The Author would like to thank Lizzie Millis from the Indiana University Maurer School of Law’s Tax Policy Colloquium for sharing this recent example of a luck-related excise tax.

to pay for the war in question.<sup>45</sup> Other national governments and some local governments within the United States use specialized real property taxes to target that portion of the property's value resulting from the good fortune of owning property located in a desirable spot and not resulting from the owner's efforts.<sup>46</sup> In each case, the tax base used roughly tracks the taxpayer's wealth arising from luck.

### 1. Excess Profits and War Profits Taxes

In the United States, the excess profits and war profits taxes used to finance the major wars in the first half of the twentieth century are perhaps the closest analogs to the taxation system proposed in this Article. By any measure, World War I and World War II were not cheap.<sup>47</sup> When they strained the federal coffers, Congress turned to the businesses that fortuitously profited from those wars to provide much-needed tax revenue.<sup>48</sup> The resulting excess profits and war profits taxes (1) estimated the supernormal returns that businesses derived from being in the right place at the right time to profit from the war-related economic activity (i.e., from being lucky) and (2) taxed that profit at relatively high

---

<sup>45</sup> Other national governments also relied on excess profits and war profits taxes to fund their wars. See, e.g., Robert M. Haig, *The Taxation of Excess Profits in Great Britain: A Study of the British Excess Profits Duty in Relation to the Problem of Excess Profits Taxation in the United States*, 10 AM. ECON. REV. (SUPPLEMENT) 1, 3 (1920) ("The determined effort to appropriate abnormal profits for public purposes is the feature which distinguishes the financial history of the World War most strikingly from that of previous wars. The British Excess Profits Duty, if not the very first of these special profits taxes, is certainly in most respects the greatest and best of them all.").

<sup>46</sup> Robert V. Andelson, *Introduction to LAND-VALUE TAXATION AROUND THE WORLD* xix, xxxiii–xxxvii (Robert V. Andelson ed., 3rd ed. 2000) (tracing the use of land-value taxation in countries like Australia, Denmark, New Zealand, South Africa, and Canada).

<sup>47</sup> World War I's military operations cost the United States approximately \$20 billion dollars from 1917-1921, which amounts to roughly \$334 billion when adjusted for inflation from those years to 2011. Stephen Daggett, CONGRESSIONAL RESEARCH SERVICE, COSTS OF MAJOR U.S. WARS 2 (2010), <http://www.fas.org/sgp/crs/natsec/RS22926.pdf>. Similarly, World War II's military operations cost about \$296 billion from 1941-1945, or \$4.104 trillion in 2011 dollars. *Id.*

<sup>48</sup> John Hakken, *Excess Profits Tax*, in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 108, 108 (Joseph J. Cordes et al. eds., 1999).

marginal tax rates.<sup>49</sup> They were levied from 1917 to 1920<sup>50</sup> and from 1940 to 1945.<sup>51</sup>

Congress employed two methods for isolating the lucky profits connected to the world wars. The first excess profits tax, which was enacted in 1917, did so by calculating the difference between the taxpayer's actual net income and "the sum of (a) \$5,000 and (b) eight per centum of the actual capital invested."<sup>52</sup> A business's "actual capital invested" approximated the equity investment in that business—either through direct investment or through reinvestment of earnings—and specifically excluded borrowed assets.<sup>53</sup> Thus, profits or returns in excess of a fixed percentage of the equity investment in the business were effectively deemed excessive and singled out for additional taxation.<sup>54</sup>

Although Congress repealed this initial excess profits tax before it could have any real consequences,<sup>55</sup> the tax's use of a fixed "normal" profit percentage to identify excess profits resurfaced in the excess-profits taxes effective from 1918 to 1921.<sup>56</sup> For those years, profits were taxable at graduated tax rates once they exceeded the sum of \$3,000 and eight percent of

---

<sup>49</sup> For example, the tax rates on excess profits for 1918 were thirty percent and sixty-five percent, and for 1919-1920 were twenty percent and forty percent. Revenue Act of 1918, ch. 18, § 301(a)-(b), 40 Stat. 1057, 1088. The tax rate on all corporate net income for 1918 was twelve percent and for 1919-1920 was ten percent. *Id.* § 230(a), 40 Stat. at 1075-76.

<sup>50</sup> See Revenue Act of 1917, ch. 159, § 200, 39 Stat. 1000, 1000 (creating the excess profits tax for World War I and applying it to taxable years beginning January 1, 1917); Revenue Act of 1921, ch. 136, § 301(a), 42 Stat. 227, 272 (replacing the existing excess profits tax with a revised tax that only applied to the 1921 calendar year).

<sup>51</sup> See Second Revenue Act of 1940, ch. 757, § 710(a), 54 Stat. 974, 975 (creating the excess profits tax for World War II and applying it to taxable years beginning after December 31, 1939); Revenue Act of 1945, ch. 453, § 122(a), 59 Stat. 556, 568 (repealing the existing excess profits tax for taxable years beginning after December 31, 1945).

<sup>52</sup> Revenue Act of 1917, ch. 159, § 201, 39 Stat. at 1000. Congress repealed this first excess profits tax before it had any real consequences. War Revenue Act of 1917, ch. 63, § 214, 40 Stat. 300, 308.

<sup>53</sup> Revenue Act of 1917, ch. 159, § 202, 39 Stat. at 1001.

<sup>54</sup> *Id.* § 201, 39 Stat. at 1000. The additional tax was only eight percent of the excess profit in this first version of the tax. *Id.*

<sup>55</sup> War Revenue Act of 1917, ch. 63, § 214, 40 Stat. at 308.

<sup>56</sup> Revenue Act of 1918, ch. 18, §§ 301(a), 312, 40 Stat. 1057, 1088, 1091.

invested capital.<sup>57</sup> Because that excess profit calculation applied to all of the relevant taxpayer's business activity, whether or not it was related to the war, this fixed-percentage version of the tax targeted all large profits and signaled that in some ways Congress was "more concerned about the generally high level of profits that were being earned in our expanding economy than we were about war profits as such."<sup>58</sup> Consistent with that view, Treasury Secretary McAdoo called the chance that the United States would "have too much prosperity and that the price level of everything may be lifted instead of lowered . . . one of the important problems of the day."<sup>59</sup> To address that concern, the Secretary proposed governmental regulation through "[r]easonable taxation."<sup>60</sup>

Excessive war profits did arise, however, and Congress tackled them explicitly in 1917 when it adopted a second method for isolating World War I's lucky profits. This second method applied to all net income earned during the 1917 taxable year,<sup>61</sup> and was later extended in modified form to the 1918 taxable year<sup>62</sup> and to "net income of more than \$10,000" earned in succeeding taxable years "from any Government contract or contracts made between April 6, 1917, and November 11, 1918."<sup>63</sup> Consistent with this method's focus on wartime activities, a taxpayer's war profits were calculated by comparing the

---

<sup>57</sup> *Id.* §§ 301(a), 312, 40 Stat. at 1088, 1091. "Invested capital" in the new law roughly mirrored "actual capital invested" from the Revenue Act of 1917, including property and cash contributed to the business and reinvested profits, but excluding assets acquired through borrowing. *See id.* § 326(a)–(b), 40 Stat. at 1092. The applicable tax rates for 1918 were thirty percent and sixty-five percent and for 1919–1921 were twenty percent and 40 percent. *Id.* § 301(a)–(b), 40 Stat. at 1088; Revenue Act of 1921, ch. 136, § 301(a), 42 Stat. 227, 272.

<sup>58</sup> E. Gordon Keith, *Concepts of Excess Profits Taxation*, in EXCESS PROFITS TAXATION 18, 19 (1953).

<sup>59</sup> William G. McAdoo, U.S. Sec'y of the Treasury, Address at a Meeting of Bankers and Business Men of the Seventh Federal Reserve District 8 (May 17, 1917), available at [http://books.google.com/books?id=\\_y4UAAAIAAJ&oe=UTF-8](http://books.google.com/books?id=_y4UAAAIAAJ&oe=UTF-8).

<sup>60</sup> *Id.*

<sup>61</sup> War Revenue Act of 1917, ch. 63, §§ 200–201, 40 Stat. 300, 302–03.

<sup>62</sup> Revenue Act of 1918, ch. 18, § 301(a), 40 Stat. at 1088.

<sup>63</sup> *Id.* § 301(c), 40 Stat. at 1089. On April 6, 1917, President Woodrow Wilson asked Congress to declare war against Germany. *The Great War, WWI Timeline: 1917*, PBS.ORG, [http://www.pbs.org/greatwar/timeline/time\\_1917.html](http://www.pbs.org/greatwar/timeline/time_1917.html) (last visited Nov. 4, 2013). On November 11, 1918, the war effectively ended when Germany and the Allies signed an armistice. *The Great War, WWI Timeline: 1918*, PBS.ORG, [http://www.pbs.org/greatwar/timeline/time\\_1918.html](http://www.pbs.org/greatwar/timeline/time_1918.html) (last visited Nov. 4, 2013).

taxpayer's current-year net income with an estimate of what that income would have been had the taxpayer's business maintained its pre-war profitability.<sup>64</sup> For taxable years 1918 and beyond, the statute set the latter estimate at "[a]n amount equal to the average net income . . . for the prewar period [(i.e., 1911 through 1913)], plus or minus, as the case may be, 10 per centum of the difference between the average invested capital for the prewar period and the invested capital for the taxable year."<sup>65</sup>

By virtue of its prewar period profitability baseline, the war profits tax was arguably somewhat more attenuated to World War I's economic windfalls than the excess-profits tax enacted at around the same time. The Senate Finance Committee noted that distinction and that the new law took "by taxation, directly or indirectly, for the purpose of war, a part of the extra gains which war itself has caused."<sup>66</sup> However, the war-profits tax was far from perfect in that regard because it depended on underlying assumptions that the profits earned during the prewar period were "normal" and that the war accounted for all deviations from that prewar profitability level. Significant changes to a business's environment that coincided with the war, but were unconnected to it, caused the tax to overshoot (or undershoot) the mark.<sup>67</sup> Attempts to compensate for those shortcomings, and other more mundane changes like additional capital investment in a business during the period covered by the tax, complicated the tax and made it more difficult and costly to apply.<sup>68</sup>

---

<sup>64</sup> See War Revenue Act of 1917, § 203(a), 40 Stat. at 304 (permitting a deduction based on "an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period").

<sup>65</sup> Revenue Act of 1918, ch. 18, §§ 301(a), 310, 311(a), 40 Stat. at 1088, 1090.

<sup>66</sup> S. REP. NO. 65-103, at 6 (1917) ("The committee proposes, instead of an excess-profits tax, a war-profits tax.").

<sup>67</sup> Keith, *supra* note 58, at 22. Keith questions whether use of a prewar profitability baseline is particularly meaningful when applied to "firms which were abnormally depressed, which were growing, or which had just introduced new products or new methods of production before the tax went into effect." *Id.*

<sup>68</sup> See, e.g., War Revenue Act of 1917, § 205(a), 40 Stat. at 304-05 (authorizing the Service to disregard the war-profits tax calculated by taking into account the taxpayer's profitability level during the prewar period when the Service found that "during the prewar period the percentage, which the net income was of the invested capital, was low as compared with the percentage, which the net income during such period of representative [taxpayers], engaged in a like or similar trade or business, was

Congress employed the same basic tools during World War II to estimate lucky war-related income and encountered many of the same difficulties.<sup>69</sup> This time, taxpayers were given a choice<sup>70</sup> between an excess-profits tax formulation that used a fixed “normal” profit percentage of eight percent to identify excess profits on the taxpayer’s invested capital<sup>71</sup> and one that used the taxpayer’s pre-war profitability from 1936 to 1939 as a baseline for “normal” profits.<sup>72</sup> As in the earlier war, the invested capital computations used in the former approach and the adjustments to pre-war profitability in the latter were exceedingly complex.<sup>73</sup> Once again, distortions arose when something abnormal (other than the war) occurred in either the pre-war period or the current year.<sup>74</sup> Because no one could anticipate every unusual circumstance, Congress authorized the Service to “make such adjustments as may be necessary to adjust abnormalities affecting income or capital.”<sup>75</sup>

As with the special income tax treatment accorded certain unlucky expenditures and losses, the excess-profits and war-profits taxes levied during the two world wars demonstrate that luck-based distinctions within our tax laws are not without precedent. Because those taxes represent a major effort on Congress’s part to isolate and tax luck income resulting from the country’s war-related economic activity, their justifications and

---

of their invested capital”). One commentator noted that the Service’s broad discretion to fix situations where the tax “appeared to be unduly burdensome” led to it being “flooded with relief requests.” Hakken, *supra* note 48, at 109.

<sup>69</sup> Initially, the tax rates for excess profits were comparable to those used in World War I, ranging from twenty-five percent to fifty percent in 1940. Second Revenue Act of 1940, ch. 757, sec. 201, § 710(a)(1), 54 Stat. 974, 975. By the end of the war, they had increased to a flat ninety-five percent. Revenue Act of 1943, ch. 63, § 202(a), 58 Stat. 21, 53. During 1942, Congress discarded the graduated tax rate schedule in the face of rapidly increasing war costs, replacing it with a fixed ninety percent tax rate. Revenue Act of 1942, ch. 619, § 202, 56 Stat. 798, 899.

<sup>70</sup> Second Revenue Act of 1940, sec. 201, § 712(a), 54 Stat. at 979.

<sup>71</sup> *Id.* sec. 201, § 714, 54 Stat. at 981.

<sup>72</sup> *Id.* sec. 201, § 713(a), 54 Stat. at 980. The base period covered the years beginning after December 31, 1935 and before January 1, 1940. *Id.* sec. 201, § 713(b), 54 Stat. at 980.

<sup>73</sup> *See, e.g., id.* sec. 201, § 719, 54 Stat. at 984–85 (adjusting for borrowed capital).

<sup>74</sup> *See, e.g., id.* sec. 201, § 721, 54 Stat. at 986 (listing certain potentially abnormal events that could require special treatment).

<sup>75</sup> *Id.* sec. 201, § 722, 54 Stat. at 986.

shortcomings are also relevant to the tax policy discussion and design of this Article's luck income taxation system. Arguably, one justification for this increased taxation was that the taxpayers' excess profits were unearned in the sense that, at least in theory, they were made possible not by the taxpayer's efforts but by the country's war efforts and, as a result, could be taken without affecting the taxpayer's behavior.<sup>76</sup> Furthermore, there was undoubtedly something appealing about "pay[ing] for war preparation and war out of war production."<sup>77</sup> Such an approach seemed particularly fair at a time when citizens were called on to sacrifice for the greater good—sometimes with their lives.<sup>78</sup> Thus, economic efficiency and equity formed the main tax policy justifications for the excess-profits and war-profits taxes.

Most of the tax policy shortcomings of those taxes derived from one fundamental problem—the difficulty in cleanly separating those profits from “normal” profits. In the words of Treasury Secretary Fred Vinson after the Second World War:

The difficulty is that calling profits excessive does not make them excessive. Calling profits normal does not make them normal. Normal profits and excessive profits look alike. There is no chemical reagent to distinguish them. The excess-profits tax, to be sure, has a formula—a very complicated formula in its entirety—for distinguishing normal and excess profits. But that formula is seriously defective.<sup>79</sup>

---

<sup>76</sup> Keith, *supra* note 58, at 21 (“Since these windfall profits are likely to be disproportionate to any ‘economic contributions’ which their recipients have made to the war effort, it would appear that they can be more safely taxed than other forms of income the taxation of which might weaken production incentives.”).

<sup>77</sup> Ralph E. Flanders, *Should We Have an Excess Profits Tax?*, in EXCESS PROFITS TAXATION 56, 56 (1953).

<sup>78</sup> *Revenues to Defray War Expenses: Hearing on H.R. 4280 Before the S. Comm. on Finance*, 65th Cong. 489 (1917) (statement of Matthew Woll, American Federation of Labor) (“We want you to look to the human side of this problem as well as the financial side, and we represent the human side. We are willing to sacrifice. Make the man that is making money and profits contribute his share, and, if need be, take all of his profits, because you are taking the lives of our people.”).

<sup>79</sup> *Revenue Act of 1945: Hearing on H.R. 4309 Before the S. Comm. on Finance*, 79th Cong. 24 (1945) (statement of Fred M. Vinson, U.S. Sec’y of the Treasury). With all due respect to Secretary Vinson, tax law is littered with blurred dividing lines that require difficult, and imperfect, judgment calls. *See, e.g.*, I.R.C. § 535(c)(1) (2006) (allowing a credit for “such part of the earnings and profits for the taxable year as are retained for

On its own, this difficulty adversely affected the desirability of these taxes by greatly increasing their complexity for taxpayers and the Service.<sup>80</sup> In addition, failure to properly isolate excess profits undermined both the economic efficiency and equity justifications supporting the taxes. When normal and excess profits are commingled, a tax targeted at excess profits may catch normal profits and, in doing so, unintentionally discourage taxpayers from pursuing economic activities that they would otherwise undertake. The same tax, for the same reason, will be “an erratic and in many instances an inequitable tax” in that it will inevitably tax “normal” profits, if it reaches too far, and miss “excess” profits, if it does not reach far enough.<sup>81</sup> The existence of statutory relief valves permitting the Service to grant relief from excessive taxation under the World War I and II excess-profits taxes is evidence that inequitable taxation was a real possibility.<sup>82</sup> The justifications and concerns discussed above are taken up in more detail below when the proposed taxation of luck income is evaluated from a policy perspective.

## 2. Oil Windfall Profit Tax

The Crude Oil Windfall Profit Tax Act of 1980<sup>83</sup> represents another attempt to capture unexpected lucky economic returns using an excise tax. When Congress passed the new tax, the Carter Administration was gradually ending nine years of crude oil price controls.<sup>84</sup> At the time, many experts expected rapid and

---

the reasonable needs of the business” when calculating whether a corporation is improperly accumulating an earnings and profits surplus); *Exacto Spring Corp. v. Comm’r*, 196 F.3d 833 (7th Cir. 1999) (considering how to separate reasonable compensation paid to a corporation’s owner from the dividends received by that owner).

<sup>80</sup> As indicated by Secretary Vinson, the formula used during the Second World War to separate normal and excess profits was “a very complicated formula in its entirety.” *Revenue Act of 1945: Hearing on H.R. 4309 Before the S. Comm. on Finance*, *supra* note 79, at 24.

<sup>81</sup> Alfred G. Buehler, *The Problem of the Excess Profits Tax*, in EXCESS PROFITS TAXATION 3, 12 (1953) (quoting *Revenue Act of 1945: Hearing on H.R. 4309 Before the S. Comm. on Finance*, *supra* note 79, at 24).

<sup>82</sup> See *supra* notes 68 and 75 and accompanying text.

<sup>83</sup> Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96–223, 94 Stat. 229.

<sup>84</sup> H.R. REP. NO. 96–304, at 3 (1980), *reprinted in* 1980 U.S.C.C.A.N. 589, 591. President Nixon first imposed price controls on crude oil as part of his August 1971 general wage-price freeze. *Id.*

significant price increases to immediately follow that deregulation “either as a result of market forces, the actions of the OPEC cartel, or both.”<sup>85</sup> Faced with that prospect, the House Ways and Means Committee observed that “[t]he revenues resulting from [those] higher prices . . . would provide income to oil producers far in excess of what most of them originally anticipated when they drilled their wells” before concluding that the additional revenues were “an appropriate object of taxation.”<sup>86</sup> In light of the Joint Committee on Taxation’s prediction that oil price decontrol would lead to about \$1 trillion of increased revenue and \$400 billion of increased profits from 1980 to 1990, that conclusion undoubtedly seemed justified.<sup>87</sup> The Senate Finance Committee agreed, only pausing to stress the need to “not adversely affect incentives to produce domestic oil.”<sup>88</sup> The resulting tax specifically targeted lucky profits from “large price increases on previously discovered oil resulting from phased decontrol” for high taxation<sup>89</sup> and was proclaimed to be “a far simpler approach to taxing windfall profits than an excess profits tax, such as was used during World War II.”<sup>90</sup>

As was the case with those earlier war-related excess profits taxes, this Article focuses on the oil windfall profit tax’s method for estimating lucky profits. The tax’s tax base was “windfall profits,” which it defined as the amount that the oil’s “removal price” exceeded that oil’s “adjusted base price.”<sup>91</sup> The removal

---

<sup>85</sup> *Id.* at 6, reprinted in 1980 U.S.C.C.A.N. at 594.

<sup>86</sup> *Id.* President Carter agreed, declaring that “unless we tax the oil companies, they will reap huge and undeserved windfall profits.” Energy Address to the Nation, 1 PUB. PAPERS 609, 610 (Apr. 5, 1979).

<sup>87</sup> SALVATORE LAZZARI, CONGRESSIONAL RESEARCH SERVICE, THE CRUDE OIL WINDFALL PROFIT TAX OF THE 1980S: IMPLICATIONS FOR CURRENT ENERGY POLICY 9 (2006), [http://assets.opencrs.com/rpts/RL33305\\_20060309.pdf](http://assets.opencrs.com/rpts/RL33305_20060309.pdf).

<sup>88</sup> S. REP. NO. 96–394, at 4 (1980), reprinted in 1980 U.S.C.C.A.N. 410, 417.

<sup>89</sup> *Id.* at 5, reprinted in 1980 U.S.C.C.A.N. at 417. Initially, tax rates ranged from thirty percent to seventy percent depending on the category of extracted oil and the type of oil producer doing the extracting. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96–223, sec. 101(a), § 4987, 94 Stat. 229, 230–31.

<sup>90</sup> H.R. REP. NO. 96–304, at 6, reprinted in 1980 U.S.C.C.A.N. at 594.

<sup>91</sup> Crude Oil Windfall Profit Tax Act of 1980, sec. 101(a), § 4988(a), 94 Stat. at 231. Windfall profits were adjusted for certain state-imposed severance taxes. *Id.* They were also capped at ninety percent of the “net income attributable to the [oil],” presumably to prevent the tax from inadvertently claiming almost all of the taxpayer’s profit. *Id.* sec. 101(a), § 4988(b)(1), 94 Stat. at 231.

price was the actual sales price of the unrefined oil.<sup>92</sup> The adjusted base price represented Congress's take on appropriate and "normal" profit levels from oil sales as the economy moved forward into the newly-deregulated oil market. Although the full details are beyond the scope of this Article, the adjusted base price varied by the type of oil involved and was generally tied to oil prices in 1979 at around the time that the Carter Administration began relaxing the price controls on oil.<sup>93</sup> Furthermore, it included an adjustment for inflation to reduce the likelihood that profits not derived from oil price deregulation would result in additional tax.<sup>94</sup> Consequently, the tax's windfall profits included the income from most non-inflationary oil price increases after 1979.

The oil windfall profit tax was repealed in 1988 after failing to accomplish Congress's objectives for it.<sup>95</sup> Although the tax may have recouped the lucky economic returns harvested by producers of domestic oil in the wake of oil price decontrol, those returns apparently did not last long. From 1980 to 1986, unregulated oil prices actually fell from about \$30 per barrel to only \$10 per barrel.<sup>96</sup> Oil windfall profit tax revenues followed suit. From 1980 through 1982, the tax revenues generated by the oil windfall profit tax were only somewhat more than half of Congress's projected revenues.<sup>97</sup> Beginning in 1983, tax revenues fell sharply and were

---

<sup>92</sup> *Id.* sec. 101(a), § 4988(c)(1), 94 Stat. at 232. A constructive sales price was used if the sale occurred between related parties, the oil was removed from the premises before sale, or the oil was refined onsite before its sale. *Id.* sec. 101(a), § 4988(c)(2)–(4), 94 Stat. at 232–33.

<sup>93</sup> *See id.* sec. 101(a), § 4989(a), (c), 94 Stat. at 233 (tying the base price of one category of oil—so-called Tier 1 oil—to “the ceiling price which would have applied to such oil under the March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil”). For more details on the structure of the oil windfall profit tax, see, e.g., LAZZARI, *supra* note 87, at 5–8.

<sup>94</sup> Crude Oil Windfall Profit Tax Act of 1980 sec. 101(a), § 4989(a)(2), (b), 94 Stat. at 233.

<sup>95</sup> Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100–418, § 1941(a), 102 Stat. 1107, 1322.

<sup>96</sup> Joseph J. Thorndike, *Historical Perspective: The Windfall Profit Tax – Career of a Concept*, 109 TAX NOTES 863, 864 (2005). At the same time, inflation moved the adjusted base prices upward, further eroding the tax base. *Id.*

<sup>97</sup> SALVATORE LAZZARI, CONGRESSIONAL RESEARCH SERVICE, THE WINDFALL PROFIT TAX ON CRUDE OIL: OVERVIEW OF THE ISSUES 17 (1990) (showing that actual revenues were \$3.052 billion, \$16.931 billion, and \$22.036 billion for 1980, 1981, and 1982, respectively, and that projected revenues for those years were \$5.159 billion, \$20.955 billion, and \$30.973 billion).

virtually nonexistent by 1987.<sup>98</sup> Furthermore, post-mortem review of the tax's impact on domestic oil production showed that it acted as a disincentive on domestic production and contributed to the country's growing dependence on foreign oil.<sup>99</sup> One economist estimated that the tax caused production to be between 1.2% and 4.8% less than it would have been in the tax's absence.<sup>100</sup> Finally, the tax turned out to be more complicated for the Service to administer, and for taxpayer's to comply with, than expected. In 1984, the U.S. Government Accounting Office declared it "the largest and perhaps most complex tax ever levied on a U.S. industry."<sup>101</sup> The oil industry agreed, claiming compliance costs of about \$40 million per year by 1988.<sup>102</sup>

Because the oil windfall profit tax was a targeted tax narrowly aimed at a specific situation that Congress believed would create short-term, excessive, and unearned profits, it is not clear how helpful the lessons derived from that tax's rise and fall are when evaluating the merits of this Article's luck income taxation system. Nevertheless, the tax's short-lived existence and ultimate fate suggest that (1) a workable tax on luck income could succeed under the right circumstances and is worth considering; (2) avoiding all detrimental disincentive effects from such a tax, while desirable, is probably not possible; and (3) even a facially simple tax regime aimed at luck income is likely to prove more complicated and costly to administer than anticipated.

### 3. Land Value Tax

Land value taxes ("LVTs") represent a completely different approach to taxing wealth arising from luck. Narrowly focused on real property, LVTs attempt to capture the landowner's unearned income from the land. This unearned income is purportedly produced by the land's inherent, or undeveloped, value, and is

---

<sup>98</sup> *Id.* at 14 (showing that actual revenues were \$15 million by 1987).

<sup>99</sup> Thorndike, *supra* note 96, at 864 (noting that, according to the American Petroleum Institute, the percentage of energy that the United States derived from foreign sources rose from thirty-two percent in 1983 to thirty-eight percent in 1986).

<sup>100</sup> LAZZARI, *supra* note 87, at 20.

<sup>101</sup> U.S. GENERAL ACCOUNTING OFFICE, IRS' ADMINISTRATION OF THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980, at 1 (June 18, 1984), <http://www.gao.gov/assets/150/141746.pdf>.

<sup>102</sup> Thorndike, *supra* note 96, at 864.

independent of any improvements by the landowner.<sup>103</sup> Thus, in its purest form a LVT is an ad valorem tax annually imposed on the undeveloped value of real property.<sup>104</sup> Ideally, the tax captures the undeveloped real property's annual land rent without reaching the rental value of the landowner's improvements.<sup>105</sup> Modified versions of the LVT impose a two-tier tax rate structure on the entire real property parcel.<sup>106</sup> The undeveloped land's value is taxed at a much higher rate than the rate imposed on the structures and improvements attached to that land.<sup>107</sup> Although never used widely in the United States,<sup>108</sup> LVTs once were prominent in countries like Australia, Denmark, and New

---

<sup>103</sup> Douglas W. Kmiec, *Deregulating Land Use: An Alternative Free Enterprise Development System*, 130 U. PA. L. REV. 28, 122 (1981). A recent example of this phenomenon was documented in Southwark outside London. As United Kingdom taxpayers invested £3.5 billion to build the Jubilee Line Extension to the London Underground, the property values along the extension increased by approximately £13.5 billion. The lucky landowners did not do anything to generate that windfall. But, they benefitted nonetheless. ANDY WIGHTMAN, *THE POOR HAD NO LAWYERS: WHO OWNS SCOTLAND (AND HOW THEY GOT IT)* 277 (2010).

<sup>104</sup> BLACK'S LAW DICTIONARY 1594 (9th ed. 2009) (defining an ad valorem tax as a "tax imposed proportionally on the value of something (esp. real property)").

<sup>105</sup> Murray N. Rothbard, *The Single Tax: Economic and Moral Implications and A Reply to Georgist Criticisms*, in *THE LOGIC OF ACTION ONE: APPLICATIONS AND CRITICISMS FROM THE AUSTRIAN SCHOOL* 294, 294-95 (1997).

<sup>106</sup> J. Anthony Coughlan, *Land Value Taxation and Constitutional Uniformity*, 7 GEO. MASON L. REV. 261, 262 n.6 (1999).

<sup>107</sup> Walter Rybeck, *United States*, in *LAND-VALUE TAXATION AROUND THE WORLD* 135, 166-70 (Robert V. Andelson ed., 3rd ed. 2000) (describing the contours of the two-rate taxes adopted by eighteen cities in the State of Pennsylvania).

<sup>108</sup> See, e.g., *id.* at 147-53 (reporting that a handful of "single tax enclaves" in the United States have tried to carry out Henry George's LVT vision in its purest form); Richard W. Lindholm & Roger G. Sturtevant, *American Land Tax Roots: Plus Experimentation in Oregon*, in *LAND VALUE TAXATION: THE PROGRESS AND POVERTY CENTENARY* 83 (Richard W. Lindholm & Arthur D. Lynn, Jr. eds. 1982); Sally Kwak & James Mak, *Political Economy of Property Tax Reform: Hawaii's Experiment with Split-Rate Property Taxation*, 70 AM. J. ECON. & SOC. 4, 7-13 (2011) (explaining the 1963 enactment and 1977 repeal of a modified LVT by the State of Hawaii, and the subsequent uses by the four counties in that state).

Zealand,<sup>109</sup> and are of increasing interest in others like Scotland.<sup>110</sup>

The connection between LVTs and taxation of luck income was clearly laid out by Henry George in his seminal work, *Progress and Poverty*.<sup>111</sup> George did not expressly call for taxation of luck income from land. Instead, he was concerned with unequal wealth distribution that he believed was caused by “inequality in the ownership of land.”<sup>112</sup> To address that concern, he proposed effectively “mak[ing] land common property”<sup>113</sup> by “confiscat[ing] rent” (i.e., taxation of rent using a 100 percent tax rate).<sup>114</sup> However, his policy justifications for that confiscation were decidedly luck-oriented, including his observations that the landowner’s “income . . . represents merely wealth that he takes from the general stock, returning nothing,” and that the landowner’s income comes from a “monopoly of the natural opportunities which Nature offers impartially to all, and in which [all] have as their birthright an equal share.”<sup>115</sup> So, according to George, income from undeveloped land is undeserved because it was “generated by nature or other public and private activity of the community.”<sup>116</sup> Presumably, anyone receiving such undeserved income is lucky.

---

<sup>109</sup> Coughlan, *supra* note 106, at 261 (listing other countries like Barbados, Jamaica, Kenya, South Africa, and Taiwan as well); see also Andelson, *supra* note 46, at xxxiii (summarizing the dramatic fall from grace that LVTs experienced in these three countries from 1955, when they were “advancing steadily,” to 1997, when little remains of the earlier taxes).

<sup>110</sup> WIGHTMAN, *supra* note 103, at 280–83 (noting that the Co-operative Party called for a land value tax in its manifesto for the 2010 elections and laying out the case for why a land value tax would be good for Scotland).

<sup>111</sup> HENRY GEORGE, *PROGRESS AND POVERTY* (Robert Schalkenbach Foundation 1939) (1879).

<sup>112</sup> *Id.* at 295. “[L]and is necessary to the exertion of labor in the production of wealth, to command the land which is necessary to labor, is to command all the fruits of labor save enough to enable labor to exist.” *Id.* at 294.

<sup>113</sup> *Id.* at 328.

<sup>114</sup> *Id.* at 405. George’s argument supports seizure of all rent, but he appeared to recognize that leaving the newly nominal landowners with some small amount of rent “would probably be much less than the cost and loss involved in attempting to rent lands through State agency . . . .” *Id.* In that, somewhat ironically, George was a forerunner of the modern government privatization effort.

<sup>115</sup> *Id.* at 420.

<sup>116</sup> Kmiec, *supra* note 103, at 122. George himself describes the ultimate source of this lucky income in his parable of the unbounded savannah. GEORGE, *supra* note 111,

A comprehensive analysis of the tax policy arguments for and against land value taxation that scholars have invoked in George's wake is well beyond this Article's scope.<sup>117</sup> By and large, the majority view seems to be that LVTs are economically efficient and equitable in theory, but are not necessarily easy to apply in practice.<sup>118</sup> LVTs should not distort economic decisions primarily because the limited land supply renders demand for land relatively inelastic to government disincentives like taxes and because the landowner does not create the land's undeveloped value.<sup>119</sup> However, some question whether LVTs distort the owner's behavior by creating an artificial incentive favoring building on the land to generate the revenue needed to pay the LVT.<sup>120</sup> The argument that LVTs are equitable also comes from an

---

at 235–43. Tracing the development of a major city starting with the first pioneers arriving on the savannah, George argues that the undeveloped land those pioneers choose to settle on increases in value because of the community forming around it, not because of any virtuous acts on the part of the pioneers or their heirs. *Id.* at 241–42. George was not the first to make such a claim. More than thirty years earlier, John Stuart Mill called for taxation of land values that were “natural” and not “the result of capital expended or industry exerted by the proprietor.” J. STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY*, bk. V, ch. II, §5 (William J. Ashley ed., 7th ed., Longmans, Green & Co. 1909) (1848); see also Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 *TAX L. REV.* 263, 327 n.111 (2000) (speculating whether Mill considered “exercise of speculative acumen” to be part of the proprietor’s “industry”).

<sup>117</sup> See, e.g., LAND VALUE TAXATION: THE *PROGRESS AND POVERTY* CENTENARY (Richard W. Lindholm & Arthur D. Lynn, Jr. eds., 1982) (consolidating the results from the 1978 Conference of the Committee on Taxation, Resources and Economic Development, which examined Henry George's American tax legacy 100 years after *Progress and Poverty*); Nicolaus Tideman, *The Economics of Efficient Taxes on Land*, in LAND AND TAXATION 103 (Nicolaus Tideman ed., 1994) (summarizing views on economic efficiency, fairness, revenue potential, and ethical justifications supporting land value taxation beginning with classical writers like Adam Smith and continuing through the present day); Harry Gunnison Brown, *The Ethics of Land Value Taxation*, in SELECTED ARTICLES BY HARRY GUNNISON BROWN: THE CASE FOR LAND VALUE TAXATION 3 (1980).

<sup>118</sup> Shawna P. Grosskopf & Marvin B. Johnson, *Land Value Tax Revenue Potentials: Methodology and Measurement*, in LAND VALUE TAXATION: THE *PROGRESS AND POVERTY* CENTENARY 41, 41 (Richard W. Lindholm & Arthur D. Lynn, Jr. eds., 1982) (“Economists of all postures have continued to be attracted by the efficiency and, to a lesser extent, the equity advantages of a land value tax over the more common real estate tax on land and building.”).

<sup>119</sup> Coughlan, *supra* note 106, at 264. Arguably, demand for land is unavoidable, too, and grows alongside our ever-increasing global population.

<sup>120</sup> See *id.* at 264–65 (citing scholarly articles taking each side of this debate). This potential forced development problem is similar to the talent slavery objection raised against endowment taxation, which would tax people based on their potential

understanding that the land's undeveloped value "is a function of its location and physical features and not of individual landowner effort."<sup>121</sup> Thus, unearned income from undeveloped land differs from earned income from labor or other capital investments, and that difference arguably justifies greater taxation.<sup>122</sup>

On the practical side, some aspects of LVTs are easy to administer and some are not. Obviously, locating the land to be taxed is straightforward.<sup>123</sup> Identifying the taxpayer(s) when various people own various interests in that land could be a bit more troublesome, but should not be insurmountable. Instead, the most consistent, and significant, criticisms of LVTs are the "problems of defining and measuring land value."<sup>124</sup> Anyone who owns a home knows that, unless the home was just purchased, a property tax valuation is at best a reasonable estimate of the home's fair market value and is easily disputed with the taxing authorities. For LVTs, that valuation problem is compounded because the assessor must accurately separate the unearned value generated by the undeveloped land from the earned value generated by the capital investments on that land.<sup>125</sup> Clearly,

---

regardless of whether that potential is developed into actual income. *See* Zelenak, *supra* note 13, at 1148 ("The talent slavery concern [posed by endowment taxation] is that a person who could earn a very high wage, but only by working full time at a job he despises, may be forced into that hated employment by the need to pay the tax.").

<sup>121</sup> Kmiec, *supra* note 103, at 122.

<sup>122</sup> George F. Break, *Henry George and Tax Reform – 100 Years Later*, in *LAND VALUE TAXATION: THE PROGRESS AND POVERTY CENTENARY* 129, 134–35 (Richard W. Lindholm & Arthur D. Lynn, Jr. eds., 1982) (agreeing with George's view that "equality" in this matter refers not to how much a person earns but how the income is earned and how much it is needed").

<sup>123</sup> *See* Coughlan, *supra* note 106, at 267.

<sup>124</sup> Mary Miles Teachout, *Defining and Measuring Land Value – A Progress Report*, in *LAND VALUE TAXATION: THE PROGRESS AND POVERTY CENTENARY* 69, 69 (Richard W. Lindholm & Arthur D. Lynn, Jr. eds., 1982).

<sup>125</sup> Coughlan, *supra* note 106, at 267 ("[F]or improved land, there can be a valuation problem as land, and buildings that sit on the land, are rarely sold separately."). Coughlan goes on to assert that "[t]his problem is regularly surmounted for real property held for business purposes, however, as the federal income tax allows buildings to be depreciated, but not land." *Id.* Unfortunately, that assertion is not correct. A building's depreciation is calculated using its adjusted basis when it is placed in service. I.R.C. § 167(c)(1) (2006). The building's initial adjusted basis is usually either the result of capitalized construction costs or its cost. *Id.* §§ 263A(a)(1)(B), 1012. When a taxpayer purchases more than one piece of property from another person (e.g., land and a building sitting on that land), the Service often accepts the purchase price allocation agreed to by taxpayer and the seller as the taxpayer's initial adjusted basis

these valuation difficulties raise ease of administration issues that may help explain why this form of taxing luck income has not thrived.

The taxes discussed above are not an exhaustive list of non-income taxes aimed at the economic rewards resulting from luck. Although each tax discussed uses a different tax base to roughly track the taxpayer's wealth arising from luck, together they provide some common threads that will help guide this Article's proposal to tax luck income. There is little question that the most problematic aspect of taxing luck income will be separating luck income from other income in a reasonably simple and accurate manner. Failure to do so will result in an unadministrable system whose compliance and enforcement costs quickly overwhelm any revenue-raising benefits. In addition, failure to properly isolate that income from other income will undermine any economic efficiency and equity justifications that support the taxation of luck income. With that reality firmly in mind, this Article turns to the difficult problem of defining luck income.

## II. LUCK INCOME DEFINED

For better or worse, luck appears to play an important role in the allocation of income and wealth within the United States. However, the exact extent of luck's role, and the best way to measure and tax luck income, are far from clear.<sup>126</sup> What is clear is that successful taxation of luck income turns on whether luck income can be separated from other income in a reasonably simple and accurate manner. This Part begins that separation process by examining recent philosophical and scientific scholarship regarding the nature of luck. The considerations raised in those works are then used to develop a broad definition of luck income

---

for the separate properties (e.g., the building). *See id.* § 1060(a). None of that information will help a land value tax assessor solve the problem of separating the undeveloped land from the building and determining its current fair market value for taxation.

<sup>126</sup> If the varied attempts to tax luck described in Part I of this Article demonstrate nothing else, they establish this point. Some scholars have concluded that separating luck from skill may simply be too difficult. *See* KNIGHT, *supra* note 5, at 311 (concluding that, because "[p]rofit arises out of the inherent, absolute unpredictability of things, . . . in an individual case there is no way of telling good judgment from good luck . . .").

that attempts to balance the tradeoff between accuracy and complexity.

### A. *The Nature of Luck*

At its simplest, luck is nothing more than “the fortuitous happening of events favorable or unfavorable to the interests of a person.”<sup>127</sup> Fortune, or chance, is the key to this definition. Under this traditional view, luck bestows its benefits and burdens without regard to merit or any other measure of value.<sup>128</sup> It is simply beyond control or influence. However, in recent years some philosophers and psychologists have considered luck’s role in the modern world and concluded that a more nuanced approach to the nature of luck may be warranted. These refined perspectives identify different types of luck and evaluate them using various distributive justice criteria. In some cases, certain types of luck are even viewed as something that can be improved. These latter situations call into question whether luck is truly independent of merit and, if not, how that merit should be accounted for when developing a taxation system for luck income.

Philosophers concerned with luck’s effect on distributive justice divide luck along a number of different lines.<sup>129</sup> One classification turns on whether a lucky outcome results from a lack of responsibility or a lack of desert. Responsibility luck arises when the outcome in question was not within the recipient’s control or was not the recipient’s choice.<sup>130</sup> Desert luck occurs when the outcome should not have happened to a recipient in light of the recipient’s “moral or prudential merits.”<sup>131</sup> There are

---

<sup>127</sup> 9 THE OXFORD ENGLISH DICTIONARY 82 (2d ed. 1989).

<sup>128</sup> Alternatively, luck is “success, prosperity or advantage coming by chance rather than as the consequence of merit or effort.” *Id.* at 82.

<sup>129</sup> For a more comprehensive summary of the various different types of luck mentioned in this Article, see Kasper Lippert-Rasmussen, *Justice and Bad Luck*, in *THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY* (Aug. 19, 2009), <http://plato.stanford.edu/archives/fall2009/entries/justice-bad-luck/> (last visited Oct. 22, 2013).

<sup>130</sup> *Id.* Technically, this type of luck is “thick responsibility luck.” The “thick” label and its counterpart, “thin,” differ in that thin luck does not identify a particular means of determining responsibility (e.g., control or choice) and thick luck does. *Id.* Thin luck is ignored in this Article because its lack of a specific standard makes it of little use when trying to separate luck income from other types of income.

<sup>131</sup> *Id.*

relative and absolute strains of desert luck depending on whether the recipient's merits are considered in the abstract or compared to other potential recipients of the lucky outcome.

The responsibility luck and desert luck definitions share a common theme—lucky outcomes are those not tied to merit. For responsibility luck, the connection between merit and outcome is typically a direct, causal one between the outcome and the recipient. Lucky outcomes are not within a recipient's power to control or choose. Non-lucky outcomes are. For desert luck, the merit-outcome connection is a bit more tenuous, but still present. Here, the recipient's general merit matters, regardless of whether a direct, causal connection between the recipient and the specific outcome in question exists. Thus, both these luck definitions are consistent with the traditional view of luck as something divorced from merit.

Philosophers interested in the luck egalitarianism framework for distributive justice often use a second, somewhat similar, luck classification system. For luck egalitarians, luck is either option luck or brute luck. Ronald Dworkin defined option luck as “a matter of how deliberate and calculated gambles turn out—whether someone gains or losses through accepting an isolated risk he or she should have anticipated and might have declined.”<sup>132</sup> Conversely, brute luck is “a matter of how risks fall out that are not in that sense deliberate gambles.”<sup>133</sup> In both cases, how the gamble actually turns out is a matter of random chance. The difference lies in whether that gamble could have been anticipated and avoided.

---

<sup>132</sup> Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283, 293 (1981).

<sup>133</sup> *Id.*

| Type of Luck                      | Definition  |
|-----------------------------------|---|
| Responsibility Luck               | Lucky outcomes are not within the recipient's control or are not chosen by the recipient.   |
| Control-based Responsibility Luck | Lucky outcomes are not within the recipient's control.  |
| Choice-based Responsibility Luck  | Lucky outcomes are not chosen by the recipient.   |
| Desert Luck                       | Lucky outcomes are not consistent with the recipient's overall moral or prudential merit.   |
| Option Luck                       | Lucky outcomes are from deliberate and calculated gambles that the recipient chose or could have avoided.   |
| Brute Luck                        | Lucky outcomes are from unchosen and unavoidable gambles.   |
| Luck Income                       | Economic outcomes (1) that the recipient cannot control and (2) either (i) that the recipient did not choose or (ii) that are "zero-sum" in nature. |

Because the option/brute luck distinction turns on whether the outcome in question is the result of the recipient's deliberate and calculated choice, they are perhaps best considered in relation to responsibility luck. Focusing first on control-based responsibility luck, both option luck and brute luck are in the "luck" bucket because each involves the presence of random chance that places the ultimate outcome outside the recipient's control. Option luck's calculated decision to accept the risk associated with that chance does not equate to control over the outcome. It merely means the recipient could choose to gamble.

Option luck and brute luck are classified differently under the choice-based version of responsibility luck. Here, brute luck

remains solidly in the “luck” bucket because, by definition, the recipient did not choose the outcome. However, option luck is not “luck.” The option luck recipient chooses a particular gamble hoping to achieve a favorable outcome. Although option luck acknowledges that random chance can intervene between choice and outcome, the recipient still chose to pursue the outcome.

When available, insurance and other risk-shifting arrangements further complicate matters by blurring the boundary between option luck and brute luck.<sup>134</sup> Insurance can protect its purchaser from negative outcomes resulting from random chance. Therefore, the decision whether or not to purchase available insurance against a bad outcome effectively transforms what would be a brute luck outcome into an option luck result. By choosing not to purchase the insurance, the recipient of the bad outcome effectively chooses exposure to the risk of loss. For that reason, relying on choice alone as a criterion for identifying luck would be unwise—at least when it comes to bad luck.

Psychologists have also contributed to the recent literature on luck. Richard Wiseman, a British psychologist, spent a number of years conducting scientific studies aimed at uncovering why some people “appear to . . . enjoy more than their fair share of lucky breaks” and others do not.<sup>135</sup> According to Wiseman, once one moves past situations like the lottery where random chance dictates the outcome, luck depends on four main principles.<sup>136</sup> Those principles are: (1) “[l]ucky people create, notice, and act upon the chance opportunities in their lives,”<sup>137</sup> (2) “[l]ucky people make successful decisions by using their intuition and gut feelings,”<sup>138</sup> (3) “[l]ucky people’s expectations about the future help them fulfill their dreams and ambitions,”<sup>139</sup> and (4) “[l]ucky people are able to transform their bad luck into good fortune” by focusing on the silver linings attached to their bad luck.<sup>140</sup> As should be obvious from the latter two principles, which have more to do with

---

<sup>134</sup> See *id.* at 293–94.

<sup>135</sup> WISEMAN, *supra* note 2, at xiii.

<sup>136</sup> *Id.* at 26.

<sup>137</sup> *Id.* at 31.

<sup>138</sup> *Id.* at 63.

<sup>139</sup> *Id.* at 89.

<sup>140</sup> *Id.* at 128.

how people relate to outcomes than their ability to manufacture or capitalize on chance opportunities, Wiseman's definition of luck extends well beyond the traditional interplay between fortune, or chance, and outcomes. Thus, much of his work is not germane for the analysis in this Article and will not be considered further.

But the portion of his work that explores the relationship between luck and merit is relevant. Wiseman claims that each principle is connected to a known psychological mechanism and can be improved through practice, thereby improving a person's luck.<sup>141</sup> That suggests that apparent lucky outcomes may actually be the result of meritorious behavior by the lucky recipients, at least in part. For example, Wiseman's first principle is that "[l]ucky people create, notice, and act upon the chance opportunities in their lives."<sup>142</sup> This principle's underlying psychological dimensions are high extroversion, low neuroticism, and high openness to new experiences.<sup>143</sup> While each person presumably inherits and unconsciously develops some tendencies along each of these lines, conscious attempts to be more relaxed, receptive to new ideas, etc. can improve that person's odds of getting lucky.<sup>144</sup> In short, lucky people have a greater chance of winning a lottery than other people, not because random chance is stacked in their favor, but because they find more lotteries to enter, buy more tickets, and never forget to check their numbers. And everyone else can do the same.<sup>145</sup>

Wiseman's work on the psychology of luck dovetails nicely with the philosophical constructs outlined above and strengthens those constructs by fleshing out their underlying psychological

---

<sup>141</sup> *Id.* at 26.

<sup>142</sup> *Id.* at 31.

<sup>143</sup> *Id.* at 33–34, 41, 50. Others have found connections between these personality traits and "beliefs in being lucky and being unlucky" while noting that "there is evidence to suggest that belief in good luck may extend beyond a positive illusion and represent more realistic expectations and ambitions." John Maltby et al., *Beliefs Around Luck: Confirming the Empirical Conceptualization of Beliefs Around Luck and the Development of the Darke and Freedman Beliefs Around Luck Scale*, 45 *PERSONALITY & INDIVIDUAL DIFFERENCES* 655, 655, 659 (2008).

<sup>144</sup> WISEMAN, *supra* note 2, at 57–62.

<sup>145</sup> The second of Dr. Wiseman's principles—"lucky people make successful decisions by using their intuition and gut feelings"—can also be improved through conscious efforts aimed at boosting one's intuition. *Id.* at 63, 79–80. Examples include meditation and being more contemplative. *Id.* at 79.

support. Arguably, his lucky people are simply taking steps to maximize their option luck by choosing to expose themselves to more chance opportunities. As with other option luck recipients, they are not actually lucky when viewed from a choice-based responsibility luck perspective because they actively seek out the outcomes they receive. While Wiseman's work suggests that his lucky people have some control over their luck, their control only extends to the point where random chance begins.<sup>146</sup> So, his lucky people are still lucky from a control-based responsibility luck perspective because, in the end, they still cannot control whether their gambles succeed.

Philosophers and psychologists studying the nature of luck have identified and explored several ways to think about luck that go beyond the traditional view of luck as merely the product of random chance. Choice, control, merit, and desert all play a part. While none of the resulting luck classifications identified above is, in and of itself, a workable system for identifying luck income, the factors considered are useful building blocks.

### *B. Luck Income*

As the preceding discussion demonstrates, luck is a multifaceted concept that defies easy definition. Nevertheless, if luck income is to be successfully taxed, a reasonably simple and accurate means of isolating and measuring luck income is essential. With that goal in mind, this Article employs the philosophical and psychological considerations explored above to build a manageable luck income framework that balances opposing accuracy and complexity concerns.

Some philosophers argue that lucky outcomes result from the recipient's lack of responsibility or lack of desert. Thus, responsibility and desert illustrate two broad considerations that may be useful when trying to identify luck income. However, only responsibility luck warrants further consideration in this Article. While desert luck's focus on the recipient's overall merit may have some equitable appeal, such a taxpayer-level analysis is not well suited for determining whether a particular income item is luck income. A luck-taxation system built around desert luck would

---

<sup>146</sup> *Id.* at 26.

presumably require the taxing authority to assess every taxpayer's relative "moral or prudential merit" before comparing that determination with the taxpayer's relative income to identify situations where relative income exceeded relative merit. Realistically, such a system would be utterly unworkable.<sup>147</sup>

Responsibility luck has more potential as a viable luck income standard. Its use of direct, causal connections between the recipient and the outcome to establish merit, and therefore separate lucky outcomes from other outcomes, fits well with the existing federal income tax system's transaction-based structure. Just as each transaction can create items of income or deduction, that transaction's characteristics (e.g., whether it was under the taxpayer's control) could classify those items as part of luck income or not. While responsibility luck's control-based and choice-based criteria for identifying luck may not be sufficient on their own, they are a starting place for defining luck income.

The luck egalitarians' option/brute luck division can be used to build on that starting point. While unchosen and uncontrollable brute luck adds little to the discussion because it should be included in luck income under any standard, option luck is another story. In light of option luck's different classification under the two responsibility luck definitions, the option luck scenario where choice and chance play a role will challenge any taxation system that uses responsibility luck as its touchstone while seeking to differentially tax luck income. Unfortunately, life is awash with option luck scenarios. The decision to invest in a particular stock through a secondary market, such as the New York Stock Exchange or the NASDAQ, and the decision to purchase a lottery ticket are two everyday examples. In each case, the acquirer chooses to undertake an investment gamble and, if

---

<sup>147</sup> The fights over what constitutes "moral or prudential merit," alone, would be legendary. The impossibility of accurately and fairly carrying out such a comprehensive evaluation of taxpayers has damned other possible tax systems like endowment taxation. See DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 156 (1986) (passing on endowment taxation because, while "[w]hat one might like to have is a tax based on an individual's potential earnings," those "earnings, or more generally the quality of a person's opportunities, cannot be observed directly") In some ways, endowment taxation should be easier to deal with than desert luck because there is some general agreement over how to keep score.

chance favors him, reaps the rewards.<sup>148</sup> Under a control-based responsibility luck tax system, both would be luck income. Under a choice-based responsibility luck tax system, neither would. Such uncertainty is undesirable in a tax system. For that reason, the option luck scenario makes clear that workable luck income guidelines must clarify whether choice, control, or some combination of the two is required to avoid the luck income classification.

Control-based responsibility luck makes sense as the starting point for building a luck income framework because the boundary between lack of control and control is a reasonable outer limit for luck income. Using that division as a first-level test for luck income is consistent with most of the philosophical and psychological perspectives on the nature of luck discussed above. Under the traditional view of luck as the fortuitous receipt of an undeserved good or bad outcome, control over whether an outcome occurs should be enough to remove that outcome from the recipient's luck income. Similarly, luck egalitarians would exclude any outcome that can be controlled from either brute luck or option luck. Richard Wiseman would agree.

In fact, the only responsibility luck regime that would call an outcome lucky despite the recipient's ability to control the outcome

---

<sup>148</sup> The gamble represented by the lottery ticket is obvious because the lottery winner is selected randomly through games of chance (e.g., numbered balls bouncing into a tube). While lottery participants can decide whether to enter the lottery, and even pick their "lucky" numbers, they have absolutely no control over which combination of numbers will win. Similarly, investments in publicly-traded stocks on the secondary market are chosen gambles whose outcomes cannot be controlled by the stock purchaser. The purchaser has no control over how, or whether, the companies invested in will perform. And, assuming no insider trading, the stock purchaser lacks knowledge about the stock that would allow the purchaser to acquire the stock for less than its actual market value. See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 24 (8th ed. 2003) ("A random walk is one in which future steps or directions cannot be predicted on the basis of past actions. . . . On Wall Street, the term 'random walk' is an obscenity. . . . Taken to its logical extreme, it means that a blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by the experts."); see also DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* 212–16 (2011) (establishing the illusion of stock-picking skill by reviewing studies showing that stocks sold by amateur stock traders to buy new stocks typically outperform the new stocks and noting that "the evidence from more than fifty years of research is conclusive: for a large majority of fund managers, the selection of stocks is more like rolling dice than like playing poker").

is choice-based responsibility luck. Such a result would arise when the recipient did not choose an outcome that was within the recipient's power to control. While that scenario is easy to logically articulate, generating real-world situations where it would actually exist is more difficult because, arguably, the presence of control leads to choice if for no other reason than choosing not to exercise control is still making a choice.<sup>149</sup> In the unlikely event that the ability to control an outcome goes unexercised because the outcome's recipient was unaware that such control was possible, the unknown control is practically and effectively nonexistent. Thus, using the boundary between lack of control and control as a first-level test for luck income is even roughly consistent with choice-based responsibility luck. Because lack of control is such a widely-accepted luck component, only outcomes that are beyond the recipient's control will be included in luck income.

The next step in developing a manageable luck income framework is deciding whether to introduce any other criteria beyond a lack of control. Given the important role choice plays in responsibility luck, the obvious choice would be to further restrict luck income to outcomes that are also not chosen. In effect, such a blanket restriction would limit luck income to brute luck. While there is little question that brute luck should be included in luck income, it is not clear that tightly limiting luck income to exclude all option luck is desirable. To the extent that consideration of other factors beyond choice (and control) is useful, incorporating—but not absolutely requiring—an absence of choice makes sense.

Another concern with limiting luck income to unchosen brute luck is the impact that wide-spread availability of insurance and other risk-shifting arrangements could have on the luck income framework. As noted above, these types of arrangements may transform unchosen brute luck outcomes into option luck ones by providing protection from uncontrollable negative outcomes. The ability to decide whether or not to risk a bad outcome would exclude that outcome from luck income under a luck income framework that requires an absence of choice. Furthermore,

---

<sup>149</sup> Even choice by apathetic failure to exercise control is still a choice. That reality strongly suggests that unchosen outcomes may be almost completely a subset of uncontrolled outcomes.

hinging luck income's scope on a determination about the availability of insurance would interject an unacceptable level of uncertainty by blurring the boundary between luck income and other income. For those reasons, requiring an absence of choice as a criterion for identifying luck income would be unwise—at least when it comes to bad luck. Because a luck income framework employing different criteria for identifying good and bad luck should be avoided as unduly complex, requiring an absence of choice for luck income should be avoided. While including some types of option luck within the luck income framework does not completely eliminate this blurring problem, it does alleviate the resulting uncertainty a bit by decreasing the absolute importance of choice within that framework. Consequently, the fact that a recipient neither chose nor controlled an outcome will be sufficient for the outcome to be luck income. But that combination will not be required.

In this Article, outcomes that are uncontrolled and economically “zero-sum” in nature will also be classified as luck income. Uncontrolled outcomes that are “zero-sum” do not change society's absolute economic wealth; they simply reallocate resources among society's members. In contrast, uncontrolled outcomes that are economically productive positively affect society as a whole.<sup>150</sup> From a societal merit perspective, merely “zero-sum” outcomes have little or no merit when compared to productive outcomes. Society has little reason to encourage such “zero-sum” outcomes. That is particularly true when the outcome's positively-impacted recipient lacks personal merit.

As noted above, personal merit and luck are intertwined. The concept of merit is central to the traditional view of luck. It also underlies desert luck and both flavors of responsibility luck in the philosophy literature. In each instance, outcomes resulting from the recipient's merit are less likely to be viewed as lucky. Accordingly, it makes sense to consider personal merit when evaluating when and how to incorporate an additional luck income factor, like the “zero-sum” nature of the outcome, into the framework.

---

<sup>150</sup> The reverse is true for destructive uncontrolled outcomes (i.e., non-“zero-sum” bad luck).

In a responsibility luck regime, a recipient's personal merit should depend on choice and control. Presumably, that merit is highest when the recipient chooses and controls the outcome and lowest when neither element is present.<sup>151</sup> In between are scenarios where only one is present. The same reasoning that supports using control-based responsibility luck as an outer boundary for luck income justifies assigning greater personal merit to recipients who control outcomes relative to those who merely choose them.<sup>152</sup> Therefore, if a meaningful "zero-sum" factor is added to this Article's luck income framework, at minimum that factor should reclassify "zero-sum," uncontrolled, chosen outcomes.<sup>153</sup> These conclusions are depicted in Figure 1.

|         |     | Control?  |   |
|---------|-----|---|---|
|         |     | No  | Yes   |
| Choice? | Yes | <b>Control-Based Responsibility Luck</b><br>(Medium-Low Personal Merit)           | <b>Not Responsibility Luck</b><br>(High Personal Merit)                 |
|         | No  | <b>Choice-Based and Control-Based Responsibility Luck</b><br>(Low Personal Merit) | <b>Choice-Based Responsibility Luck</b><br>(Medium-High Personal Merit) |

|   |  |
|---|--|
|  All Included in Luck Income |  Only "Zero-Sum" Portion Included |
|---|--|

**Figure 1: Responsibility Luck and Personal Merit**

Going further does not make sense. As discussed above, control-based responsibility luck is the outer boundary for this

<sup>151</sup> Under this Article's luck income framework, regardless of whether the outcome was "zero-sum" or not, the latter outcome would be luck income and the former would not.

<sup>152</sup> See *supra* note 149 and accompanying text.

<sup>153</sup> Outcomes that are uncontrolled and unchosen will not be meaningfully affected by adding a "zero-sum" factor because their classification as luck income would not change.

Article's luck income framework.<sup>154</sup> "Zero-sum," controlled outcomes, whether chosen or not, would lie outside that boundary. Although obviously a matter of judgment, not extending the framework to include those outcomes seems to strike the right balance between the outcome recipient's personal merit and the overall societal value assigned to the outcome. While it is true that from a societal perspective the "zero-sum" outcome has little or no merit, the recipient's relatively high personal merit makes up for that deficiency and makes labeling the outcome "lucky" a bit of a reach. In short, the recipient's personal merit justifies excluding "zero-sum," controlled outcomes from the luck income framework.

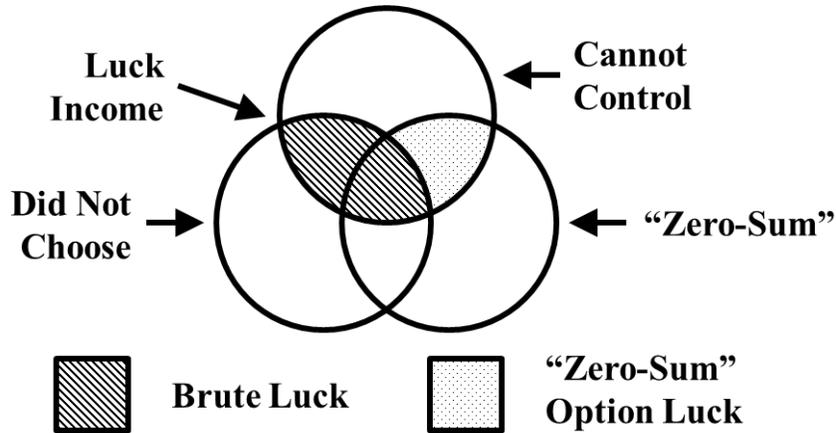
From a structural perspective, adding "zero-sum," uncontrolled, chosen outcomes to the luck income framework also has the virtue of avoiding some obvious boundary problems involving choice that would result in unneeded administrative complexity. Consider the situation where a person finds money lying on the ground. If the framework limits luck income to uncontrolled, unchosen outcomes, then a person who was actively looking for money on the ground would not have luck income because the outcome was chosen; whereas, a person who just happened upon the money would have luck income. Practically speaking, distinguishing between these two people is not easy. A broader luck income definition that includes "zero-sum," uncontrolled, chosen outcomes eliminates the need to do so by including both outcomes within luck income. As with the insurance-created blurring problem discussed above, decreasing the importance of choice within the luck income framework for situations like the found money scenario improves that framework by making it simpler to administer.

Taken together, the criteria gleaned from the above examination of the nature of luck create a broad luck income framework that can be used to identify luck income for taxation. Under the resulting framework, luck income encompasses outcomes (1) that the recipient cannot control and (2) either (i) that the recipient did not chose or (ii) that are "zero-sum" in

---

<sup>154</sup> See *supra* note 149 and accompanying text.

nature. Figure 2 below contains a Venn diagram depiction of luck income under this Article's framework:<sup>155</sup>



**Figure 2: Luck Income Framework**

The areas inside the circles represent outcomes meeting their respective criteria (e.g., the outcomes inside the circle labeled “Cannot Control” are those that the recipient cannot control). The shaded areas represent luck income. Translating that shaded area into luck egalitarian terms, the area shaded with diagonal lines is brute luck because it represents outcomes that the recipient did not choose and cannot control. The dotted area is “zero-sum” option luck because it covers the remainder of the area common to “Cannot Control” and “Zero-Sum.” So, for this Article, luck income consists of brute luck and “zero-sum” option luck.

Successful taxation of luck income turns on whether luck income can be separated from other income in a reasonably simple and accurate manner. This Article's broad luck income framework attempts to do just that by balancing the tradeoff between accuracy and complexity. But those are not necessarily the only relevant considerations. In the next part, more general tax policy

<sup>155</sup> Figure 2 is intended for illustrative purposes only. The relative size and position of each circle is not meant to represent reality. *See supra* note 149.

considerations are used to evaluate whether singling out luck income for special tax treatment is desirable.

### III. TAX POLICY CONSIDERATIONS

Specially taxing luck income may not be desirable, even if it is possible to do. When evaluating the merit of a particular tax provision or a broader tax system, legal scholars and policymakers typically focus on a few key principles. These core tax policy principles are economic efficiency, equity/distributive justice, and complexity/ease of administration.<sup>156</sup> When applied to the luck income framework developed in Part II, these tax policy principles generally support increased taxation of luck income. However, that support is qualified. Analysis of economic efficiency and distributive justice considerations points toward characterizing luck income separately and imposing higher tax rates on it. The final policy consideration—avoiding taxation complexity and keeping the tax system easy to administer—points in the other direction. That split decision is not surprising given the historical track record of previous attempts at taxing luck.<sup>157</sup> As with those earlier attempts, this Article's proposed special tax treatment of luck income must balance the hoped-for economic efficiency and equity gains with countervailing complexity costs. The analysis in this Part suggests that that balancing act is worthwhile.

#### A. *Economic Efficiency*

The economic efficiency principle focuses on the interaction between the proposed taxation approach and taxpayers' economic decisions.<sup>158</sup> From a tax policy perspective, a tax that raises revenue without distorting those decisions is economically efficient because the tax does not create deadweight loss by interfering with taxpayers' personal wealth-maximizing

---

<sup>156</sup> MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 28 (6th ed. 2009). These three criteria figured heavily in the policy discussion surrounding the historical attempts to tax luck discussed in Part I.B above. *See supra* notes 76–82 and accompanying text.

<sup>157</sup> *See supra* Part I.B.

<sup>158</sup> GRAETZ & SCHENK, *supra* note 156, at 29. Economic resources wasted on an inefficient, overly complex tax system are generally considered under the simplification/ease of administration tax policy factor. *See infra* Part III.C.

decisions.<sup>159</sup> In practice, that means taxing activities that taxpayers will undertake regardless of whether they are subjected to the tax in question. The demand for such activities is perfectly inelastic because the increased tax cost does not contract taxpayer demand for the activity. By comparison, imposing a high tax on an elastic activity<sup>160</sup>—one whose demand does significantly contract with increased taxation—will almost certainly result in the taxpayer altering or ceasing her behavior. Thus, from an economic efficiency perspective, the desirability of taxing luck income depends in large part on the inelasticity of the activities that generate luck income.

### 1. The Inelasticity of Luck

Activities that are inelastic with respect to taxes share several characteristics. First, the tax levied on the activity cannot be so great that it effectively destroys the activity's after-tax economic benefit. Second, the activity cannot have any close substitutes that are more favorably taxed than the activity, because taxpayers will simply gravitate from the activity to the more lightly taxed substitute. Finally, the activity cannot be readily movable beyond the reach of the taxing authority because, while the tax will not erode demand for the activity itself, high mobility will erode the tax's effectiveness by enabling a lower-taxed foreign substitute.

Luck's inelasticity is not uniform. The activities producing outcomes described in this Article's luck income framework are divisible into two categories. The first category is activities where the taxpayer neither chooses nor controls the activity's outcome (i.e., brute luck outcomes). When an outcome simply happens to a taxpayer, that outcome is not the product of taxpayer demand.

---

<sup>159</sup> Here deadweight loss is the total change in welfare resulting from the potentially behavior-distorting tax and equals the negative taxpayer surplus offset by the increased tax revenue claimed by the government. ROBERT S. PINDYCK & DANIEL L. RUBINFELD, *MICROECONOMICS* 335–39 (7th ed. 2009).

<sup>160</sup> Technically speaking, there is no such thing as an elastic or inelastic activity. Only supply and demand can be elastic or inelastic. DANIEL H. COLE & PETER Z. GROSSMAN, *PRINCIPLES OF LAW & ECONOMICS* 8 (2d ed. 2011). Nevertheless, for ease of expression, this Article uses the phrase “elastic activities” to refer to activities whose demand responds strongly to changes in taxation and the phrase “inelastic activities” to refer to activities whose demand is relatively insensitive to changes in taxation.

Indeed, meaningful demand for a particular outcome cannot really exist without the ability to choose, or even control, that outcome. As a result, these brute luck activities are almost by definition inelastic because there is no taxpayer demand for the tax to adversely affect. Concerns about excessive taxation and low-tax substitutes—domestic or foreign—are simply not relevant in this case because these activities will continue to occur with or without additional taxation.

The second category of luck income activities is not so easily dealt with. This category consists of activities where the taxpayer chooses a “zero-sum” outcome that is beyond the taxpayer’s ability to control (i.e., “zero-sum” option luck outcomes). Because these outcomes are chosen, taxpayer demand for them exists and can be diminished by increased taxation. A tax that captures too much of the pre-tax economic benefits of these “zero-sum” option luck activities will eventually quash demand for them and shift taxpayer activity elsewhere. In other words, activities in this category of luck income are not perfectly inelastic.

But these activities may not be all that elastic to luck income taxation, either. While it is not possible to address every activity within this category, there is reason to believe that most should be relatively inelastic. Many of the close substitutes for these chosen, uncontrolled, “zero-sum” activities will also be luck income under this Article’s framework. With respect to those substitutes, the proposed tax treatment should not affect taxpayer decisions because it is a constant in the decision-making process. Furthermore, the fact that many types of luck income (e.g., lottery winnings) require relatively small investment, and yield unusually high returns on that investment, should also reduce the proposed tax treatment’s impact on their attractiveness so long as that treatment does not completely destroy the activities’ after-tax economic benefits.

Nevertheless, the proposed tax treatment would have some effect on choices between activities in this second category and substitutes that note luck income (i.e., that are either controlled or economically productive, or both). That elasticity means that the proposed luck income tax treatment is not completely economically efficient, and understanding the magnitude of that elasticity is important. Recently, noted economists Peter Diamond

and Emmanuel Saez summarized empirical work estimating the elasticity of top incomes with respect to the highest marginal income tax rate.<sup>161</sup> The studies they reviewed used “reported income,” which is typically either adjusted gross income or taxable income and which includes income resulting from labor, capital, luck, and any other possible source.<sup>162</sup> According to Diamond and Saez, “[a] number of studies have shown large and quick responses of reported incomes along the tax avoidance margin at the top of the [income] distribution, but no compelling study to date has shown substantial responses along the real economic responses margin among top earners.”<sup>163</sup> They concluded that an elasticity of 0.25 is a “mid-range estimate from the empirical literature” for top income earners.<sup>164</sup> At that relatively weak elasticity level, a one percent increase in the “net-of-tax rate” (i.e.,  $1 - \text{tax rate}$ ) should generate a 0.25% increase in reported income.<sup>165</sup> While others have challenged that estimate as too low for high-income individuals, even Diamond’s and Saez’s critics concede that tax rate elasticity should be lower still for low-income individuals.<sup>166</sup> In short, when it comes to “labor supply, business creation, or savings decisions,” most taxpayer behavior is not really all that sensitive to tax rates.<sup>167</sup> Given that luck income is beyond taxpayer control, and not necessarily focused on high-

---

<sup>161</sup> Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165 (2011).

<sup>162</sup> *Id.* at 172.

<sup>163</sup> *Id.* “[R]eal economic responses” are “labor supply, business creation, [and] savings decisions.” *Id.*

<sup>164</sup> *Id.* at 171. This elasticity estimate comes from a recent literature review by Saez and two other economists. Emmanuel Saez, Joel Slemrod & Seth H. Giertz, *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LITERATURE 3, 42 (2012). Saez and his coauthors concluded that, “[w]hile there are no truly convincing estimates of the long-run elasticity, the best available estimates range from 0.12 to 0.40.” *Id.* The midpoint of that range is roughly 0.25. *Id.*

<sup>165</sup> See Diamond & Saez, *supra* note 161, at 169. An increase in the “net-of-tax rate” corresponds to a decrease in the marginal tax rate (e.g., a marginal tax rate decrease from 40% to 35% results in a “net-of-tax rate” increase from 60% to 65%). Thus, increasing marginal tax rates do exert some downward pressure on reported income.

<sup>166</sup> Aparna Mathur et al., *Should the Top Marginal Income Tax Rate Be 73 Percent?*, 137 TAX NOTES 905, 910–12 (2012). Consistent with that conclusion, Saez and his coauthors reported results from studies finding that taxpayers who claim itemized deductions had an elasticity of 0.65 while non-itemizers’ elasticity was “negative and insignificant.” Saez, Slemrod & Giertz, *supra* note 164, at 39.

<sup>167</sup> Diamond & Saez, *supra* note 161, at 172.

income individuals, it seems reasonable to assume that taxpayer elasticity for luck income activities, and the resulting behavioral distortions, should be fairly small (i.e.,  $\leq 0.25$ ).

Even a fairly small inefficiency is too great if the distortion's cost outweighs the accompanying benefits. While the resulting inefficiency may be justifiable based on other tax policy considerations involving relative merit and fairness,<sup>168</sup> its presence does indicate that setting the tax rate on luck income at an appropriate level to avoid excessive undesirable effects on taxpayer behavior is important. In short, an optimal income tax rate is desirable.

## 2. Optimal Income Tax Theory

Ever since James Mirrlees's seminal exploration of optimal income tax theory in 1971,<sup>169</sup> academic economists have worked to develop his theory into a useful tool.<sup>170</sup> The result is a collection of economic models designed to raise the tax revenue needed for government through an income tax system that maximizes the modeler's chosen social welfare function.<sup>171</sup> Beginning with Mirrlees, modelers have preferred a utilitarian approach that seeks to maximize the collective utility of all individuals in the society and that generally assumes greater social welfare when resources are more evenly distributed within that society.<sup>172</sup> Of course, Mirrlees and his followers recognized that the resulting "redistributive taxes and transfers [could] negatively affect incentives to work, save, and earn income in the first place."<sup>173</sup> Their optimal income tax models factored in these negative behavioral effects and only tolerated the resulting economic

---

<sup>168</sup> See *infra* Part III.B.

<sup>169</sup> J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971).

<sup>170</sup> Emmanuel Saez, *Using Elasticities to Derive Optimal Income Tax Rates*, 68 REV. ECON. STUD. 205, 205 (2001).

<sup>171</sup> Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157, 159 (2003); Diamond & Saez, *supra* note 161, at 165.

<sup>172</sup> Mankiw, *supra* note 5, at 290–91. The generally-accepted diminishing marginal utility of resources provides theoretical support for the view that redistributive transfer from resource-rich to resource-poor members of society increase overall utility.

<sup>173</sup> Diamond & Saez, *supra* note 161, at 165.

distortions when the other benefits of the taxes that lead to those distortions justified them. Perhaps not surprisingly, optimal income tax models that assumed that a taxpayer's innate ability and effort were the only factors contributing to the taxpayer's income pointed to the conclusion that low marginal tax rates were appropriate for high income earners.<sup>174</sup> In fact, in the extreme case of the top income earner, the models show that a marginal tax rate of zero percent is best.<sup>175</sup>

When randomness (i.e., luck) is added to the model as an income-level driver alongside ability and effort, the results change and the models indicate that high marginal tax rates on top income earners are desirable.<sup>176</sup> Imposing such rates on top incomes that, at least in part, result from random events effectively institutes a system of social insurance to smooth out the effects of good or bad luck.<sup>177</sup> In the extreme case where all income inequality results purely from luck, all income above the mean income could be efficiently recaptured through taxation without deterring taxpayers' efforts.<sup>178</sup> While the extreme case is not common, it reflects the fact that, "if the only way to become a millionaire is to be lucky, there should be very small incentive losses from taxing a million dollar income at a high rate."<sup>179</sup> In addition, the tax collected can be disbursed in a manner that effectively insures other members of society against "million dollar occurrences of bad luck."<sup>180</sup>

Unfortunately, income-level variations in the real world usually arise because of a mixture of taxpayer ability, effort, and

---

<sup>174</sup> Varian, *supra* note 3.

<sup>175</sup> MATTI TUOMALA, OPTIMAL INCOME TAX AND REDISTRIBUTION 6 (1990). Intuitively, that result makes sense because the marginal tax rate applied to the next dollar earned by the top income earner will not actually raise any tax revenue because no taxpayer makes that much income, but it could act as a behavioral deterrent when the top income earner considers whether to earn another dollar. *Id.* at 7. However, because the zero percent marginal tax rate would only apply to the very top income earner, it is of limited practical use and is not widely considered in tax policy decisions. *Id.* at 7–8; Diamond & Saez, *supra* note 161, at 173.

<sup>176</sup> Hal R. Varian, *Redistributive Taxation as Social Insurance*, 14 J. PUB. ECON. 49, 55, 57 (1980).

<sup>177</sup> *Id.* at 51.

<sup>178</sup> TUOMALA, *supra* note 175, at 15.

<sup>179</sup> Varian, *supra* note 176, at 63.

<sup>180</sup> *Id.*

luck, and the relative contributions of those three factors can be difficult to measure.<sup>181</sup> Although that reality makes an optimal income tax analysis more difficult, numerical modeling suggests that a progressive marginal tax scheme is best.<sup>182</sup> Those models do not, however, provide a single optimal tax rate for luck income.<sup>183</sup> So what does optimal income tax theory add to this discussion of whether and how to tax luck income? Merely that taxing luck income can be efficient to the extent that such income can be effectively isolated, and that, generally speaking, higher tax rates are sensible for luck income.

In short, economic efficiency tax policy considerations support separately characterizing luck income and imposing higher tax rates on it because that tax system can be expected not to significantly distort taxpayers' economic decision making. Some types of luck income are perfectly inelastic with respect to taxation because they are neither controlled nor chosen by the taxpayer. Heavily taxing that portion of luck income should not affect taxpayer behavior and can contribute to the social insurance benefit found in the optimal income tax models. Although disincentive effects may be a problem for the remaining types of luck income, which are chosen and "zero-sum," recent empirical studies suggest that even here undesirable behavioral distortions may be relatively small for most taxpayers. That result seems particularly likely because the taxpayers in question have no control over whether their efforts lead to success. So, while this latter type of luck income is not perfectly tax inelastic, that fact should not preclude subjecting it to the higher tax rates generated by the optimal income tax models that account for income randomness. For these reasons, specially taxing luck income at a high tax rate is desirable from an economic efficiency perspective.

---

<sup>181</sup> TUOMALA, *supra* note 175, at 137.

<sup>182</sup> *Id.* at 156–57.

<sup>183</sup> Varian, *supra* note 176, at 66.

### B. Distributive Justice Considerations

Income taxes are one part of a tax-and-transfer system through which the federal government redistributes economic benefits and burdens among members of society.<sup>184</sup> It goes without saying that whether, and how, that redistribution should be carried out is politically sensitive and involves deeply-held beliefs.<sup>185</sup> Distributive justice considerations provide a framework for assessing whether the income tax system's contribution to society's distribution of economic benefits and burdens is fair or equitable. Generally, discussions about distributive justice and income taxation revolve around identifying the appropriate basis (or bases) that should be used to distribute the tax's economic burden throughout society. While an exhaustive treatment of the distributive justice considerations explored in the philosophy literature would be a herculean effort that is clearly beyond the scope of this Article,<sup>186</sup> a survey of the most relevant tax-specific considerations and their application to this Article's luck income framework is manageable. The overall results are somewhat mixed. But, the most relevant considerations support characterizing luck income separately and imposing higher tax rates on it.

That said, a number of the most general distributive justice considerations regarding taxes do not suggest that treating luck income differently from other types of income is fair or equitable.

---

<sup>184</sup> Julian Lamont & Christi Favor, *Distributive Justice*, in *THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY* (Edward N. Zalta ed., Spring 2013), <http://plato.stanford.edu/archives/spr2013/entries/justice-distributive/> (last visited Oct. 1, 2013).

<sup>185</sup> Mankiw, *supra* note 5, at 285 ("I don't think it is an exaggeration to say that the single most important difference between the political left and the political right is over the questions of whether, and to what extent, 'spreading the wealth around' is a proper function of government."). As one tax historian put it:

[T]he fact is that Americans argue almost incessantly about taxes. *While our debates are framed by dry sets of numbers, percentages and tables, they involve the most deeply felt and passionate moral and personal sentiments.* It could hardly be otherwise. No other aspect of government is as intrusive to the average citizen. Few subjects reflect as many conflicting attitudes toward the role that government plays in our lives.

STEVEN R. WEISMAN, *THE GREAT TAX WARS 2* (2002) (emphasis added).

<sup>186</sup> For an overview of the philosophy literature on distributive justice, see Lamont & Favor, *supra* note 184.

These broader considerations focus on whether the tax's economic burden is distributed throughout society in a fair manner without regard to the source of the taxpayers' income (e.g., labor, capital, or luck). Perhaps that source indifference should not be surprising, given that the basic criterion used to keep score when allocating the income tax is fungible (i.e., income and the resulting money). Nevertheless, if income tax fairness is judged without taking into account the income's source, then distributive justice considerations cannot provide a basis for this Article's proposal to isolate luck income and subject it to a high tax rate.<sup>187</sup>

Examples of source-indifferent distributive justice tax considerations include utilitarianism, ability to pay, the equal absolute sacrifice principle, and the equal benefit principle.<sup>188</sup> The first, utilitarianism, would use the income tax to maximize overall social welfare or utility by requiring higher-income taxpayers to pay a greater percentage of their income as taxes. The diminishing marginal utility of income underpins that approach. Because a dollar of income has a lower marginal utility for a wealthy person than it does for a poor person, seizing more of that dollar through higher taxation of wealthy taxpayers helps minimize the tax's negative effect on overall social welfare. Yet, the source of the income that resulted in the dollar has no bearing on its utility for the wealthy and poor taxpayers in question and, therefore, no place in a utilitarian analysis of whether claiming the dollar through an income tax is just or not.

Similar reasoning applies to the other three considerations mentioned above. The ability to pay consideration would allocate taxes in proportion to the economic resources that taxpayers have available to pay those taxes. Under an equal absolute sacrifice approach, each taxpayer would share the overall tax burden

---

<sup>187</sup> Of course, income fungibility (and its effect on tax fairness) does not stop Congress from making distinctions between income types by source when it chooses to do so. The most obvious example where source matters is the special tax rates applicable to long-term capital gains and losses. I.R.C. §§ 1(h), 1222 (2006). Others include the tax-exempt status of gifts and municipal bond interest. *Id.* §§ 102(a), 103(a).

<sup>188</sup> Some economic scholars have lumped these considerations into two overarching groups—the benefit principle and the ability to pay principle. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 218–19 (5th ed. 1989). In that formulation, utilitarianism and equal sacrifice are specific manifestations of the ability to pay principle. *Id.* at 228–31.

equally by paying the same amount of tax as every other taxpayer. Finally, the equal benefit principle would require each taxpayer to pay tax in proportion to the value of the benefits received by that taxpayer from the governmental spending financed by those taxes. None of these three approaches takes into account how the taxpayer came by the economic resources that lead to the taxpayer's tax burden. For the latter two, income is not even a direct factor in allocating that tax burden to the taxpayer.<sup>189</sup> Consequently, treating luck income differently from other types of income for tax purposes is not fair under these general distributive justice considerations.

When distributive justice considerations extend beyond the mere distribution of society's economic resources to include *how* those resources were acquired, the luck income taxation approach proposed here appears fair. Luck egalitarianism, mentioned above in the context of defining luck income, is an entire school of thought on distributive justice that seeks to achieve a just distribution of resources within society by counteracting the economic impact of certain types of luck.<sup>190</sup> Luck egalitarians generally believe that justice requires people to bear the consequences of the choices that they make, but not the consequences of the random things that happen to them and that are simply beyond their control.<sup>191</sup> Thus, luck egalitarians assert that government should offset the good and bad consequences of brute luck because those uncontrolled and unchosen outcomes are undeserved and, therefore, unjust.<sup>192</sup>

The views of luck egalitarians regarding option luck outcomes that are chosen, but uncontrolled, vary somewhat. Ronald Dworkin has taken the position that the effects of good and bad option luck should not be disturbed because people's fates

---

<sup>189</sup> Arguably, the equal benefit principle could result in indirect taxation of certain types of luck income. For example, governmental spending decisions that are not within the taxpayer's control could lead to a lucky outcome that confers significant economic benefits on the taxpayer. Under the equal benefit principle, that lucky outcome would cause the taxpayer to pay more taxes. The Jubilee Line Extension to the London Underground mentioned above is one example of how this situation could arise in the real world. *See supra* note 103.

<sup>190</sup> *See supra* notes 132–133 and accompanying text.

<sup>191</sup> RONALD DWORKIN, SOVEREIGN VIRTUE 287 (2000).

<sup>192</sup> Lippert-Rasmussen, *supra* note 129.

should be “sensitive to the choices they have made.”<sup>193</sup> Some other luck egalitarians argue that, while smoothing resource distributions to remove the effects of option luck is not necessarily required for a just society, choosing to do so is not unjust because there is no principled reason to favor uncontrolled option luck outcomes over other resource-allocation possibilities (so long as the redistribution system applied to option luck outcomes is publicly known in advance and does not interfere with the settled expectations of society members).<sup>194</sup> In short, governments should work to neutralize brute luck and may, under appropriate circumstances, adjust for option luck, too.

This Article’s luck income framework fits nicely within the luck egalitarian distributive justice viewpoint. Luck income, as depicted by the shaded areas in Figure 2, includes outcomes (1) that the recipient cannot control and (2) either (i) that the recipient did not choose or (ii) that are “zero-sum” in nature. Translating that shaded area into luck egalitarian terms, the area shaded with diagonal lines is brute luck because it represents outcomes that the recipient did not choose and cannot control. The dotted area is “zero-sum” option luck because it covers the remainder of the area common to “Cannot Control” and “Zero-Sum.” So, for this Article, luck income consists of brute luck and “zero-sum” option luck. It does not include productive (i.e., non-“zero-sum”) option luck. Neutralizing—or at least partially neutralizing—brute luck income through heavy taxation is completely consistent with the luck egalitarian view that such outcomes are unjust because they are undeserved. Similarly, leaving productive option luck income untaxed, or at least not taxed any more than any other income resulting from a recipient’s labor or capital, also fits well within the luck egalitarians’ concept of justice.

The same cannot be said for “zero-sum” option luck because taxing that income goes beyond what traditional luck egalitarians like Dworkin would condone. However, luck egalitarians who believe that there is no principled reason to favor uncontrolled option luck outcomes over other resource-allocation possibilities

---

<sup>193</sup> DWORKIN, *supra* note 191, at 6.

<sup>194</sup> Peter Vallentyne, *Brute Luck, Option Luck, and Equality of Initial Opportunities*, 112 ETHICS 529, 549–51 (2002).

should find it just. After all, “zero-sum” option luck situations are those where a potential income recipient attempts to shift wealth from others to the recipient, but cannot control whether or not that attempt will succeed. In such a situation, it is entirely possible (and even likely) that the people on the other side, who end up transferring wealth to the income recipient, also attempted to keep the wealth for themselves but were also unable to control whether or not that attempt would succeed. Between the two sides, the only difference is whether an uncontrolled, random event went their way or not. Such a situation seems like a perfect example of one where there is no principled reason to favor one resource allocation over the other, and where neutralizing the resulting luck income through taxation could be just.

N. Gregory Mankiw’s “just deserts” approach to distributive justice also incorporates considerations of luck and merit into its analytical framework.<sup>195</sup> The central principle underlying just deserts theory is that “[p]eople should get what they deserve.”<sup>196</sup> Therefore, distributive justice should focus on “the congruence between . . . contributions [to society] and . . . compensation.”<sup>197</sup> Mankiw notes that “people are rarely outraged when high incomes go to those who obviously earned them,” like Steve Jobs or J.K. Rowling.<sup>198</sup> Instead, the “high incomes that generate anger are those that come from manipulating the system,” as was the case when Wall Street bankers received large bonuses shortly after the U.S. government bailed out their investment banks.<sup>199</sup> Just deserts theory is all about whether the recipient’s compensation (i.e., income) is commensurate with her merit (i.e., contribution to society).

Just deserts theory fits the luck income taxation framework proposed in this Article. Arguably, brute luck income cannot correlate with the recipient’s merit because it is the result of uncontrolled and unchosen events. So, reclaiming brute luck income through taxation is just under just deserts theory. Furthermore, neutralizing “zero-sum” luck income through

---

<sup>195</sup> Mankiw, *supra* note 5, at 295.

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

taxation is also consistent with just deserts theory because, while the recipient contributed to earning the income by choosing to undertake the uncontrolled activities that resulted in the income, those activities were not productive and did not contribute to society's overall wealth. They merely redistributed income among members of society, leaving total societal wealth constant. Because the recipient did not make a social contribution, he is not worthy of compensation, and heavy taxation of the unjust income is appropriate. Finally, productive option luck income resulting from chosen, but uncontrolled, outcomes that are economically productive contribute to society as a whole. Although the recipient cannot claim all the credit for the outcome, her choice made that outcome possible and did contribute to society. Not taxing the resulting income as luck income seems reasonable and just. Thus, all aspects of the luck income taxation framework appear to be consistent with a just deserts approach to distributive justice.

That luck income taxation framework is also consistent with the results from empirical work in this area. A recent economic study conducted by Alexander Cappelen and three colleagues measured fairness attitudes toward risk-taking and luck.<sup>200</sup> Their study, which used Norwegian economics students, found that many participants favored some level of outcome redistribution even though the outcome recipients had the same opportunities at the start of the experiment and chose to face different levels of risk.<sup>201</sup> When the outcome differences arose solely from luck, as opposed to participants' choices, more than forty percent of the participants favored equalizing the outcomes of the lucky and unlucky recipients and approximately seventy percent favored some level of redistribution from the lucky recipient to the unlucky one.<sup>202</sup> Those findings are consistent with a belief that differences in brute luck income should be eliminated—or at least greatly reduced—through taxation, and that some taxation of option luck income to reduce differences is also appropriate. Unfortunately, the current empirical work on fairness attitudes toward risk taking and luck has not progressed to the point of

---

<sup>200</sup> Alexander W. Cappelen et al., *Just Luck: An Experimental Study of Risk-Taking and Fairness*, 103 AM. ECON. REV. 1398, 1399 (2013).

<sup>201</sup> *Id.* at 1400–01.

<sup>202</sup> *Id.* at 1404 fig.1.

isolating attitudes toward each of the luck income types identified in this Article's luck income taxation framework. Nevertheless, the initial results tend to indicate support for that framework.

In conclusion, while a number of traditional distributive justice frameworks used to evaluate income tax systems do not support separate classification and taxation of luck income, more nuanced frameworks that consider luck's role in acquiring income do. The traditional frameworks, like utilitarianism and ability to pay, generally treat wealth as fungible and, as a result, do not distinguish between income items based on source.<sup>203</sup> For that reason, they cannot be used to justify luck income taxation. However, when philosophers and others concerned with distributive justice explicitly address luck and its impact on the distribution of economic benefits and burdens within society, the resulting distributive justice frameworks—luck egalitarianism and just deserts theory—support this Article's proposal to characterize luck income separately and impose a higher tax rate on it.

### *C. Complexity and Practical Administration*

All else being equal, simple is better when it comes to laws and legal systems. That is particularly true when dealing with a body of law like taxation that affects almost everyone on a daily basis. So it should not be surprising that minimizing complexity is an important tax policy consideration when evaluating modifications to the federal income tax system like the one discussed here. The fate of previous efforts to tax luck's economic rewards through other forms of taxes highlights the importance of

---

<sup>203</sup> Of course, despite that fungibility, our income tax system does distinguish between some different types of income and does treat those types differently. *See, e.g.*, I.R.C. § 103(a) (2006) (excluding "interest on any State or local bond" from gross income). The justifications for these classifications vary and are often specific to the particular income type. *See* H.R. REP. NO. 63-5 app., 394 (1913) (stating that "in computing net income . . . there shall be excluded the interest upon the obligations of a State or any political subdivision thereof, . . . the principal and interest of which are now exempt by law from Federal taxation"); *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 586 (1895) (holding that "it is obvious that taxation on the interest [from municipal securities] would operate on the power to borrow before it is exercised . . . and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution."), *overruled by* *South Carolina v. Baker*, 485 U.S. 505, 524-525 (1988).

minimizing, or at least mitigating, the effects of tax complexity.<sup>204</sup> Excess profits taxes, war profits taxes, and the oil windfall profits tax all failed because taxpayers, the Service, and Congress concluded that their compliance and enforcement costs were simply too large to justify the increased tax revenue that they generated.<sup>205</sup> Similarly, land value taxes struggle for acceptance in part because of the compliance concerns created by complex land valuation issues.<sup>206</sup> These failures demonstrate that increased complexity, and the uncertainty that accompanies it, could be a serious tax policy argument against this Article's luck income taxation system.

Scholars who study the effects of tax complexity typically focus on three different complexity types—compliance, transactional, and rules complexity.<sup>207</sup> Compliance complexity “refer[s] to the problems faced by the taxpayer in keeping records, choosing forms, making necessary calculations, and so on.”<sup>208</sup> It also extends to the Service's efforts to efficiently and effectively administer and enforce the tax laws.<sup>209</sup> Transactional complexity addresses a different taxpayer-related problem. Taxpayers everywhere arrange their economic affairs to legally minimize their taxes.<sup>210</sup> The more complex tax laws are, the more difficult it

---

<sup>204</sup> See *supra* Part I.B.

<sup>205</sup> See *supra* notes 79–82 and 101–102 and accompanying text.

<sup>206</sup> See *supra* notes 118 and 123–125 and accompanying text.

<sup>207</sup> See, e.g., BRADFORD, *supra* note 147, at 266–67 (distinguishing three types of complexity—compliance, transactional, and rule); Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 42–43 (1989) (same); Steve R. Johnson, *The E.L. Wiegand Lecture: Administrability-Based Tax Simplification*, 4 NEV. L.J. 573, 581–82 (2004) (considering detail complexity, outcome complexity, and forms complexity); Peter A. Prescott, *Jumping the Shark: The Case for Repealing the TEFRA Partnership Audit Rules*, 11 FLA. TAX REV. 503, 519–20 (2011) (focusing on procedural/compliance and rule complexity to evaluating the long-term effects of the TEFRA partnership audit procedures).

<sup>208</sup> BRADFORD, *supra* note 147, at 266–67.

<sup>209</sup> Prescott, *supra* note 207, at 520 (explaining how the procedural complexity confronting the Service when it tries to cope with current partnership tax audit procedures is a variation of compliance complexity).

<sup>210</sup> Such minimization is the normal state of affairs, as Judge Learned Hand observed long ago: “Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions.” *Comm'r v. Newman*, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting).

is for taxpayers to accomplish that objective in a straightforward manner that does not require excessive economic contortions.<sup>211</sup> Those contortions are transactional complexity.<sup>212</sup> Finally, rules complexity refers to the problems that taxpayers, the Service, and the courts have “interpreting the written and unwritten rules” that make up the tax law.<sup>213</sup> Implementing a tax on luck income would affect each type of complexity.

Without question, the line drawing needed to separate luck income for special taxation will increase compliance complexity. History leaves little doubt about that. After all, increased compliance complexity helped doom a number of earlier attempts to tax luck’s economic rewards.<sup>214</sup> The situation is no different under the current Code, which contains numerous separate income classifications that increase compliance complexity by creating line-drawing problems. The most prevalent example is the separation between ordinary income and capital income.<sup>215</sup> Because capital income is taxed differently than ordinary income, taxpayers must classify income items as they are realized and recognized throughout the year as either ordinary or capital, must separately track and substantiate the aggregate amounts in each income classification,<sup>216</sup> and must prepare a number of additional

---

<sup>211</sup> A costly side effect of transaction complexity is that, once complicated transactions aimed at reducing taxes become commonplace, more aggressive taxpayers will feel justified using such transactions to push the envelope beyond what is legally permissible. *See, e.g.*, *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 128–39 (D. Conn. 2004) (taking eleven pages to explain the transactions that the taxpayers attempted to use to minimize their income taxes from their successful hedge fund operation), *aff’d sub nom.* *Long-Term Capital Holdings, LP v. United States*, 150 F. App’x 40 (2d Cir. 2005). The *Long Term Capital Holdings* case was notorious enough that a number of commentators reduced the transactions to a more condensed form. *See, e.g.*, Alvin C. Warren, Jr., *Understanding Long Term Capital*, 106 TAX NOTES 681, 681–86 (2005) (describing the complex transactions with a fair amount of detail); Peter A. Prescott, *Taxpayer Civil Penalty Protection: Long Term Capital Holdings and Its Wake*, 81 TEMPLE L. REV. 995, 1002–04 (2008) (simplifying the transactions down to the bare minimum needed to understand the tax planning).

<sup>212</sup> BRADFORD, *supra* note 147, at 267.

<sup>213</sup> *Id.*

<sup>214</sup> *See supra* Part I.B.

<sup>215</sup> Other examples include the separation between active and passive income/loss in I.R.C. § 469 (2006) and U.S.-source and foreign-source income in I.R.C. §§ 861–865 (2006).

<sup>216</sup> This one is actually worse than it appears because taxpayers must separately identify and separately track short-term capital gains, short-term capital losses, long-

tax return forms in connection with capital gains and losses each year.<sup>217</sup>

The Service also faces increased compliance complexity because of the distinction between ordinary income and capital income. In addition to its obligation to create the forms and tools that taxpayers use to correctly report capital income, the Service must develop procedural tools to help it enforce the line between capital income and ordinary income so that taxpayers do not incorrectly report one income type as the other. Those compliance-checking tools can, in turn, create additional compliance complexity for unrelated third parties. A familiar example is Form 1099-B (Proceeds From Broker and Barter Exchange Transactions), which investment brokers must use each year to report transactional information about their clients to the Service.<sup>218</sup> In short, if past and present examples demonstrate anything, introducing a new income classification could increase compliance complexity for nearly everyone involved with the tax system unless steps are taken to limit the number of taxpayers affected by the new classification.

Transactional complexity should increase as well if luck income is isolated and taxed at a high tax rate. Taxpayers who expect to recognize luck income will immediately begin looking for ways to convert that income into lower-taxed ordinary income or much lower-taxed capital income. Many of those ways will not be economically productive and will do little more than consume the energy of taxpayers (and their advisors) in exchange for personal tax savings. Once again, the existing distinction between ordinary income and capital income is analogous and instructive. The lottery cases are a fairly straightforward example of transactional

---

term capital gains, and long-term capital losses. I.R.C. § 1222(1)–(4) (2006). Then there are the subcategories within long-term capital gains and losses, like collectible gains and losses. *Id.* § 1(h)(5) (2006).

<sup>217</sup> For individual taxpayers, Schedule D of Form 1040 (Capital Gains and Losses) and Schedule 4797 (Sales of Business Property) are two of the most obvious examples. When business entities are involved, additional forms complexity arises because the entity must track and report its different types of income to the Service and its owners. One example of this additional complexity is lines 8 through 10 on Schedule K of Form 1065 (U.S. Return of Partnership Income).

<sup>218</sup> See Treas. Reg. § 1.6045-1(d)(2) (1983) (requiring this third-party reporting by brokers).

complexity arising along that ordinary/capital income line.<sup>219</sup> Rather than wait for the lottery annuity payments to arrive over time, the lottery-winning taxpayers attempted to convert that future ordinary income into current capital gain by selling the right to those future payments for a lump sum.<sup>220</sup> Although the taxpayers' efforts to legally minimize the tax on their winnings failed,<sup>221</sup> most likely they would not have felt the need to sell the future lottery payments at all if doing so had not looked like a way to save taxes.<sup>222</sup>

Just as taxpayers rearrange their financial affairs to convert ordinary income into lower-taxed capital income, they can be expected to work toward converting even higher-taxed luck income into ordinary income or, better still, even lower-taxed capital income. Logically, the magnitude of the transactional complexity problem created by a separate luck income classification should increase with the differences in marginal tax rates applicable to the three types of income. So, a high tax rate on luck income could create a powerful incentive for taxpayers to engage in unproductive tax minimization behavior that is on par with, or exceeds, the current level of activity along the ordinary/capital income line. Of course, the number of taxpayers earning luck income will also contribute to the overall transactional complexity experienced by taxpayers as a group. If only a few taxpayers earn significant amounts of luck income, the resulting overall increase in transactional complexity will not be large even if every one of those taxpayers engages in tax minimization transactions. Because the luck income taxation system discussed in this Article involves a high tax rate, it could create a strong tax minimization incentive that increases transactional complexity. However, the magnitude of that increase could be managed by installing safeguards that limit the reach of that additional transaction complexity, and therefore its overall impact.

---

<sup>219</sup> See *Watkins v. Comm'r*, 447 F.3d 1269 (10th Cir. 2006); *Lattera v. Comm'r*, 437 F.3d 399 (3d Cir. 2006); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004).

<sup>220</sup> *Lattera*, 437 F.3d at 401.

<sup>221</sup> *Id.* at 410.

<sup>222</sup> The sale did transform the stream of future lottery payments into an immediately accessible lump-sum amount, but borrowing against the lottery payments could have achieved that same result.

Like compliance and transactional complexity, rules complexity can be expected to increase if luck income is separately classified and taxed. At minimum, the Code would need a new section defining luck income and imposing the tax rate on that income.<sup>223</sup> Other new Code sections that prevent (1) the conversion of luck income into lower-taxed ordinary or capital income<sup>224</sup> and (2) the shifting of luck income between taxpayers could also be necessary if Congress does not want to leave policing the boundary between luck income and other types of income entirely to the courts.<sup>225</sup> Furthermore, the various entity taxation portions of the Code, like subchapter K governing partnerships, might need tweaking to prevent the use of entities to convert or shift luck income.<sup>226</sup> Of course, the Treasury Department and the courts will inevitably need to interpret each of these new provisions, and the resulting regulations and judicial decisions will add to the volume of relevant law that taxpayers will need to wade through when dealing with luck income.

Too much complexity here can lead to excessive and wasteful litigation between taxpayers and the Service. Unfortunately, if the amount of rules complexity created by the division between ordinary income and capital income is any indication of what

---

<sup>223</sup> The line between ordinary income and capital income actually takes up four Code sections. I.R.C. § 1222 generally defines capital gains and losses as gain or loss “from the sale or exchange of a capital asset.” I.R.C. § 1222(1)–(4) (2006). Capital assets are identified by exclusion in section 1221(a). Finally, ordinary gains and losses are defined in I.R.C. §§ 64 and 65, respectively. I.R.C. §§ 64–65 (2006).

<sup>224</sup> I.R.C. § 1245 is an existing example of this type of section. That section prevents the conversion of ordinary income into lower-taxed capital gain when a taxpayer sells or exchanges depreciated trade or business property for a gain that only exists because of excess depreciation deductions in preceding years. I.R.C. § 1245(a) (2006). But for this section, the ordinary income offset by the excess depreciation deductions, which are ordinary deductions, in the preceding years would be effectively converted to capital gain on the later sale or exchange.

<sup>225</sup> The “kiddie tax” in I.R.C. § 1(g) is a statutory provision aimed at preventing parents from shifting ordinary income and capital gain to their children so that the income is taxed at the children’s lower tax rates. I.R.C. § 1(g) (2006).

<sup>226</sup> These provisions may not need much revision to serve the purpose because they already deal with the ordinary/capital income line so extensively and thoroughly. Subchapter K is replete with sections designed to police the line between ordinary income and capital income. *See, e.g.*, I.R.C. § 751(a) (2006) (preventing taxpayers from using the sale or exchange of a partnership interest to convert ordinary income built into the partnership’s unrealized receivables and inventory items into capital gain built into the partnership interest).

would happen along the definitional line dividing luck income from other income types, significant rules complexity is a real risk. Although the safeguards contemplated above in connection with compliance and transactional complexity would reduce the overall magnitude of the rules-complexity by limiting the number of taxpayers affected by the luck income classification, those safeguards will not reduce the rules-complexity costs for affected taxpayers. Piggybacking on the existing mechanisms for policing ordinary income and capital income could also reduce the overall rules complexity increase. Even so, rules complexity will increase.

Increased tax complexity played a major role in the demise of earlier attempts at taxing luck's economic rewards. As the preceding discussion illustrates, increasing complexity is a major policy argument for not imposing higher tax rates on luck income. The equity gains and improved economic efficiency (i.e., reduced deadweight loss) from implementing the luck income taxation scheme proposed in this Article counterbalance that complexity cost. Clearly, a simple and clear means of isolating luck income from other types of income will be crucial to the proposal's success. Part IV outlines an approach that attempts to do just that.

#### IV. TAXING LUCK INCOME

It is often said that the perfect is the enemy of the good.<sup>227</sup> For the reasons outlined in the preceding section, curtailing complexity requires a sacrifice. That sacrifice is perfect accuracy. Rather than striving to perfectly separate and tax all types of luck income, this Article's luck income taxation approach is designed to capture the lowest hanging fruit and to provide flexibility for easy expansion into more complicated areas. It is also constructed to fit within the existing income tax system so that its footprint is as small as possible. The proposed taxation of luck income that follows is certainly not perfect. But it is good enough to serve as a starting point for further discussion.

---

<sup>227</sup> *Perfect is the enemy of good*, Wikipedia, [http://en.wikipedia.org/wiki/Perfect\\_is\\_the\\_enemy\\_of\\_good](http://en.wikipedia.org/wiki/Perfect_is_the_enemy_of_good) (last visited Nov. 4, 2013) ("The perfect is the enemy of good is an aphorism or proverb meaning that insisting on perfection often results in no improvement at all. The phrase is commonly attributed to Voltaire[s] . . . moral poem, *La Béguéule* . . .").

To capture the economic efficiency and equity gains outlined above, this Article proposes to segregate luck income from other types of income and subject it to a fixed tax rate that exceeds the highest marginal tax rate on ordinary income. Of course, in the current political climate the odds against implementation of *any* system of taxing luck income are astronomical. The luck income taxation scheme outlined below should raise much-needed revenue<sup>228</sup> and could contribute toward reducing income inequality in the United States, both of which are currently Democratic Party policy objectives.<sup>229</sup> However, most Republicans have very little tolerance for tax increases,<sup>230</sup> and neither party publicly supports making the Code more complicated than it already is.<sup>231</sup> So, whatever its merits, this Article's proposal is best

---

<sup>228</sup> Joseph Isenbergh, *The Future of Taxation* 3 (Univ. of Chi. Law Sch., John M. Olin Law & Econ. Working Paper No. 509, 2010), available at <http://www.law.uchicago.edu/Lawecon/wp501-550> (“In this look at the future of taxation I promised arithmetic certainty, and here it is. Over the next 10 to 15 years current taxes will increase mightily. I take no position here on the necessity or wisdom of massive fiscal stimulus to restart the U.S. economy. But it has arrived—and in its wake will pull up current taxes for a decade at least (or spread inflation, another form of higher taxation).”).

<sup>229</sup> President Barack Obama, Remarks by the President in the State of the Union Address (Feb. 12, 2013), available at <http://www.whitehouse.gov/the-press-office/2013/02/12/remarks-president-state-union-address> (noting that, “[o]ver the last few years, both parties have worked together to reduce the deficit by more than \$2.5 trillion – mostly through spending cuts, but also by raising tax rates on the wealthiest 1 percent of Americans” and that demanding “a tax code that ensures billionaires with high-powered accountants can’t work the system and pay a lower rate than their hardworking secretaries”).

<sup>230</sup> Of the 233 Republican representatives and 45 Republican senators in the 113th U.S. Congress, 219 representatives and 39 senators have signed Americans for Tax Reform’s Taxpayer Protection Pledge, which commits the signer to “oppose any and all efforts to increase the marginal income tax rates for individuals and/or businesses.” *Federal Taxpayer Protection Pledge*, AMERICANS FOR TAX REFORM, <http://www.atr.org/taxpayer-protection-pledge> (last visited Nov. 4, 2013). This commitment is taken very seriously. See *The Colbert Report: Interview of Grover Norquist* (Comedy Central television broadcast June 27, 2011), available at <http://www.colbertnation.com/the-colbert-report-videos/390707/june-27-2011/grover-norquist> (causing the head lobbyist for Americans for Tax Reform to choose to sacrifice terrorized grandmothers to death by fire and bite if required to avoid raising taxes on the top two percent of Americans).

<sup>231</sup> Bruce Bartlett, *How to Really Simplify the Tax Code*, N.Y. TIMES, Apr. 10, 2012, <http://economix.blogs.nytimes.com/2012/04/10/how-to-really-simplify-the-tax-code/> (“Politicians often rail against the complexity of the tax system as the key source of taxpayer frustration.”).

viewed as a good start toward thinking about the successful implementation of a system that taxes luck income.

#### A. A Proposal for Taxing Luck Income

A critical part of that success is keeping the new luck income tax as simple as possible. To that end, this Article's proposal for taxing luck income is built into the existing income tax so that it can easily incorporate that tax's existing structure. That means that, just like other types of income, luck income would be taxed using a transaction-based system that relies on realization and recognition to trigger taxation.<sup>232</sup> Nothing new would be taxed and there would be no need to create new rules governing when, or to whom, luck income would be taxed. Luck income would merely be a subset of gross income that is taxed differently than ordinary income and capital income.

Luck income would be defined in a new Code section. That new section would contain an exclusive list of specific luck income items, like the ones discussed in Part IV.B below, and would end with a final item authorizing the Treasury Department to issue regulations that add items to the statutory luck income list. The new Code section would require the Treasury Department's regulatory additions to be consistent with the broad luck income framework described above (i.e., the additions must be income (1) that the taxpayer could not control and (2) either (i) that the taxpayer did not choose or (ii) that are "zero-sum" in nature).<sup>233</sup> It would also incorporate a *de minimis* threshold that would apply to each luck income realization event and would exclude smaller amounts from luck income taxation. Finally, the new Code section would subject luck income to a fixed tax rate somewhere between 80 and 90 percent.

---

<sup>232</sup> See, e.g., *Helvering v. Horst*, 311 U.S. 112, 115 (1940) ("Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event rather than the acquisition of the right to receive it."); Treas. Reg. § 1.61-6(b) (1960) ("Certain realized gains or losses on the sale or exchange of property are not 'recognized', that is, are not included in or deducted from gross income at the time the transaction occurs.").

<sup>233</sup> See *supra* Part II.B (deriving the broad luck income framework and representing it pictorially in Figure 2).

The proposed statutory approach for defining luck income borrows concepts from the current Code's handling of gross income and uses them to reduce the resulting increased statutory complexity. Like the current Code's gross income definition in section 61, the proposed luck income definition would contain a statutory list. However, unlike the inclusive section 61 list that identifies common gross income examples without limiting the full scope of gross income as "income from whatever source derived,"<sup>234</sup> and therefore includes many types of income that are not actually on the statutory list, the new luck income list would be exclusive. Thus, at least initially, any income that Congress did not see fit to include on the statutory list would not be luck income, even if it satisfied the broad luck income framework's requirements. Put differently, the default for unanticipated types of luck income would be treatment as *not* luck income. This exclusivity approach is designed to reach the most obvious, and generally agreed-upon, luck income items without unexpected overreaching.

While limiting luck income's statutory scope in this manner is attractive as a means of cautiously implementing the new tax system, later expansion may be desirable. Given the difficulty of isolating luck income from other types of income, identifying appropriate luck income items will likely require extensive study by technical experts. For that reason, the proposed Code section's approach of granting the Treasury Department the power to add less obvious, or more controversial, luck income items through regulations makes sense. The Treasury Department is well-suited to study and characterize new types of income as luck income, and to revisit and revise past characterizations as needed when unforeseen complications arise. Delegating this power to the Treasury Department will allow a measured expansion into more complicated areas of the luck income framework.<sup>235</sup>

As noted in Part III.C above, limiting the number of taxpayers affected by the new luck income tax limits the new tax's unfortunate impact on complexity.<sup>236</sup> In particular, designing the new tax system to exclude most taxpayers in most years should

---

<sup>234</sup> I.R.C. § 61(a) (2006).

<sup>235</sup> Of course, Congress can always reject the Treasury Department's decisions by statute (but doing so will increase the Code's complexity).

<sup>236</sup> See *supra* notes 214–23 and accompanying text.

greatly reduce any undesirable compliance and transactional complexity increases. The most direct way to exclude a large number of potential luck income taxpayers each year is to install a *de minimis* threshold that applies to each luck income realization event. Taxpayers would simply treat realized amounts of luck income that fall below the threshold as ordinary or capital income, just as they would be under the existing income tax system. Such a threshold would reduce compliance complexity by relieving most luck-income taxpayers of the need to separately track and classify small luck income items. While setting the *de minimis* threshold's level is a matter of political judgment, arguably it should be set at a level that excludes routine, or forgettable, realization events from luck income taxation without protecting too many larger, more memorable, ones. Perhaps something like \$500 would be a reasonable place to start.<sup>237</sup> Like other thresholds designed to spare taxpayers from dealing with onerous taxation and reporting requirements,<sup>238</sup> the *de minimis* threshold for luck income should be adjusted each year to keep inflation from eroding the threshold's simplification benefits.<sup>239</sup> A well-designed *de minimis* threshold for luck income could significantly reduce compliance and transactional complexity problems arising because of the new luck income classification while still preserving the most valuable parts of the accompanying valuable equity and economic efficiency gains.

---

<sup>237</sup> For an example of another threshold that serves a similar purpose, see I.R.C. § 6041A(a) (2006), which only requires a service recipient to report the compensation paid to the service provider if the aggregate payments to the provider throughout the year are at least \$600.

<sup>238</sup> See, e.g., I.R.C. § 2503(b)(2) (2006) (setting the annual taxable gift exclusion for *de minimis* gifts at \$10,000 and adjusting that amount for changes in the cost-of-living since 1997); Rev. Proc. 2012-41, 2012-45 I.R.B. 539, 541 (reporting that the inflation-adjusted I.R.C. § 2503 gift tax exclusion for calendar year 2013 is \$14,000).

<sup>239</sup> The best example of this phenomenon in recent years is the erosion of the protection provided by the alternative minimum tax exemption amount. The exemption amount was originally set by Congress at a fixed amount to keep most taxpayers out of the alternative minimum tax. Inflation has slowly eaten away at that protection, causing Congress to temporarily fix the problem by adjusting the exemption amount for inflation on numerous occasions. See, e.g., Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 301(a), 120 Stat. 345, 353 (2006). Early in 2013, Congress permanently fixed the problem by inflation adjusting the exemption amount. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 104(b), 126 Stat. 2313, 2320-21 (2013).

The tax rate structure is also designed to keep the new luck income tax system simple. Instead of the graduated tax rate tables that apply to ordinary income,<sup>240</sup> or the multiple fixed tax rates that apply to net capital gain,<sup>241</sup> a single tax rate would apply to all luck income. As with the annual *de minimis* luck income threshold, setting the tax rate is a matter of political judgment that would almost certainly be controversial. Based on the work of Emmanuel Saez and others who have studied income inelasticity with respect to the highest marginal income tax rate,<sup>242</sup> and the optimal income tax models incorporating income randomness,<sup>243</sup> a tax rate somewhere between 80 and 90 percent should not create significant undesirable economic efficiency effects. This range is also fairly consistent with the tax rates imposed on “lucky” excess profits during World Wars I and II. The highest graduated tax rate during World War I was 65 percent.<sup>244</sup> The tax rate during much of World War II was a fixed 95 percent.<sup>245</sup>

Theoretically, that rate could be as high as 100 percent for luck income from brute luck because taxpayers cannot be deterred from earning income that they did not choose and over which they have no control.<sup>246</sup> A tax rate approaching 100 percent on this type of luck income would also be consistent with the luck egalitarian and just deserts theories of distributive justice because income resulting from the taxpayer’s brute luck is arguably not commensurate with the taxpayer’s merit. Unfortunately, the same cannot be said for luck income from “zero-sum” option luck because its existence depends on taxpayer choice.

For “zero-sum” option luck generating activities, a tax rate approaching 100 percent would effectively eliminate taxpayer incentives to engage in them. Here, something between 80 and 90

---

<sup>240</sup> See, e.g., I.R.C. §§ 1(a), 11(b)(1) (2006) (containing the graduated tax rate table for (1) married individuals filing joint tax returns and surviving spouses and (2) corporations, respectively).

<sup>241</sup> While most net capital gains are taxed at twenty percent, marginal tax rates on such income can range from zero percent to twenty-eight percent. See *id.* § 1(h)(1).

<sup>242</sup> See *supra* text accompanying notes 161–67.

<sup>243</sup> See *supra* text accompanying notes 176–83.

<sup>244</sup> See *supra* note 49.

<sup>245</sup> See *supra* note 69.

<sup>246</sup> Of course, taxpayers receiving luck income from brute luck can control whether or not they report that income to the Service. The resulting tax evasion would reduce efficiency gains and require the Service to expend resources counteracting it.

percent is appropriate. The 80 percent lower bound is derived from Peter Diamond's and Saez's empirically-based mid-range estimate of elasticity at 0.25 for reported income (i.e., adjusted gross income or taxable income) of high-income individuals subjected to top marginal income tax rates.<sup>247</sup> Diamond and Saez appear to have drawn that estimate from a literature review by Saez, Joel Slemrod, and Seth Giertz, which concluded that, “[w]hile there are no truly convincing estimates of the long-run elasticity, the best available estimates range from 0.12 to 0.40.”<sup>248</sup> Saez and others have also noted that the elasticity figure for lower-income individuals should be lower still.<sup>249</sup> Assuming that taxpayer elasticity for luck income is roughly comparable to that of reported income, and taking into account the fact that low-income taxpayers will also face luck income taxation, the 0.25 elasticity estimate for high-income taxpayers should serve as a reasonable upper-bound elasticity estimate for “zero-sum” option luck income.<sup>250</sup> That elasticity corresponds to an 80 percent tax rate,<sup>251</sup> which is the lower-bound tax rate for luck income suggested here. The 90 percent upper-bound luck income tax rate roughly corresponds to the lower-bound elasticity estimate of 0.12 reported

---

<sup>247</sup> Diamond & Saez, *supra* note 161, at 171.

<sup>248</sup> Saez, Slemrod & Giertz, *supra* note 164, at 42. The article proceeds to point out that the mechanical midpoint of this range is 0.25. *Id.*

<sup>249</sup> See *supra* note 166 and accompanying text.

<sup>250</sup> While a change to the relevant tax base, here from adjusted gross income or taxable income to luck income, can create comparability problems, in this situation they are probably not significant. After all, luck income is a subset of the other two and adjusted gross income/taxable income elasticity is only used as an upper-bound on the luck income elasticity, not a precise measure of it. Because of the nature of luck income, it seems likely that the luck income elasticity is lower than the elasticity of top earners' adjusted gross income/taxable income. See *supra* Part III.A.1.

<sup>251</sup> The formula for converting elasticity to the revenue-maximizing tax rate ( $\tau^*$ ) when a tax system has only one tax rate is:  $\tau^* = 1 / (1 + \text{elasticity})$ . Saez, Slemrod & Giertz, *supra* note 164, at 9. Inserting elasticity of 0.25 gives  $\tau^* = 1 / (1 + 0.25) = 0.80$ . Note that the revenue-maximizing tax rate is also the optimal tax rate when the government imposing the tax makes the common utilitarian assumption that the taxpayer facing the top marginal tax rate loses little or no consumption value from being taxed when compared to the average taxpayer. Diamond & Saez, *supra* note 161, at 168–69. Because the tax on luck income is not limited to high-income individuals, that assumption may not hold here and the revenue-maximizing tax rate may not be the optimal tax rate that maximizes social welfare. See *supra* text accompanying notes 169–74.

by Saez and his coauthors.<sup>252</sup> That upper-bound should prevent the single luck income tax rate from completely discouraging taxpayers who wish to pursue “zero-sum” option luck income.

While many luck egalitarians might balk at appropriating “zero-sum” option luck income through taxation, some would not.<sup>253</sup> And all would agree that appropriating brute luck income is not unjust.<sup>254</sup> Just deserts adherents would view both parts of luck income as inconsistent with the taxpayer’s contribution to society.<sup>255</sup> In light of these considerations, use of a single tax rate for luck income between 80 percent and 90 percent is appropriate.

It would be absurd not to acknowledge that this Article’s measured approach to initially taxing luck income intentionally avoids addressing a number of possible issues that could create a lot of additional complexity in the future. For example, how should the Code treat expenses incurred to obtain luck income when those expenses are incurred in a different taxable year than the luck income is received?<sup>256</sup> Other potential issues include: (1) the interplay between luck income and existing classifications in the Code, such as passive activity income and losses;<sup>257</sup> and (2) whether excess losses from bad luck (i.e., negative luck income) should be deducted against ordinary income and capital income or suspended to future deduction against other unrelated luck income. This short list of possible future issues is by no means complete. While each of them might eventually need to be addressed if the luck income taxation system proposed here is implemented, not doing so at the start is consistent with the goal of keeping the initial system simple enough to be workable so that it does not die of its own weight like the excess profits, war profits, and oil windfall profits taxes that came before it. Those failures demonstrated that trying to get everything right from the start is difficult, if not impossible. There is also the possibility that the

---

<sup>252</sup> Saez, Slemrod & Giertz, *supra* note 164, at 42. The math to convert an elasticity of 0.12 to the upper-bound luck income tax rate is as follows:  $r^* = 1 / (1 + 0.12) = 0.893$ .

<sup>253</sup> See *supra* text accompanying notes 193–95.

<sup>254</sup> See *supra* text accompanying notes 190–92.

<sup>255</sup> See *supra* text accompanying notes 195–203.

<sup>256</sup> One way to deal with this problem might be to have a special net operating loss deduction for luck income akin to the one already found in the Code. See I.R.C. § 172 (2006).

<sup>257</sup> See *id.* § 469.

system will never expand to the point where these potential issues become serious problems. In the end, initially ignoring them seems reasonable.

### B. Some Simple Examples

Saying that Congress should create a new Code section that exclusively lists specific luck income items necessarily raises the question of what should go on that list. What follows are brief descriptions of a few likely candidates. In each case, the potential luck income item falls well within the broader luck income framework proposed in this Article (i.e., income (1) that the taxpayer could not control and (2) either (i) that the taxpayer did not choose or (ii) that are “zero-sum” in nature). Together, they could make up the initial luck income list in the new Code section adopted by Congress. Other potential additions to that list, such as the gifts and inheritances received by “lucky” heirs, could follow after appropriate consideration by Congress and the Treasury Department.<sup>258</sup>

---

<sup>258</sup> Superficially, an intra-family inheritance seems like a perfect example of luck income. The inheritance itself is a “zero-sum” event that merely transfers wealth from the decedent to the “lucky” heir, and the heir has no actual control over whether or not the decedent bequeaths the inheritance to the heir. Furthermore, the opportunity to receive the inheritance (i.e., the existence of wealth to inherit) is not something that the heir chose. The heir was simply lucky enough to be born into the right family. Still, there is some anecdotal and empirical evidence suggesting that heirs “work” for their money by satisfying the bequeathing relative’s need for attention during the later stages of life. B. Douglas Bernheim, Andrei Shleifer & Lawrence H. Summers, *The Strategic Bequest Motive*, 93 J. POL. ECON. 1045, 1058, 1072 (1985) (observing that “microeconomic panel data reveals that contact between parents and children is much higher in families where the elderly parent has a substantial amount of bequeathable wealth to offer” and reporting that interviews of potential heirs indicated an acceptance by those heirs that the bulk of the inheritance should go to the child who did the most for the decedent). If that is true, drastically shrinking a decedent’s bequeathable wealth through heavy luck income taxation could have undesirable negative consequences for inter-generational, intra-family relationships and happiness. *See id.* at 1063–65, 1074 (distinguishing between bequeathable wealth (e.g., financial wealth and real estate), which empirical analysis shows leads to increased attention from children, and nonbequeathable annuity wealth (e.g., social security benefits), which does not, and noting that a “general decline in attentiveness of children to parents is widely alleged to have taken place since the introduction of social security”). Extending luck income to cover gifts and inheritances could also complicate luck income taxation by introducing possible behavioral distortions affecting the decedent (as opposed to the income recipient) and by creating structural statutory issues like how (and whether) to preserve the \$5.25 million lifetime applicable exclusion amount

### 1. Lottery Winnings and Gambling

Lottery winnings<sup>259</sup> and gambling<sup>260</sup> are currently taxed as ordinary income. Due to their random nature, both are effectively beyond the taxpayer's control, which makes them candidates for re-characterization to luck income. Because gamblers and lottery participants choose to participate in the games that result in their winnings, those winning are not the result of brute luck and do not fit into luck income under the uncontrolled and unchosen portion of the luck income framework. However, neither activity increases overall societal wealth because it simply redistributes existing resources among the winners and losers.<sup>261</sup> In the lottery case, small amounts of money are collected from each entrant and reassigned to the winner. A similar dynamic occurs when gambling. Therefore, lottery winnings and gambling are both examples of "zero-sum" option luck and are brought under the luck income framework because they are uncontrolled and "zero-sum."

### 2. Treasure Trove/Found Money

Treasure trove and found money are also examples of uncontrolled and "zero-sum" luck income. Each is currently taxed as ordinary income when realized and recognized, which normally occurs when the taxpayer takes possession of another's lost or

---

that each decedent currently receives as taxation shifts from the decedent to the heir. See I.R.C. § 2010(a), (c) (2006); Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 448. For a general discussion of whether to replace the gift and estate tax system with the income taxation of inheritances, see Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978).

<sup>259</sup> See *supra* note 33 and accompanying text.

<sup>260</sup> See *supra* note 43 and accompanying text.

<sup>261</sup> For lotteries, one of the winners is the state government running the lottery because it claims a portion of the ticket revenue. See, e.g., *Summary Financial Information*, TEX. LOTTERY COMM'N <http://www.txlottery.org/export/sites/lottery/Documents/financial/Monthly-Transfer-Documents/Document.pdf> (last visited Nov. 4, 2013) (showing transfers to the General Revenue Fund, the Foundation School Fund, and the Texas Veterans Commission). It is worth noting that many lottery participants and gamblers must gain psychological benefits—happiness—from engaging in these activities. Otherwise, they should not participate in what they should know are likely to be financially-costly games.

abandoned property.<sup>262</sup> The taxpayer may or may not be actively looking for lost or abandoned property when some is found. In the former case, the resulting income is uncontrolled, chosen, and “zero-sum” because, while the taxpayer sought out the income, which was then transferred from another owner to the taxpayer, the taxpayer had no control over whether the search would prove successful. In the latter case, where the taxpayer is not searching for lost or abandoned property, the income satisfies all three luck income framework characteristics because it is uncontrolled, unchosen, and “zero-sum.” In both cases, the income is luck income.

### 3. Punitive Damages

As noted in Part I.A.1, punitive damages played an important part in the Supreme Court’s decision to broadly define gross income for federal income tax purposes because the Court had to decide whether they are included even though they do not result from the taxpayer’s labor or capital.<sup>263</sup> Punitive damages are simply a penalty imposed by society “to punish and thereby deter blameworthy conduct” that happens to be awarded to the taxpayer who was harmed by that conduct as a windfall.<sup>264</sup> While the taxpayer receiving the windfall does choose whether to pursue the punitive damages in the taxpayer’s lawsuit, the taxpayer still has no control over the events that gave rise to the punitive damages claim, whether those damages will be awarded, or their amount if they are. For that reason, punitive damages are another example of “zero-sum” option luck income (i.e., they are uncontrolled,

---

<sup>262</sup> See Treas. Reg. § 1.61-14 (as amended in 1993) (“Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.”); *Cesarini v. United States*, 296 F. Supp. 3, 7-8 (N.D. Ohio 1969) (including money found in a piano in the taxpayer’s gross income in the year it was found and possessed by the taxpayer because that was when the taxpayer’s rights in it arose under state law), *aff’d*, 428 F.2d 812 (6th Cir. 1970). Note that a taxpayer who finds mislaid property acquires no ownership rights in that property. See, e.g., *Hendle v. Stevens*, 586 N.E.2d 826, 833 (Ill. App. Ct. 1992).

<sup>263</sup> See *supra* notes 17-28 and accompanying text.

<sup>264</sup> BLACK’S LAW DICTIONARY, *supra* note 104, at 448. The punitive damages are a windfall because the taxpayer also receives compensatory damages that compensate the taxpayer for the actual damage caused by the person paying the punitive damages.

chosen, and “zero-sum”) and are an easy fit for the statutory luck income list discussed above.

As it turns out, over the past twenty years several states have begun subjecting punitive damages awarded in their courts to the economic equivalent of the high luck income tax rate proposed here.<sup>265</sup> In those states, the legislatures passed sharing or split-recovery statutes that claim a portion of punitive damages for the state. For example, a defendant in an Indiana court who is found to owe punitive damages must pay them to the clerk of the court and the clerk must remit “seventy-five percent (75%) of the punitive damage award to the treasurer of state, who shall deposit the funds into the violent crime victims compensation fund.”<sup>266</sup> The victorious plaintiff keeps the remaining twenty-five percent.<sup>267</sup> In effect, the punitive damages in Indiana are subject to a 75% state tax, with the remainder subject to federal and state income taxes. The Supreme Court of Ohio has even instituted a common law version of a split-recovery statute that operates on a case-by-case basis.<sup>268</sup> The court held that part of the plaintiff’s punitive damages should “go to a place that will achieve a societal good,”<sup>269</sup> because that approach properly aligns the damages’ purpose (i.e., “to punish the guilty, deter future misconduct, and to demonstrate society’s disapproval”) with their eventual use.<sup>270</sup> The split-recovery statutes, and their common law brethren, prevent the punitive damages from being completely captured by the plaintiff as an unearned windfall that results simply by being in the right place at the right time. That rationale is quite similar to the distributive justice argument discussed above for heavily taxing luck income and supports inclusion of punitive damages as part of luck income.

---

<sup>265</sup> See, e.g., GA. CODE ANN. § 51-12-5.1(e)(2) (Supp. 2010) (requiring seventy-five percent of punitive damages awarded in product liability cases to go to the state treasury).

<sup>266</sup> IND. CODE ANN. § 34-51-3-6(c)(2) (LexisNexis 2008); see also Cheatham v. Pohle, 789 N.E.2d 467 (Ind. 2003).

<sup>267</sup> IND. CODE ANN. § 34-51-3-6(c)(1) (LexisNexis 2008).

<sup>268</sup> Dardinger v. Anthem Blue Cross & Blue Shield, 781 N.E.2d 121, 145-46 (Ohio 2002).

<sup>269</sup> *Id.* at 146.

<sup>270</sup> *Id.* at 145 (quoting Davis v. Wal-Mart Stores, Inc., 756 N.E.2d 657, 661 (Ohio 2001) (Sweeney, J., concurring in part and dissenting in part)).

The luck income taxation system described in this Part is designed to capture the economic efficiency and distributive justice benefits from taxing luck income while keeping the resulting complexity increases within acceptable limits by folding the new system into the existing Code and borrowing many of its provisions. The new Code section would combine a statutory list of widely-accepted luck income items, like the examples just identified, with a flexible regulatory grant to the Treasury Department that uses the luck income framework derived in Part II.B. That combination should be a reasonably simple starting point that permits incremental expansion, as appropriate, to reach more problematic luck income examples like the entrepreneurs' and business executives' widely-varying economic returns discussed in the Introduction, which appeared to largely result from their varying amounts of luck but required ability and effort, too.<sup>271</sup>

#### CONCLUSION

For better or worse, luck and taxes are unavoidable facts of life. This Article explores the relationship between the two and attempts to determine how they should interrelate with an eye toward furthering the traditional tax policy considerations of raising revenue, promoting economic efficiency, improving distributive justice, and limiting tax complexity. In general, isolating and taxing luck income should raise revenue while promoting economic efficiency and distributive justice goals. Unfortunately, it would also raise tax complexity concerns. That mix of benefits and concerns is consistent with the results of past efforts to target luck-related income for taxation. Thus, the challenge is to develop a luck income taxation system that minimizes complexity increases without sacrificing the revenue, economic efficiency, and distributive justice benefits. This Article's theoretical luck income framework and practical implementation plan are designed to do just that. While the result is certainly not perfect, and is politically unlikely to go anywhere, it is a good starting point for thinking about what a successful luck income taxation system might look like and how it could work.

---

<sup>271</sup> See *supra* text accompanying notes 1–5.

