# THE U.S. CONSUMPTION TAX: EVOLUTION, NOT REVOLUTION

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### I. INTRODUCTION

Much of the recent discussion in the literature regarding fundamental tax reform has centered around the abandonment of the income tax in favor of a consumption tax. Not as well publicized is that there has been significant movement toward a consumption tax already, through evolution. And, the income tax is likely to move even further in that direction in the coming years.<sup>1</sup> This article focuses on these thoughts and observations and considers their implications for fundamental tax reform.

In general, the tax base under the income tax is the taxpayer's "taxable income," a net income concept. In contrast, the tax base under a consumption tax is the amount consumed. The income tax is usually justified on the basis that income is the best measure of ability to pay and therefore represents the fairest tax base. A consumption tax is also justified on fairness grounds on the argument that consumption is a measure of what the taxpayer is taking out of society, an arguably more appropriate basis to tax than income, which is a measure of what the taxpayer contributes to society. The consumption tax is also rationalized on economic grounds as creating desirable incentives for saving and investing while also being free of distortion in favor of present consumption against future consumption.

The article begins in Part II by explaining the difference between an income tax and a consumption tax and provides the backgrounds of the alternative forms of consumption tax: (1) consumed income, (2) yield exemption, and (3) point of sale taxation.

Part III identifies various tax provisions in the income tax law that reflect a consumption tax, some of which are in the consumed income form and some in the yield exemption form. Several of the provisions are of only recent vintage in the current Internal Revenue Code and reflect the surreptitious nature of the trend from an income tax regime to a consumption tax regime. Part IV considers the positions of both the advocates of the consumption tax and of the income tax as a means of explaining the evolution of the current hybrid system. Part V discusses some implications of the trend and analyzes that phenomenon both from the perspective of a consumption tax advocate and from the perspective of

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<sup>&</sup>lt;sup>1</sup>See Press Release, President George W. Bush, "President's Growth Package" (Jan. 7, 2003); Press Release, U.S. Dept. of the Treasury, Details of the President's Dividend Exclusion Proposal (Jan. 21, 2003) [both hereinafter cited as the "Bush Treasury Proposal"]; see also Robert F. Manning & David F. Windish, A Concise Explanation of the Administration's Tax Proposals, 98 TAX NOTES (TA) 902 (Feb. 10, 2003).

an income tax advocate. Each side may be both happy and unhappy with the resulting camel.<sup>2</sup>

### II. A CONSUMPTION TAX: THE ALTERNATIVE METHODS

One way to measure personal consumption is to begin with a taxpayer's income and then subtract savings or increases in wealth. Income is generally defined for economic purposes as a taxpayer's (1) personal consumption during the year plus (2) increase in wealth during the year.<sup>3</sup> As such, the tax base in an income tax system would generally encompass both of those elements. By subtracting savings from income, the resulting tax base would capture only a taxpayer's personal consumption. This model of the consumption tax is sometimes referred to as the "cash flow consumed income tax" or simply the "consumed income tax." It was originally proposed by William Andrews, a Professor of Law at the Harvard Law School, in a 1974 law review article.<sup>4</sup> That article is generally regarded as the genesis of serious thinking about the consumption tax as a replacement for the income tax.

Another way to tax consumption is to tax all income from labor and business, regardless of whether it is saved or spent, but exclude income earned on investment assets. This model of the consumption tax is referred to as "yield exemption." Under certain assumptions, this method of achieving a consumption tax is the economic equivalent of the consumed income version. This equivalence and its implications are discussed below.

Finally, a third way to tax consumption is to impose a tax on the consumption expenditures at the point of sale. This model of the consumption tax is referred to as "point of sale taxation." A retail sales tax and its cousin, the value added tax (VAT), use this method.

The first two of these alternatives foresee collection of tax annually based on income or receipts and therefore appear closely related to the current income tax. As a result, they are most easily compared with the income tax and are the easiest forms to transition from the income tax. A point of sale tax also can be converted to an annually collected tax on business, as explained below.

#### A. The Consumed Income Tax

Under the consumed income tax, the individual taxpayer includes all items of income, both from labor and from capital, in his tax base, and then subtracts or deducts the portion of that income that he saves or invests. The resulting amount represents the portion of his income that he has not saved, (*i.e.*, that he has consumed), and is the amount that is subject to  $\tan^{5}$  In that manner, the con-

<sup>&</sup>lt;sup>2</sup>A camel is a horse designed by a committee.

<sup>&</sup>lt;sup>3</sup>HENRY C. SIMMONS, PERSONAL INCOME TAXATION 50 (1938), refining Robert Haig, "The Concept of Income," in The Federal Income Tax 1, 7 (1921).

<sup>&</sup>lt;sup>4</sup>William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113 (1974).

<sup>&</sup>lt;sup>5</sup>*Id*. at 1149.

sumed income tax would levy the tax directly on consumption.<sup>6</sup> The consumed income tax is computed and collected at the individual level.<sup>7</sup> Thus, for example, an individual who saves \$10,000 from his \$100,000 income for the year would only be taxed on his net of \$90,000. Administratively, this type of consumption tax is problematic since a method must be devised to establish the amount of a taxpayer's savings. The likely solution would be to designate qualified accounts at savings banks, security brokerage houses, and other types of financial institutions to track these savings.<sup>8</sup>

The counterpart to this process for the business taxpayer permits that taxpayer to deduct currently from gross income any amounts spent on investment in plant and equipment during the year (in addition to ordinary operating expenses). Under the income tax, in general, these expenditures could require capitalization if they create an asset or benefit extending substantially beyond the year of the expenditure.<sup>9</sup>

The analysis of a consumption tax often focuses on the cash flow consumed income tax because it can be collected, mechanically, in a manner similar to the current income tax. It therefore is most easily compared and contrasted to the income tax. Observations regarding the consumption tax gleaned from this comparison will generally be instructive regarding other forms of consumption tax as well.

#### B. Yield Exemption: Exclusion from Tax of Investment Earnings

A similar end result—taxing consumption, but not savings—can be achieved in other ways as well, employing variations of the income tax model. For example, suppose instead of permitting a deduction for a taxpayer's savings or investment during the year, the tax law permitted the returns from that investment to be exempt from tax instead. Under certain specific circumstances (involving assumptions that (i) tax rates are uniform over time,<sup>10</sup> (ii) the deduction produces an immediate tax saving determined by that uniform rate, and (iii) the tax savings from the deduction will yield the same return as the rest of the investment<sup>11</sup>), this variation will replicate the effect of allowing the deduction.

To illustrate this point, consider a taxpayer's investment of \$100 in year 1 for which a deduction would be allowed under the cash flow consumption tax

<sup>&</sup>lt;sup>6</sup>See id. Under Andrews' formulation, a taxpayer would also include borrowings in his tax base and deduct repayments.

<sup>&</sup>lt;sup>7</sup>See generally id. at 1120.

<sup>&</sup>lt;sup>8</sup>See generally Paul H. O'Neill & Robert A. Lutz, *Unlimited Savings Allowance (USA) Tax System*, 66 TAX NOTES (TA) 1482, 1522 (Mar. 13, 1995) (describing the type of form which would be used to keep track of savings and investments).

<sup>&</sup>lt;sup>9</sup>I.R.C. § 263; Reg. § 1.263(a)-2(a).

<sup>&</sup>lt;sup>10</sup>This assures that the tax saved by virtue of the deduction will be collected at the same rate upon sale of the asset.

<sup>&</sup>lt;sup>11</sup>This equates a yield exemption investment with an immediately deductible investment of the same amount. If the equivalence is instead based on the amount of after-tax investment, then the assumption is not necessary, as illustrated later in the text.

model. Suppose that the taxpayer's tax rate is 30% and the item will generate the cumulative amount of \$200 in year 3, which will be withdrawn for consumption and therefore taxable. As a result, a post-tax investment of \$70 (the result of a pre-tax investment of \$100 for which a deduction is allowed) will result in pre-tax income of \$200, which when withdrawn and taxed will amount to post-tax income of \$140 (\$200 - \$60 (tax)). Under these facts, the taxpayer's net after-tax profit is \$70 (\$140 (post-tax return) - \$70 (post-tax investment)) and rate of profit for the relevant years is 100%.

Similarly, if no deduction is allowed for the investment, but the resulting income is exempted from tax, as under the yield exemption model, then under these same assumptions, the taxpayer's rate of profit will be the same as the foregoing illustration. Specifically, the \$100 nondeductible expenditure represents a post tax investment of \$100. In year 3, it generates the cumulative amount of \$200, which is exempt from tax. Under these facts, the taxpayer's net after-tax profit is \$100 and rate of profit for the relevant years is 100%.

In these two examples, the taxpayer's rate of profit is the same, namely 100%. Further, the taxpayer in the first example could duplicate the second taxpayer's amount of profit by investing the after-tax contribution amount of \$100 instead of only \$70. For example, suppose the taxpayer invested \$142.86 before tax and therefore \$100 (142.86 - \$42.86 (tax savings)) after tax to generate \$285.72 before tax, representing \$200 after tax amount (285.72 - \$85.72 (tax)), and \$100 after-tax profit from the \$100 after-tax amount invested. The taxpayer's rate of profit remains at 100%, and his after-tax profit amount is \$100 (\$200-\$100).<sup>12</sup> The above comparison is illustrated in the following table.

 
 TABLE 1

 Comparison of Cash Flow Consumed Income Treatment with Yield Exemption Treatment

	Contribution	Taxes Due During Investment Period	Amount in Account, Including Earnings at End of Period	Taxes Due at End of Period	Amount Remaining After Tax	After-Tax Profit
Cash Flow Treatment	142.86*	0	285.72	85.72**	200	100
Yield Exemption Treatment	100	0	200	0	200	100

\* Represents \$100 after effect of deduction: \$142.86 (1-.30) = \$100

\*\* \$285.72 x 30% = \$85.72

<sup>&</sup>lt;sup>12</sup>This equivalence can be demonstrated mathematically as follows: Let C equal the after-tax contribution amount (so that  $C_{(1-t)}$  represents the before tax equivalent amount), r equal the rate of return and t equal the tax rate (assumed to be constant). Then, the equivalence can be demonstrated in the following way. The yield exemption savings at the end of the period will be represented by C(1+r). Under the consumed income model, the after-tax savings would be computed as follows: After-tax savings =  $C_{(1-t)}(1+r)(1-t)$ ; *i.e.*, the before-tax contribution  $C_{(1-t)}$  multiplied by one plus the rate of return (1+r), multiplied by the percentage remaining after a tax of t is imposed on the entire account upon distribution (1-t). This simplifies to C(1+r) and demonstrates the equivalence.

The first illustration, under the cash flow model, is the method followed under the traditional IRA. The second illustration, under the yield exemption model, is the method followed under the Roth IRA. The above comparison shows them to be identical in effect. The investment result from the Roth IRA may be preferred over that of the traditional IRA because the contribution limit for the Roth IRA (currently \$3,000 per year) is computed as an after-tax amount, whereas the contribution limit of a traditional IRA (also currently \$3,000 per year) is computed as a pre-tax amount and is therefore the equivalent of only \$2,100 (\$3,000 x 70%) of after-tax dollars, assuming a 30% tax rate.<sup>13</sup> If there were no contribution limits, however, the two would be mathematically equivalent.<sup>14</sup>

The above equivalence, demonstrated in the Treasury Department's words that "permitting the capital cost of an asset to be expensed has the effect of exempting the income from ownership of the asset from taxation,"<sup>15</sup> is dependent on certain conditions. These include the application of a constant rate of tax, not progressive and not varying from year to year; the taxpayer's ability to use the deduction to offset income currently to generate a current tax savings; and a constant available yield on investments throughout the relevant period. The absence of any of these conditions will alter the results, but the basic principle of equivalence is still important.

Notably, even if the expected yield from investments was 100% over a threeyear period, but was not certain, with an equal chance of the return being 75% and 125%, a risk averse taxpayer who had decided to invest (without regard to any tax deduction) a set amount would prefer a current deduction to yield exemption. And, if the return ended up being more or less than 100%, the two alternative consumption tax alternatives would yield different results. But the difference derives solely from the fact that in a yield exemption regime, a set amount represents a larger net investment than that same amount would represent in a cash flow regime, where the invested amount gives rise to a deduction, effectively reducing the net investment to an amount that is less than the nominal amount contributed. Thus, the proposition merely reflects the preference of a risk-averse investor to invest less where the return is uncertain than a risk taker. The general proposition holds, however, and in principle the immediate deduction and yield exemption are economically equivalent. As a result, a consumption tax could be created using the principle of yield exemption for all investments and savings in lieu of immediate deduction for the investment.

<sup>&</sup>lt;sup>13</sup>There are also other statutory rule differences between the two, *e.g.*, higher income limitations for qualification and more liberal pay-out requirements under a Roth IRA than a traditional IRA.

<sup>&</sup>lt;sup>14</sup>See Leonard Burman et al., *The Taxation of Retirement Saving: Choosing Between Front-Loaded and Back-Loaded Options*, 54 NAT'L TAX J. 689 (2001) (analyzing the relative benefits of traditional IRAs and Roth IRAs as dependent upon the contribution limits under current law and expected tax rates at the times of contribution and withdrawal).

<sup>&</sup>lt;sup>15</sup>See 116 Cong. Rec. 25,685 (1970) (citing 1970 Treasury Department Study on Tax Depreciation Policy).

Of course, from a budget scoring point of view, a yield exemption provision differs from a cash flow provision in that a cash flow provision reduces tax collections up front, in the year or years of its direct effect, whereas a yield exemption provision affects the back end income-producing years of the investment only. As a result, the tax alternatives may be subject to different political pressures. Moreover, if the investment return ends up being unexpectedly high, the choice from the government's view of yield exemption over consumed income would appear to be unfortunate, because of the unexpected loss of potential revenue from the government not being a partner in the investment.<sup>16</sup> The disappointment only occurs with hindsight. The exact opposite reaction would result from a losing investment in that the government would not be a partner in the loss, either. The government's *expected loss* of revenue, in present value terms, would be the same under both regimes for comparable provisions based on after-tax investments. Accordingly, consumed income and yield exemption should have equivalent long-term effects on the budget.

Pushing the analysis of yield exemption somewhat further, a partial consumption tax effect can be accomplished by imposing a preferential tax rate on the return from investment or savings. For example, if gain from sale of an asset were taxed at one-half of the regular tax rate, a hybrid consumption tax—income tax effect would result. Further, if the tax rate were reduced to zero for sales by decedents' estates, which is the effect of section 1014, then the hybrid referred to above would come closer to the consumption tax side.

# C. Consumption Tax at Point of Sale: The Retail Sales Tax and Value-Added Tax

A third method involves taxing consumption expenditures at the point of sale. Indeed, when most lay people think about a consumption tax, they think about a tax levied indirectly on consumption. The principal indirect consumption taxes are a retail sales tax and a VAT.

A retail sales tax imposes a tax on the purchase of commodities, which could include labor.<sup>17</sup> A general sales tax imposes that tax at a uniform rate.<sup>18</sup> In contrast to a general sales tax, a selective sales tax or excise tax is levied at different rates (including zero) on different commodities.<sup>19</sup>

The national sales tax, a consumption tax under consideration to replace the income tax, is generally described as an ad valorum tax.<sup>20</sup> Sales at stages earlier

<sup>&</sup>lt;sup>16</sup>See U.S. DEP'T. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM, at 128-129 (1977) (which sees this possibility as a reason to prefer the consumed income approach to the yield exemption approach for investments other than fixed income securities or savings accounts).

<sup>&</sup>lt;sup>17</sup>See Harvey S. Rosen, Public Finance 441 (5th ed. 1999).

 $<sup>^{18}</sup>Id.$ 

<sup>&</sup>lt;sup>19</sup>Id. at 442 (selective sales tax also referred to as an excise tax, or a differential commodity tax).

<sup>&</sup>lt;sup>20</sup>See *id.* (an ad valorem tax is calculated based on the percentage of the purchase price); Lawrence J. Kotlikoff, *Saving and Consumption Taxation: The Federal Retail Sales Tax Example, in* FRONTIERS OF TAX REFORM 160, 176 (Michael J. Boskin ed., 1996) (describing a tax based on a percentage of purchase price).

than the retail level are not subject to the tax.<sup>21</sup> This exemption of non-retail sales avoids the cascading effect of tax imposed at each stage of production<sup>22</sup> and thereby avoids discriminating against non-vertically integrated companies in favor of vertically integrated companies.<sup>23</sup> Imposing the tax on the gross amount of retail sales ensures that all of the component costs of production (*e.g.*, raw materials, labor, etc.) as well as returns on capital (*e.g.*, interest, rent, and profits) will be in the tax base because they will be reflected in the price of the product.

A VAT is, in substance, a form of a retail sales tax.<sup>24</sup> Its advantages over a retail sales tax lie in its compliance properties and its built-in protection from evasion.<sup>25</sup> A VAT is collected in stages.<sup>26</sup> Each producer pays a tax on the value added to the product being sold.<sup>27</sup> The tax is implemented by means of a tax imposed at the full rate on the full value of the product when sold at retail.<sup>28</sup> Thus, the price of the product to the consumer includes the tax computed by applying the VAT rate to the tax-exclusive price of the product or service.<sup>29</sup>

Under a credit-style VAT, the retail seller is permitted a credit against the tax that must be remitted upon retail sale of the product.<sup>30</sup> The credit equals the VAT that the seller paid for raw materials, which was included in the price paid by the seller.<sup>31</sup> In this manner, the retail seller is required only to remit a net tax payment equivalent to the VAT rate multiplied by the value that the retail seller added to the product.<sup>32</sup> Thus, a credit-style VAT collects a tax at each stage of production through ultimate retail sale, but the aggregate amount of tax collected is no greater than the amount that would be collected as a retail sales tax at the

<sup>&</sup>lt;sup>21</sup>See Malcolm Gillis et al., *Indirect Consumption Taxes: Common Issues and Differences Among Alternative Approaches*, 51 Tax L. REV. 725, 731 (1996) (contrasting the retail sales tax, which does not tax business inputs, with the business transfer tax and the value-added tax methods); Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Tax, Flat Tax, Retail Sales Tax, and USA Tax Into Perspective*, 33 SAN DIEGO L. REV. 1281, 1315 (1996) (noting that a feature of the retail sales tax is to refrain from taxing purchases by businesses for resale).

<sup>&</sup>lt;sup>22</sup>See Schenk, *supra* note 21, at 1315 (1996) (discussing the effect of cascading); *see also* Joseph Isenbergh, *The End of Income Taxation*, 45 Tax L. Rev. 283, 332 (1990) (discussing the impact of cascading on consumers); JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 209 (MIT Press 1996) (detailing the distorting effect of cascading on consumers).

<sup>&</sup>lt;sup>23</sup>Schenk, *supra* note 21 at 1315.

<sup>&</sup>lt;sup>24</sup>See David F. Bradford, Fundamental Issues in Consumption Taxation 7 (1996).

<sup>&</sup>lt;sup>25</sup>See generally Alan Schenk, Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?, 7 VA. TAX REV. 207, 285 (1987).

<sup>&</sup>lt;sup>26</sup>See Alan Schenk, *Radical Tax Reform for the 21st Century: The Role for a Consumption Tax*, 2 CHAP. L. REV. 133, 139 (1999).

<sup>&</sup>lt;sup>27</sup>See id.

<sup>&</sup>lt;sup>28</sup>See id. at 139-40.

<sup>&</sup>lt;sup>29</sup>See id.

<sup>&</sup>lt;sup>30</sup>See Gilbert E. Metcalf, *The Role of Value-Added Tax in Fundamental Tax Reform, in* FRONTIERS OF TAX REFORM 91, 93-94 (Michael J. Boskin ed., 1996) [hereinafter "Metcalf *in* FRONTIERS"]; Schenk, *supra* note 26, at 139.

<sup>&</sup>lt;sup>31</sup>Metcalf in FRONTIERS, supra note 30, at 93-94.

<sup>&</sup>lt;sup>32</sup>See Schenk, supra note 26, at 139-40.

final sale.<sup>33</sup> To the extent the ultimate retail seller fails to pay over the VAT portion of a sale, it will not be entitled to its credit.<sup>34</sup> Only the tax on the retailer's mark-up will be lost.<sup>35</sup>

A point of sale VAT can be converted into an annually collected VAT, which can be employed to tax the business taxpayer annually in a manner similar to the corporate income tax. The VAT, referred to as a subtraction style VAT, however, is a consumption tax rather than an income tax. A subtraction-style VAT is collected at each stage of production, but the tax due at each stage is computed by multiplying the VAT rate by the excess of the gross receipts over deductible expenditures of the payor.<sup>36</sup> The cost of raw materials and capital are deductible in computing value added.<sup>37</sup> In contrast, the cost of labor and returns on capital are not deductible.<sup>38</sup>

Facially, a subtraction style VAT resembles the corporate income tax, except that investments are expensed and no deduction is allowed for labor and interest costs.<sup>39</sup> If wages and interest income were taxed to the respective recipients but allowed as a deduction at the business tax level, then the remaining distinction between a subtraction style VAT at the business level and a business income tax would be the treatment of capital expenditures—deductible under a VAT but capitalized and depreciated, if appropriate, under a business income tax.

# III. CONSUMPTION TAX PROVISIONS OF THE INTERNAL REVENUE CODE

The current Internal Revenue Code already contains many consumption tax provisions. As discussed below, it seems likely that more are on the way.

# A. The Realization Requirement, Capital Gains, Dividends, and Stepped-up Basis at Death under Section 1014

Under longstanding principles of the U.S. tax law, gain is not includable in income until there is an event of realization.<sup>40</sup> Mere appreciation in value of property, without more, does not create income subject to tax. Under a pure personal income tax system based upon the Haig-Simons definition of economic income, an increase in wealth would result in taxable income to the taxpayer. The Federal tax system deviates from that ideal because of the realization requirement.

<sup>&</sup>lt;sup>33</sup>See id.

<sup>&</sup>lt;sup>34</sup>See Metcalf in FRONTIERS, supra note 30, at 96.

<sup>&</sup>lt;sup>35</sup>Id.

<sup>&</sup>lt;sup>36</sup>*Id*. at 94.

<sup>&</sup>lt;sup>37</sup>See generally 3 U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECO-NOMIC GROWTH, at 5-7 (1984) (the cost of capital is only fully deductible in a consumption style VAT, not a Gross Domestic Product (GDP) or Income Type VAT).

<sup>&</sup>lt;sup>38</sup>See *id.*; see also Metcalf *in* FRONTIERS, supra note 30, at 92 (value added includes the value of labor and return to capital, so they would be included in the tax base).

<sup>&</sup>lt;sup>39</sup>See U.S. DEP'T OF TREASURY, *supra* note 16, at 7-8; SLEMROD & BAKIJA, *supra* note 22, at 197-99. <sup>40</sup>See I.R.C. §1001(a).

If a property owner were never forced to sell property, then the appreciation of the property would escape taxation. In this connection, some exchanges of property for other property are treated as nonrecognition transactions in that, in general, gain on the exchange is not subjected to tax at the time of the exchange but rather is deferred until the property received in the exchange is sold or otherwise disposed of in a taxable transaction. The mechanism of this deferral involves treating the basis in the property exchanged as the basis in the property received in the exchanges; section 368 dealing with corporate reorganizations, which triggers the nonrecognition provisions of sections 354, 356, 357, and 358; and sections 351 and 751 dealing with incorporations and partnership formations, respectively, fall into this category. The impact of all of these nonrecognition transactions is to accomplish, with some exceptions, the same result as avoiding an event of realization and therefore treatment as if the new property were a continuation of the taxpayer's investment in the old property.

A system under which no taxpayer ever sold property in a transaction requiring gain recognition would resemble a yield exemption consumption tax model, particularly if the property did not generate a current flow of taxable income.<sup>41</sup> For example, appreciating stock in a company that paid no dividends provides the owner with yield exemption treatment as long as the stock is not sold or exchanged in a taxable transaction. Indeed, if the stock is transferred by gift, exemption from current tax for the appreciation at the time of the gift continues in the hands of the recipient by means of the carryover basis accorded the stock<sup>42</sup> in that a lifetime gift is not an event of realization for the donor.<sup>43</sup>

When a system described above, involving potentially endless deferral, is coupled with a provision like section 1014, which allows a basis increase to the value of the property at the date of the owner's death (which is not an event of realization for the decedent),<sup>44</sup> the system becomes one of complete yield exemption as long as the property is retained until death. Thus, those taxpayers who acquire property that appreciates in value and hold that property until death, or give it to a recipient who holds the property until his death, attain full yield exemption treatment, the functional equivalent of consumption tax treatment.

Does the combination of non-realization and section 1014 basis step-up at death represent an exception or the norm? For wealthy people, the combination certainly represents an area of affirmative tax planning.<sup>45</sup> It is for that reason that

<sup>&</sup>lt;sup>41</sup>Andrews, *supra* note 4, at 1128-29 (Professor Andrews pointed out that this fundamental deviation from a pure accretion income tax made the income tax something of a hybrid consumption tax).

<sup>&</sup>lt;sup>42</sup>I.R.C. §§ 1015(a), 1041(b) (in the case of a gift to a spouse).

<sup>&</sup>lt;sup>43</sup>I.R.C. § 1001(c). See Boris Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 40.3 (3d ed. 1999) [hereinafter Bittker & Lokken].

<sup>&</sup>lt;sup>44</sup>BITTKER & LOKKEN, *supra* note 43.

<sup>&</sup>lt;sup>45</sup>Of course, taxpayers who desire to shift portfolio investments may realize gains, but they have a choice and in many cases can offset those gains with losses they realize for that purpose.

tax-free reorganizations<sup>46</sup> of closely held corporate businesses are attractive tax planning techniques, particularly for elderly taxpayers. But even for investment portfolio stock, tax planners advise against sales by elderly taxpayers unless there are overwhelming investment reasons for the sales. In any event, the amount of foregone income tax revenue resulting from these rules is extremely large.<sup>47</sup>

Taxpayers who hold property for a number of years while it appreciates and sell it before death are accorded only partial yield exemption treatment. The longer the property is held and the lower the capital gain tax rate applicable to the taxpayer at the time of sale, the greater the resemblance of the treatment to full yield exemption and therefore consumption tax. For example, less wealthy taxpayers who use portfolio stocks as a substitute for or interchangeably with savings accounts for future consumption do not enjoy the full benefits of yield exemption, although they may enjoy substantial benefit from deferral and the capital gains rate preference.

If the capital gains tax were to be eliminated entirely, then yield exemption consumption tax treatment would be attained without the need for the taxpayer to die to get it. In that event taxpayers who either needed or desired to sell their appreciated property could enjoy the same beneficial treatment as wealthy taxpayers. Perhaps as a step in that direction, the individual long-term capital gain tax rate for most long-term capital gains was reduced recently from 20% to 15% (from ten percent to five percent for lower bracket taxpayers) upon the enactment on May 23, 2003, of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Jobs and Growth Act").<sup>48</sup>

Foregone revenue from unrealized capital gains is not regarded as a tax expenditure, technically, because it is not a deviation from the reference tax baseline, even though it is a departure from a comprehensive income tax. *Id.* at 112. The tax cost of the realization requirement, therefore, is not estimated by the Treasury. The tax expenditures attributable to the capital gains tax rate preference and stepped-up basis at death under section 1014, however, are included in the tax expenditure budget. Tax expenditures in 2003 attributable to the capital gains rate preference and section 1014 are as follows:

Estimates of total income tax expenditures (In millions of dollars)	<u>2003</u>
Capital gains	60,200
Step-up basis for capital gains at death under section 1014	28,710

*Id.* at 99. The Tax Expenditure Budget projects that the capital gains tax expenditure will fall in the future but the step-up basis tax expenditure will rise. *Id.* 

<sup>&</sup>lt;sup>46</sup>See section 368, which triggers section 354 or section 356, and thereby treats the taxpayer's new investment as a continuation of the old, avoiding immediate taxation of any gain (apart from boot) until the taxpayer engages in a sale or other realization transaction with the new property.

<sup>&</sup>lt;sup>47</sup>Forgone revenue resulting from special tax provisions that deviate from a reference baseline income tax are referred to as "tax expenditures" and are catalogued annually in what has become known as the Tax Expenditure Budget. Tax expenditures are defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." 2003 BUDGET OF THE UNITED STATES GOVERNMENT, ANALYTICAL PERSPECTIVES at 95 [hereinafter "Tax Expenditure Budget 2003"]. In 1974, the Congress of the United States mandated as part of the Congressional Budget Act of 1974 that the annual Federal budget presentation include a list of these tax expenditures. *Id.* 

 $<sup>{}^{48}</sup>$ I.R.C § 1(h)(1)( $\overline{B}$ ), (C). The 28% rate applicable to collectables and the 25% rate on unrecaptured section 1250 gain for high bracket taxpayers were retained. I.R.C. § 1(h)(1)(D), (E).

The discussion above assumed no current payment of dividends. Until recently, the current income tax treated dividends as taxable income, taxable at the same rates as other ordinary income. The 2003 Jobs and Growth Act, however, reduced the tax rate applicable to dividends to that applicable to long-term capital gains, *i.e.*, 15% (five percent for low bracket taxpayers).<sup>49</sup> As such, the income tax still results in a deviation from yield exemption treatment for stock even if not sold until death, but that deviation has been reduced. The previous income tax treatment of dividends may explain why almost all closely held C corporations and so many publicly traded companies have been averse to paying dividends. If distributions to shareholders were desired, public companies would prefer to redeem stock so that shareholders could limit their income inclusion to gain instead of the entire payment, because of the available basis offset, and could benefit from preferential capital gains treatment of that gain.

The Bush Treasury proposed legislation to exclude dividends from income completely, but that proposal was modified in the legislation, as discussed above, to merely a preferential rate equivalent to the capital gains rate. A complete exemption from income of dividends would be a straightforward yield exemption provision, and represent additional movement toward a consumption tax at the individual level. Arguably, it represents a correction from the double tax of corporate income, and there is some truth to that. But the corporate tax, replete with investment incentives, may also be characterized as a hybrid income/consumption business tax. If this proposal is enacted in the future, then yield exemption consumption tax treatment could be approached, because current returns on stock would be excluded and deferral and preferential capital gain treatment upon sale would result in partial yield exemption.

#### **B.** Retirement Plans

Retirement plans represent the largest statutory inroad of a consumption tax feature into the income tax regime.<sup>50</sup> Corporate defined contribution retirement plans including those that permit employees to indirectly fund their own accounts by voluntarily reducing their wages to provide a source for employer funding, referred to generally as section 401(k) plans,<sup>51</sup> Keogh Plans for self employed<sup>52</sup> and Individual Retirement Accounts ("IRA"s), both traditional<sup>53</sup> and

<sup>49</sup>I.R.C. § 1(h)(3)(A)-(B), (h)(11).

<sup>50</sup>Tax expenditures in 2003 attributable to retirement plans are as follows:

Estimates of total income tax expenditures (In millions of dollars)	<u>2003</u>
Employer plans	53,080
401(k) plans	59,510
Individual retirement accounts	18,660
Keogh plans	6,770

Tax Expenditure Budget 2003, *supra* note 47, at 100-01. These numbers are projected to increase in the future. *Id*.

<sup>51</sup>I.R.C. § 401(k).

<sup>52</sup>I.R.C. § 401(c). <sup>53</sup>I.R.C. § 408.

<sup>11</sup> 

Roth,<sup>54</sup> are the principal types of retirement plans. Section 401(k) plans, Keogh plans and traditional IRAs provide tax deferral. They permit deductions or exclusions for amounts contributed to the plan by or for the benefit of the taxpayer and tax-free build-up of interest, dividends or appreciation as long as the funds remain in the plan, but they require income inclusion when funds are withdrawn. In this sense, the plans operate in the same manner as a cash flow consumed income consumption tax would, but are limited to amounts contributed to the designated retirement accounts. In addition, amounts that may be contributed to the plans and therefore deferred as income are subject to annual limitations. The highest of these limitations is \$40,000 (as adjusted for cost of living increases) for Keogh Plans and defined contribution corporate-sponsored plans with employer contributions.<sup>55</sup> Employee elective contributions to section 401(k) plans are limited to \$12,000 in 2003, increasing to \$15,000 per year when the changes under the 2001 Act are fully phased in for 2006 (subject to the overall \$40,000 contribution limit mentioned above)<sup>56</sup> and traditional IRAs currently have even lower contribution limits of \$3,000 increasing to \$5,000 in 2008.57

The aggregate amounts involved in retirement plans are by anyone's measure quite large. The table below sets forth the growth in 401(k) plans from 1984 to 1993 in terms of number of plans and participants, and the amounts contributed, retained and distributed by the plans.

+01(k) I fail 11chd3, 1904-1995					
	Number of Plans	Participants	Contributions	Plan Assets	Distributions
Year	(thousands)	(millions)	(\$billions)	(\$billions)	(\$billions)
1984	17.3	7.5	16.3	91.8	10.6
1985	29.9	10.3	24.3	143.9	16.4
1986	37.4	11.6	29.2	182.8	22.1
1987	45.1	13.1	33.2	215.5	22.2
1988	68.1	15.2	39.4	277.0	25.2
1989	83.3	17.3	46.1	367.0	30.9
1990	97.6	19.5	49.0	384.9	32.0
1991	111.4	19.1	51.5	440.3	32.7
1992	139.7	22.4	64.3	553.0	43.2
1993	154.5	23.1	69.3	616.3	44.2

**TABLE 2** 401(k) Plan Trends, 1984-1993<sup>58</sup>

54I.R.C. § 408A.

<sup>55</sup>I.R.C. § 415(c)(1)(A).

 $^{56}$ I.R.C. § 402(g)(1)(A)-(B). An additional "catch up" amount is allowed for taxpayers over the age of 50 in the amount of \$2,000 for 2003, increasing to \$5,000 in 2006. I.R.C. §§ 402(g)(1)(C), 414(v)(2)(B)(i).

<sup>57</sup>Section 219 provides limits on contributions, currently at \$3,000 but scheduled to increase to \$5,000 in 2008, with an additional amount for taxpayers over 50 years of age of \$500 through 2005, and \$1,000 thereafter. I.R.C. \$ 219(b)(1)(A), 5(A)-(B)(ii).

<sup>58</sup>JOINT ECONOMIC COMMITTEE, THE ROOTS OF BROADENED STOCK OWNERSHIP, at 9 tbl. 2 (Apr. 2000), *at* http://www.house.gov/jec/tax/stock/stock.htm.

As of November, 2002, it is estimated that there were 432,403 section 401(k) plans, involving 47,210,000 participants, with estimated total assets in these plans of 1.81 trillion.<sup>59</sup>

Retirement plans differ from a consumption tax, however, in their treatment of distributions from the plan. Distributions are taxable to the recipient when received, whether or not consumed. Moreover, retirement plans (other than Roth IRAs) require that distributions begin no later than when the beneficiary attains the age of 70<sup>1</sup>/<sub>2</sub><sup>60</sup> and continue during the periods following commencement of distributions based upon an actuarial measure of the beneficiary's remaining life (and the life of the surviving spouse, if elected). Further, even upon the death of the plan beneficiary, the amount in the plan (other than a Roth IRA) will be subject to tax upon distribution as income in respect of a decedent, although with significant additional deferral, particularly for a surviving spouse, who can roll this amount over into her own IRA.<sup>61</sup> Nevertheless, because of the rules requiring distributions, retirement plans approach but do not quite reach the cash flow consumed income consumption tax model.

Both contribution limitations and distribution requirements are being reviewed by the Treasury, and it is likely that allowable contribution amounts will be expanded and distribution requirements will be eased in future years in order to encourage savings and not force dissaving. During the past few years, in fact, the contribution limits have increased for all types of plans.

Roth IRAs contain their consumption tax feature by means of exemption of the earnings from taxation rather than by an allowance of a deduction or exemption for the contribution itself. As long as funds remain in the plan, earnings on those funds will enjoy permanent exemption from tax. The future earnings on funds once distributed are no longer free of tax. In contrast to the traditional IRA, however, the Roth IRA, as currently in effect, does not provide for mandatory distributions during the owner's lifetime.<sup>62</sup> As such, the Roth IRA represents a means of accumulating wealth to be transmitted at death. Further, beginning in 2006, section 401(k) plan participants will be able to choose the Roth yield exemption regime for these plans rather than contribution deduction or exemption.<sup>63</sup>

Curiously, both traditional and Roth IRAs permit penalty-free distributions for various specified purposes other than death, disability or attaining age  $59^{1}/_{2}$ ,

<sup>&</sup>lt;sup>59</sup>Employee Benefit Research Institute, *History of 401(k) Plans: An Update*, (Nov. 2003), *at* http://www.ebri.org/facts/1102fact.htm.

<sup>&</sup>lt;sup>60</sup>This provision is under examination by the Treasury and its elimination or liberalization may be the subject of future legislative change, although at this point the form of the liberalization appears to be the creation of new kinds of savings vehicles, a Lifetime Savings Account or a Retirement Savings Account, in addition to traditional or Roth IRAs available to taxpayers.

<sup>61</sup>I.R.C. § 402(c)(9).

 $<sup>^{62}</sup>$ I.R.C. § 408A(c)(5); see BITTKER & LOKKEN, *supra* note 43, at ¶ 62.4.1. Roth IRAs are subject to the same distribution rules as traditional IRAs after the owner's death. Reg. § 1.408A-6, Q-8-A14(b).

<sup>&</sup>lt;sup>63</sup>I.R.C. § 402A. See U.S. Dep't of the Treasury, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals (2000).

referred to as a "qualified special purpose distribution."<sup>64</sup> These include traditional IRA distributions for certain medical expenses;<sup>65</sup> those made during periods of the owner's unemployment, subject to requirements and limitations;<sup>66</sup> those made for an owner's "qualified higher education expenses;<sup>67</sup> and "qualified first-time homebuyer distributions."<sup>68</sup>

Roth IRA penalty free distributions are more limited, but include distributions up to \$10,000 lifetime maximum used to purchase a principal residence by or for a first-time homebuyer who is the owner of the IRA, her spouse, a child, grand-child or ancestor of the owner or spouse.<sup>69</sup>

These flexible distribution rules, which allow distributions for reasons other than retirement, belie the original purpose of creation of the accounts as individual *retirement* accounts. This flexibility, which post-dates the original enactment of the traditional IRA legislation, evidences the more general consumption tax nature of the arrangements.

If one were to posit the simplifying assumption that retired people spend all of the amounts that they saved previously in their lives, because for example, they purchase an annuity with the balance in their retirement accounts for their lives (including spouses), or a distribution schedule can be selected to reflect their consumption pattern, then the equivalence to a consumption tax pattern is complete, at least with regard to retirement plans. Thus, if legislation under the income tax would better permit taking distributions only when consumption was desired, a consumption tax pattern would be approached.

But what about savings outside of retirement plans? These savings are not treated preferentially. But unrestricted savings of most wage earners (apart from their homes) pale in comparison to the savings built into retirement plans and anticipated future social security benefits.<sup>70</sup>

<sup>70</sup>See Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances, 86 Feb. Res. Bull. 1 (Jan. 2003), which analyzes patterns of growth in net income and wealth and their distributions across segments of society based upon income, wealth, and various other characteristics. The analysis and discussion are based upon the Survey of Consumer Finances (SCF), which is a triennial survey sponsored by the Board of Governors of the Federal Reserve System in cooperation with the Statistics of Income Division of the Internal Revenue Service. The most recent SFC indicates that Retirement Accounts are a category of financial assets consisting of IRAs, Keogh accounts, and certain employer-sponsored accounts, which include 401(k), 403(b), and thrift savings accounts from current or past jobs from which loans or withdrawals can be made and accounts from past jobs from which the family expects to receive the account balance in the future. Id. at 11. Notably, this category of assets does not include defined-benefit type retirement plans, the income provided by which is typically based upon worker's salaries and years of work with an employer, group of employers or a union. Id. at 11-14. Measurement of the value of defined benefit plans is made difficult by uncertainties in work decisions, inflation rates, discount rates, mortality, etc. Id. (Less important for purposes of this point, the category of Retirement Accounts also does not include any measure of expected Federal Social Security benefits.) Nevertheless, even with the omission(s), 52.2% of all families had retirement accounts in 2001, up from 48.9% in 1998, with a mean value of \$29,000, up from \$26,100 in 1998. Id. at 12-13.

<sup>64</sup>I.R.C. § 408A(d)(2)(A), (B).

<sup>&</sup>lt;sup>65</sup>I.R.C. § 72(t)(2)(B).

<sup>66</sup>I.R.C. § 72(t)(2)(D).

<sup>&</sup>lt;sup>67</sup>I.R.C. § 72(t)(2)(E).

<sup>68</sup>I.R.C. § 72(t)(2)(F).

<sup>&</sup>lt;sup>69</sup>I.R.C. §§ 72(t)(8), 408A(d)(5).

The Bush Treasury Proposal would have both simplified and expanded individual retirement arrangements by replacing traditional, Roth, and nondeductible IRAs with Retirement Savings Accounts ("RSAs") and would have permitted other kinds of tax advantaged savings through Lifetime Savings Accounts (LSAs).<sup>71</sup>

The proposal, in general, would have permitted a taxpayer to contribute up to \$7,500 per year to each type of account.<sup>72</sup> Both are yield exemption accounts, so that after-tax money is contributed (no deduction is allowed for the contribution), but the amount earned in the accounts would not be subject to tax and could be withdrawn tax-free. The LSAs, for which there would be no income limitations, would allow withdrawals freely regardless of the age of the owner or the use of the distributions and there would be no minimum distribution requirement during the owner's life. The RSAs, as proposed, would require for withdrawal that the taxpayer be at least 58 years old, disabled or deceased.<sup>73</sup> Importantly, both yield exemption provisions would be likely to soak up a taxpayer's available money, leaving little other money that would earn a currently taxable yield. The LSAs, in particular, could have this effect because the \$7,500 limit on contributions applies per account holder,<sup>74</sup> so that an individual can make separate contributions in that amount to accounts for other individuals.<sup>75</sup> Neither the retirement nor the savings proposals were enacted in the 2003 Jobs and Growth Act, but may very well be proposed again in the future.

# C. Section 529 Education Plans

Section 529 authorizes states to create "qualified tuition programs" under which income from funds invested in the program is exempt from federal income tax as it accumulates and, further, is exempt from federal income tax if it

Arthur B. Kennickell & Annika E. Sunden, *Pensions, Social Security, and the Distribution of Wealth,* Finance and Economics Discussion Series (1997-55), Board of Governors of the Federal Reserve System (Oct. 1997), *at* http://www.federalreserve.gov/pubs/oss/oss2/papers/pensionk\_s.pdf, attempt to calculate net worth that includes the annuity value of defined benefit plans as well as Net Social Security Wealth, the latter of which is not directly relevant to the discussion in the text. Their analysis is based upon the SFC for 1989 and 1992. They adjust the retirement account data in the SFC to include for purposes of computing Pension Wealth the present value of employer provided defined benefit plans, and also compute Net Social Security Wealth, consisting of the present value of expected Social Security benefits. Pension Wealth, *i.e.*, the adjusted retirement benefit values, overall exceeded other wealth of respondents, not including the principal residence and business assets, and represented a proportionately greater portion of respondent's financial wealth (excluding principal residence and business assets) for the lower 89.9% of households by wealth than the households between the 90 and 99 percentiles and to an even greater extent than households in the top one percent in wealth, for whom retirement accounts were much less important relative to other non-residence, non-business assets. *See id.* at tbl. 4.

<sup>&</sup>lt;sup>71</sup>Bush Treasury Proposal, *supra* note 1. See Manning & Windish, *supra* note 1, at 918-19.

<sup>&</sup>lt;sup>72</sup>Bush Treasury Proposal, *supra* note 1. The Lifetime Savings Account, however, permits additional contributions to accounts to be owned by other individuals.

<sup>&</sup>lt;sup>73</sup>Id.

<sup>&</sup>lt;sup>74</sup>The aggregate of all contributions to all accounts in a given name could not exceed \$7,500. *Id.* <sup>75</sup>*Id.* 

is distributed and used to pay for qualified higher education expenses of the beneficiary.<sup>76</sup> These expenses include tuition, fees, books, supplies, and equipment required for enrollment at an eligible educational institution.

Section 529 Plans, as they are sometimes called, allow the creator a great deal of flexibility to choose when to make distributions, to change beneficiaries, and generally to use the funds at her own discretion as long as they are segregated into designated accounts and remain there until paid for the tuition expense of the designated beneficiary, who may but need not be some member of the creator's family.<sup>77</sup> In addition, the designation can be shifted from the original designated beneficiary to a member of the designated beneficiary's extended family (up to first cousins, but as a practical matter more likely to be siblings, children or grandchildren).<sup>78</sup>

No federal income tax deduction is allowed for contributions to the plan (although some states allow a minimal deduction for state income tax purposes),<sup>79</sup> but the earnings on the invested funds, if ultimately used for qualified higher educational expenses, are completely exempt from tax.<sup>80</sup> As such, these plans represent a yield exemption form of consumption tax feature, like a Roth IRA.<sup>81</sup>

Amounts in section 529 Plans can accumulate for a beneficiary up to the amount necessary to provide for the qualified higher education expenses of the beneficiary.<sup>82</sup> The plans themselves must provide safeguards to ensure compliance and can therefore limit contributions.<sup>83</sup> The benefits, of course, are greatest the longer the funds remain in the plan. As a result, any parent saving for a young child's or grandchild's education and willing to dedicate amounts for that purpose would be well advised to create and fund a qualified tuition program. Even the short-term benefits for older children could be significant if interest rates were sufficiently high or stock market gains could be anticipated. That is not to suggest that any parent should dump all of her funds into such a plan. However, their availability and flexibility make these plans the favored means of

<sup>&</sup>lt;sup>76</sup>I.R.C. § 529(e)(3). See generally, BITTKER & LOKKEN, supra note 43, at ¶ 16.8A (suppl.).

<sup>&</sup>lt;sup>77</sup>I.R.C. § 529(a), (b), (e)(i).

<sup>&</sup>lt;sup>78</sup>I.R.C. §§ 152(a), 529(e)(2).

 $<sup>^{79}</sup>See, e.g.,$  Maryland, which allows the donor a state income tax deduction up to \$2,500 per beneficiary. Md. CODE ANN., Tax – GEN. \$10-208 (2002).

<sup>&</sup>lt;sup>80</sup>I.R.C. § 529(c)(1).

<sup>&</sup>lt;sup>81</sup>Because section 529 plans are yield exemption provisions, they would make up a small portion of the current tax expenditure budget if they were listed separately, which they are not. For reference purposes, state prepaid tuition plans, a close relative of section 529 plans, account for only \$340 million of tax expenditures in 2003. One would expect that tax expenditures attributable to section 529 plans would increase dramatically in the future, because plans will likely increase in number and assets within plans will likely grow as a result of further contributions and compounding of earnings.

<sup>82</sup>I.R.C. § 529(b)(6).

<sup>&</sup>lt;sup>83</sup>The Maryland plan, for example, limits contributions in the plan to a maximum account balance of \$175,000 per student. Earnings may cause the account balance to exceed that amount, but no future contributions will be permitted unless the allowed maximum is increased by the plan. MARY-LAND COLLEGE INVESTMENT PLAN DISCLOSURE STATEMENT 4 (2001).

providing educational benefits for children that would otherwise be funded without the tax benefits.

#### D. Home Ownership

The income tax benefits associated with home ownership are (1) non-taxability of imputed income from the use of the home—a benefit similar to the periodic return on the investment in the home,<sup>84</sup> (2) excludability from income of all or most of the gain on the sale of the home (for most taxpayers),<sup>85</sup> and (3) deductibility of home mortgage interest, subject to statutory limits,<sup>86</sup> and real property taxes.<sup>87</sup> The first two of these benefits accorded a home would accomplish a yield exemption model of a consumption tax for a home purchased with after-tax money. But the present tax treatment of a home is even better than pure consumption tax treatment, because the interest expense from the home mortgage, fairly regarded as either part of the cost of the home, or an expense of earning tax exempt income, is allowed as a deduction.

If the treatment of the home followed the consumed income model, then the home would be regarded as a rental property rented to the owner herself. Under that treatment, the purchase price net of borrowed funds would be deductible as the net investment in the home and the interest charges for the mortgage would be deductible as a rental activity expense.<sup>88</sup> On the other hand, imputed income from the use of the house and any proceeds from sale, if not reinvested, would be included in the tax base.

Under the yield exemption consumption tax model, in contrast, the cost of the investment would not be deductible, but the yield on the investment would not be includible. The imputed income, net of mortgage interest, plus unrealized appreciation represents the net return on invested equity, which should be exempt from tax in this model. The current income tax does even more than that. It exempts the entire imputed rental income and appreciation (for most homeowners) and has the further effect of exempting otherwise taxable earnings that are used to pay interest on the mortgage, the effect of allowing a deduction for the interest. Thus, the current tax treatment of a home reflects a yield exemption consumption tax regime, to the extent that gains are within the statutory exclusion limits. But even analyzed under a consumption tax regime, home ownership enjoys special status, because it benefits from the tax incentive provision allowing for the deduction of home mortgage interest, within the statutory deduction limits of section 163(h), as well as the favorable tax deduction treatment of real

<sup>&</sup>lt;sup>84</sup>BITTKER & LOKKEN, *supra* note 43, at ¶ 5.3.3.

<sup>&</sup>lt;sup>85</sup>Section 121, which contains qualification requirements, limits the scope, in general, to a home used by the taxpayer as her principal residence for two of the five years prior to the sale and limits the benefit to \$250,000 of excludible gain for a single individual and \$500,000 of excludible gain for a married couple. I.R.C. § 121(a)-(b).

<sup>86</sup>I.R.C. §163(h).

<sup>&</sup>lt;sup>87</sup>I.R.C. §164(a)(1).

<sup>&</sup>lt;sup>88</sup>I.R.C. §162. The passive activity loss rules under section 469, which depart from a pure Haig-Simons income determination, are ignored for purposes of this explanation.

estate taxes on the home.

The amount of forgone revenue attributable to home ownership as measured in the tax expenditure budget is huge.<sup>89</sup> Moreover, more than two-thirds of families own their primary residence.<sup>90</sup>

#### E. Business Tax Incentives

As discussed earlier, the distinguishing feature between an income tax and a consumption tax at the business level in the form of an annually collected subtraction-style VAT (and therefore its economically equivalent point of sale counterparts, the retail sales tax and credit-style VAT)<sup>91</sup> is the complete deductibility of business expenditures without the capitalization requirement, and the nondeductibility of labor and interest costs. However, if wages and interest income are includible in the recipients' income and thereby subjected to tax, which they are under the income tax, then the remaining distinguishing feature is the deductibility of business expenditures, free of the capitalization requirement. In contrast, an income tax requires capitalization of long-term expenditures coupled with depreciation where appropriate.

Business tax incentives in the current income tax take the form of either an immediate deduction of the cost of an item that would generally have to be capitalized, as under section 179,<sup>92</sup> extra or accelerated depreciation,<sup>93</sup> or a tax credit for all or a portion of the expenditure.<sup>94</sup> Of late, immediate expensing or accelerated deductions have been the elixirs of choice.<sup>95</sup> For example, section

<sup>89</sup>Tax Expenditures for 2003 attributable to home ownership are as follows:

Estimates of total income tax expenditures (In millions of dollars)	<u>2003</u>
Deductibility of mortgage interest on owner-occupied homes	66,110
Deductibility of State and local property tax on owner-occupied homes	23,580
Capital gains exclusion on home sales	20,260

Tax Expenditure Budget 2003, *supra* note 47, at 99. Imputed income of the rental value of owner occupied housing is not regarded as a tax expenditure, technically, because it is not a deviation from the reference tax baseline, even though it is a departure from a pure comprehensive income tax. *Id.* at 112.

<sup>90</sup>See Recent Changes in Family Finances: Evidence from 1998 and 2001 Survey of Consumer Finances, in 89 FeD. Res. BULL. 16, 17 n.19, 19t.8B (Jan. 2003). According to the 2001 SCF, for all but the 90-100 percentile in wealth, the home represents more than half of the mean non-business, non-financial wealth of SCF respondents. *Id.* 

91See supra Part II.C.

<sup>92</sup>I.R.C. § 179 (relating to tangible personal property purchased for a trade or business).

<sup>93</sup>I.R.C. § 168 (statutory accelerated depreciation, generally); I.R.C. § 168(k) (amended by the 2003 Jobs and Growth Act) (bonus depreciation of 50% of the cost of the eligible property allowed in the year of acquisition, which expires in 2006).

94See, e.g., I.R.C. §§ 38, 41, 42, 47.

<sup>95</sup>Tax expenditures for 2003 attributed to business tax incentives are as follows:

Estimates of total income tax expenditures (In millions of dollars)	<u>2003</u>
Accelerated depreciation of buildings other than rental housing	4,240
Accelerated depreciation of machinery and equipment	36,480
Expensing of certain small investments	1,420
Exclusion of reimbursed employee parking expenses	2,190
Exclusion of employer-provided transit passes	360

Tax Expenditure Budget (2003), supra note 47, at 99-100.

179 allows immediate expensing for tangible personal property, like equipment, used by the taxpayer in his trade or business, up to \$100,000 (reduced to \$25,000 in 2006 and thereafter) acquired in a taxable year for businesses that purchase no more than \$400,000 (reduced to \$200,000 in 2006 and thereafter) of qualifying property during the year, above which the \$100,000 is reduced.<sup>96</sup> In addition, section 174 allows an immediate deduction for research and experimental expenses incurred in connection with the taxpayer's trade or business, which would otherwise have to be capitalized.

MACRS depreciation allows depreciation deductions on equipment more quickly than the rate at which the item is likely to get used up economically. New bonus depreciation, as it is called, accelerates the depreciation into the first year of 50% of the purchase price (adjusted basis) of "qualified property" as it is defined in the section,<sup>97</sup> with the remaining adjusted basis depreciable under the older statutory method.

Tax credit incentives allow tax credits for a portion of the expenditures that the government desires to encourage. Tax credits include business tax credits<sup>98</sup> as well as energy tax credits,<sup>99</sup> research and development tax credits<sup>100</sup> and others. Absent from this list is the investment tax credit (ITC), originally enacted in 1962 as a tax credit of seven percent of the cost of depreciable personal property, *i.e.*, equipment, purchased or constructed by the taxpayer for use in the taxpayer's trade or business, later increased to ten percent and ultimately repealed in the Tax Reform Act of 1986.<sup>101</sup> The ITC, however, is re-proposed perennially as a stimulus to business investment.

A tax credit is a more precise and easily understood subsidy in the income tax regime that is not dependent on the recipient's tax rate. As such, it is sometimes viewed as a separate class of business tax incentive. However, it can be readily converted to its deduction equivalent for any particular taxpayer by reference to the tax rate applicable to that taxpayer. It can therefore be equated with an immediate deduction for a portion of the purchase price, particularly if the basis of the property is reduced by the amount of the credit, as it was when the ITC was first enacted in 1962, or 50% of the amount of the credit, as it was generally in the last iteration of the ITC before its repeal.<sup>102</sup>

Each new business tax incentive in the form of immediate expensing, faster write-off or tax credit brings the income tax closer to the subtraction method

<sup>&</sup>lt;sup>96</sup>I.R.C. § 179(b) (as amended by the 2003 Jobs and Growth Act). The scope of qualifying property was also expanded temporarily until 2006 to include off-the-shelf computer software.

<sup>&</sup>lt;sup>97</sup>I.R.C. § 168(k)(2) (enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, (hereinafter "2001 Act") (amended by the 2003 Jobs and Growth Act, adding I.R.C. § 168(k)(4)).

<sup>98</sup>See, e.g., I.R.C. §§ 47, 48. 99See, e.g., I.R.C. § 48.

<sup>100</sup>See, e.g., I.R.C. § 41.

<sup>&</sup>lt;sup>101</sup>I.R.C. § 38 (repealed by Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085.(1986)).

<sup>102</sup>I.R.C. § 50(c).

VAT form of consumption tax model described earlier for business entities. As discussed above, the Bush Treasury is seeking to expand the scope of business tax incentives.

#### F. Observation

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It appears that the current Federal income tax really is a hybrid system, containing several important consumption tax features and trending even more in that direction with every enactment of and proposal for additional savings incentives. To the extent that the current system can be characterized as a hybrid consumption tax, certain income tax features could be viewed as penalties on some behavior or disincentives. For example, one might view the current income tax system as something close to a consumption tax in which some savings (those outside of retirement accounts or section 529 plans) are penalized. Taxable interest and dividends from bonds and stock owned in non-tax advantaged accounts, for example, represent the principal area of disadvantaged savings. That is particularly true of stocks, because dividends yield no corporate tax deduction to the paying corporation, unlike interest on bonds, which is deductible. In contrast, savings that are in tax-advantaged retirement accounts,<sup>103</sup> newly enacted education accounts,<sup>104</sup> medical saving accounts<sup>105</sup> and even home ownership can all be interpreted as elements of a disguised consumption tax system.

Given that, it would be a mistake to view the provisions enacted under the 2003 Jobs and Growth Act, or the Bush Treasury proposals, as radical departures from an income tax model currently in effect, because it would be incorrect to view the current system as exclusively an income tax. Arguably, the recently enacted provisions and the Bush Treasury proposal could be viewed as eliminating penalty provisions in an essentially consumption tax system. At the very least, the current tax system is an income tax-consumption tax hybrid, with the trend toward the consumption tax side in an evolutionary process.

## IV. INCOME TAX VS. CONSUMPTION TAX: THE POSITIONS

The present hybrid system of taxation appears to be the result of a desire to adhere to the basic tenets of an income tax system to achieve the fairness that has been ascribed historically to the income tax, but to build in various incentives in the form of consumption tax system elements to correct the likely adverse economic effects of a pure income tax system. The corrections have created the hybrid system. The conflict between the basic system and its modifications can best be understood by reviewing the on-going debate between income tax advocates and consumption tax advocates.

The standard and most basic argument in favor of an income tax is fairness. The income tax in its purest form treats all income alike, regardless of whether it

<sup>103</sup>I.R.C. §§ 401, 408, 408A.

<sup>104</sup>I.R.C. § 529.

<sup>105</sup>I.R.C. § 220.

derives from services, capital or otherwise. The Code, at least in academic theory, although deviating from this basic principle as discussed above, is seen as striving towards this ideal, as exemplified by the use of the Haig-Simons definition of income as the standard by academics<sup>106</sup> and the tax expenditure budget<sup>107</sup> by policy makers. In contrast, a consumption tax is viewed by income tax proponents as favoring capital over labor.<sup>108</sup>

Consumption tax advocates, on the other hand, see the income tax as creating disincentives toward work and saving and investment.<sup>109</sup> A consumption tax, they contend, would eliminate these disincentives. On the surface, it would appear that taxing the fruits of labor would cause someone to favor leisure over labor, and taxing savings or the future earnings on amounts saved would cause one to save less in favor of current consumption. Consumption tax proponents believe that a shift to a consumption tax system will result in greater individual savings and investment, capital formation, and ultimately greater economic productivity. Such a shift will lighten the tax burden on capital by allowing a deduction for investment in the case of a cash flow system, or by exempting from tax the return from investment in the case of a yield exemption system, or by excluding investment expenditures from tax imposition, in the case of a point of sale tax system. As a result, it would follow that a shift to a consumption tax will reallocate the burden of taxation from capital to labor, because capital will be more lightly taxed than it is under the income tax. Arguably, labor will enjoy greater wages, because it will become more productive as a result of the additional capital formation resulting from the shift, and advocates contend that the increased return to labor will more than make up for the greater proportion of the tax burden borne by labor.<sup>110</sup>

The same analysis should apply to particular consumption tax provisions within a hybrid system, even if the system in its entirety cannot be classified as a complete cash flow, yield exemption or point of sale consumption tax. Thus, when any consumption tax provision is evaluated, the battleground will be economic efficiency (stimulus to growth in the economy) versus fairness (overallocation of burden to labor). A close analysis of the economic theory and empirical evidence of these claims, however, should cause one to be at least

<sup>&</sup>lt;sup>106</sup>MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION (Rev. 4th ed. 2002); WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 7-8 (13th ed. 2003).

<sup>&</sup>lt;sup>107</sup>Tax Expenditure Budget 2003, *supra* note 47, at 112.

<sup>&</sup>lt;sup>108</sup>Alvin Warren, *Would a Consumption Tax be Fairer than an Income Tax*, 89 YALE L. J. 1081 (1980); Alvin Warren, *Fairness and a Consumption-Type Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975).

<sup>&</sup>lt;sup>109</sup>See, e.g., Bill Archer, Goals of Fundamental Tax Reform, in FRONTIERS IN TAX REFORM, supra note 20; Bill Archer, Tax Reform and the Consumption Tax, NationalIssues.com (2002), at http:// www.nationalissues.com/taxes/sales\_tax/reform\_and\_consumption.html; Robert E. Hall & Alvin Rabushka, The Flat Tax: A Simple, Progressive Consumption Tax" in FRONTIERS IN TAX REFORM, supra note 20, at 44-48; Bruce Bartlett, Consumption Junction, NRO: NATIONAL REVIEW ONLINE (April 8, 2002), at www.Nationalreview.com/nrof\_bartlett/bartlett040802.asp.

<sup>&</sup>lt;sup>110</sup>See Archer, Goals of Fundamental Tax Reform, in FRONTIERS IN TAX REFORM, supra note 20.

somewhat circumspect about these predictions of consumption tax proponents, even if on balance they appear likely to be correct.<sup>111</sup>

Effect on Labor Supply. As indicated above, an important behavioral disincentive claimed by consumption tax advocates involves the effect of the taxation of income on the labor supply.<sup>112</sup> An income tax exempts leisure from taxation and therefore causes a substitution of leisure for other commodities. On the other hand, an income tax also reduces the wealth of the taxpayer and therefore may cause the taxpayer to work more hours to compensate for the reduced wealth. Moreover, its effect will likely vary among taxpayers depending upon their wealth, level of income, desire for leisure, need for savings, and non-pecuniary rewards from work.<sup>113</sup> Further, a progressive income tax magnifies this effect for the highest income taxpayers, because it effectively decreases the after-tax cost of leisure as wage rates increase. Accordingly, theory alone cannot predict whether the income tax depresses or increases the supply of labor.<sup>114</sup>Rather, one can only determine empirically the effect of the tax on the work/leisure trade-off,<sup>115</sup> and even then, one is unlikely to be able to conclude much about its effect on labor without specifying the type of labor, level of compensation for that labor, and the supplier of that labor (e.g., male or female, old or young, married or single).<sup>116</sup>

*Effect on Saving.* The effect of the income tax on saving is of even greater current interest in the tax policy debate than the effect of the income tax on the supply of labor,<sup>117</sup> and the resulting effect on investment and capital formation,

<sup>&</sup>lt;sup>111</sup>The analysis that follows regarding the effects of the income tax on labor supply and savings is more fully set forth in Daniel S. Goldberg, *E-Tax: Fundamental Tax Reform and the Transition to a Currency-Free Economy*, 20 VA. TAX. REV. 3, 20-25 (2000).

<sup>&</sup>lt;sup>112</sup>JOEL SLEMROD & JOHN BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 104 (1996).

<sup>&</sup>lt;sup>113</sup>See Rosen, supra note 17, at 382-85; Lawrence Zelenak & Kemper Morelan, Can the Graduated Income Tax Survive Optimal Tax Analysis?, 53 TAX L. REV. 51, 52 n.5 (1999) (discussing the income and substitution effects).

<sup>&</sup>lt;sup>114</sup>See ROSEN, supra note 17, at 376-79. See also Martin J. McMahon, Jr. & Alice G. Abreu, Winner-Take-All Markets: Easing the Case for Progressive Taxation, 4 FLA. TAX REV. 1, 58-59 (1998) (exploring the economic theory underlying the effect of tax rates on the labor supply and its manifestation in the income and substitution effects); Lawrence Zelenak, The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital, 51 TAX L. REV. 1, 12 n.50 (1995) (offering an example of the operation of the substitution and income effects on consumption); Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look at Progressive Taxation, 75 CAL. L. REV. 1905, 1920 (1987) (discussing the substitution and income effects on taxation).

<sup>&</sup>lt;sup>115</sup>See ROSEN, supra note 17, at 379-80 (summarizing some empirical findings); see also Robert Triest, Fundamental Tax Reform and Labor Supply, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 247, 256 (Henry J. Aaron & William G. Gale eds., 1996).

<sup>&</sup>lt;sup>116</sup>See Rosen, supra note 17, at 380-82. For higher income taxpayers, it is entirely possible that an increase in the marginal tax rate will reduce the amount of labor supplied sufficiently to reduce the overall tax collection from that taxpayer. See *id.* at 383-85. This has been referred to as the Laffer Curve. See ALFRED L. MALABRE, JR., LOST PROPHETS 181-82 (1994); see also Joel B. Slemrod, On the High-Income Laffer Curve, in TAX PROGRESSIVITY AND INCOME INEQUALITY 177, 203 (Joel B. Slemrod ed., 1994). According to SLEMROD & BAKUA, supra note 22, at 124-25, all but the "most ardent supply-siders" believe that labor supply responds significantly to tax cuts; see also Rosen, supra note 17, at 384-85.

<sup>&</sup>lt;sup>117</sup>For a general discussion, see ROSEN, supra note 17, at 385-94.

which is necessary for increases in future productivity.<sup>118</sup> The income tax imposed on the earnings of savings effectively taxes those savings a second time.<sup>119</sup> That consequence would cause income taxation to depress savings because the taxation of interest income should cause a substitution of current consumption for future consumption.<sup>120</sup> This phenomenon is an example of the substitution effect.<sup>121</sup> The bias towards present consumption has the effect of reducing future accumulations.<sup>122</sup>

However, the taxation of interest income also reduces a taxpayer's future wealth and may cause the taxpayer to save more in order to offset that reduction in future wealth.<sup>123</sup> This phenomenon is an example of the income effect.<sup>124</sup> The substitution effect and the income effect may work in the same direction, thereby reducing savings, or they may work in opposite directions, creating offsetting effects with an uncertain net result.<sup>125</sup> Moreover, since the effect of interest rates on the magnitude of savings is itself a subject of controversy,<sup>126</sup> it follows that the effect of taxation of that interest income is also controversial. The effect of taxation on savings cannot be predicted with certainty without empirical work and it is not at all clear that any empirical work can be definitive, either, because of the multitude of changing variables.<sup>127</sup>

<sup>123</sup>See ROSEN, supra note 17, at 390.

<sup>125</sup>Id. at 385-94.

<sup>&</sup>lt;sup>118</sup>See ANDREW ABEL & BEN BERNANKE, MACROECONOMICS 119 (3d ed. 1998). See also Thomas Michael Federico, Recent Congressional Consumption Tax Proposals: A Theoretical Inquiry into their Effects on the Declining U.S. Saving Rate, 7 U. FLA. J.L. & PUB. POL'Y 337, 357 (1996) (savings are adversely affected under the income tax because they are taxed twice); M. Scotland Morris, Reframing the Flat Tax Debate: Three Not-So-Easy Steps for Evaluating Radical Tax Reform Proposals, 48 FLA. L. REV. 159, 172 (1996) (noting that an income tax taxes both consumption and savings, while a consumption tax does not tax savings).

<sup>&</sup>lt;sup>119</sup>See Federico, *supra* note 118, at 357; See, e.g., Archer, *Tax Reform and the Consumption Tax*, NationalIssues.com (2002), *supra* note 109.

<sup>&</sup>lt;sup>120</sup>See Federico, *supra* note 118, at 357; *see also* SLEMROD & BAKIJA, *supra* note 22, at 168-70, 389 (where tax reduces the rate of interest received, the opportunity cost for consuming a dollar in the present becomes more appealing than consuming that same dollar, plus the reduced interest, in the future).

<sup>&</sup>lt;sup>121</sup>See SLEMROD & BAKIJA, supra note 22, at 104.

<sup>&</sup>lt;sup>122</sup>See id. at 109.

 $<sup>^{124}</sup>Id.$ 

<sup>&</sup>lt;sup>126</sup>See Eric M. Engen & William G. Gale, *The Effects of Fundamental Tax Reform on Saving, in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 83, 96 (Henry J. Aaron & William G. Gale eds., 1996).

<sup>&</sup>lt;sup>127</sup>Compare DAVID BRADFORD, TAXATION WEALTH AND SAVING, 157-67 (2000), who believes that a shift in taxes from capital income to labor income will not necessarily cause an increase in aggregate accumulation of wealth, and Jane G. Gravelle, Do Individual Retirement Accounts Increase Savings? 5 JOURNAL OF ECONOMIC PERSPECTIVES 133-48 (Spring 1991), who believes savings incentives such as IRAs simply induce shifts in savings to tax favored vehicles and in fact could reduce national savings by causing increased deficits, with Jason G. Cummins et al., A Reconsideration of Investment Behavior Using Tax Reforms as Natural Experiments, BROKINGS PAPERS ON ECONOMIC ACTIVITY 2:1994, 11-59, American Enterprise Institute Website at http://aei.org/doclib/20030213\_rahass94b.pdf, who have concluded that tax reforms favoring capital can have a positive effect on business investment, and R. Glenn Hubbard & Jonathan S. Skinner, Assessing the Effectiveness of Tax Incentives, American Enterprise Institute for Policy Research (1996), who conclude that targeted savings tax incentives generate substantial net capital accumulation per dollar of foregone revenue, at least in the short run, and Eric M. Engen & William G. Gale, IRAs and Saving in a

As discussed earlier,<sup>128</sup> under the current income tax system, the double taxation of savings is not complete, because some returns on savings, such as capital gains and dividends, are not taxed until realized or received, and are taxed at preferential rates.<sup>129</sup> This observation does not affect the analysis above regarding the effects of an income tax but rather recognizes, as this article points out, that the current system is a hybrid.

The crucial philosophical disagreement between income tax and consumption tax advocates, however, would exist even if the replacement of the income tax with a consumption tax would create a positive incentive for, and on balance induce, more work and saving. Income tax advocates argue that any economic efficiency of a consumption tax should not be exalted over the burden-sharing equity of an income tax. Income, in their view, is the fairest basis for taxation, and a consumption tax would unfairly favor those who earn income from capital over those who earn income from services.<sup>130</sup> Further, a consumption tax would fail to account for accumulated wealth as a source of power, which itself represents economic well-being.<sup>131</sup> The likely comparison may very well be (1) the consumption tax's correction for disincentives toward work and savings, a by-product of the income tax, with (2) a distribution of wealth that is not satisfactory to the society at large and thereby causes instability and ultimately adversely affects production.

The above debate has been going on at least since the time of John Stuart Mill<sup>132</sup> and will undoubtedly proceed long after the publication of this paper. Perhaps it is the inability to reach a definitive conclusion that explains the current hybrid state of the federal income tax.

# V. REFLECTIONS ON THE EVOLUTION TO THE CURRENT HYBRID SYSTEM

#### A. The Hybrid System in General

If one were to design a consumption tax with components, as opposed to adopting one of the three primary models, one could treat individual items in

128See Part III.A., supra.

<sup>131</sup>*Id*. at 942-43.

Stochastic Life-Cycle Model, Washington D.C.: Brookings Institution, Mimeo (1993), and Eric M. Engen et al., *Do Savings Incentives Work?*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1:1994, 85-151, who find the same phenomenon on a long-term basis, studying IRA and 401(k) programs. Hubbard and Skinner, in their American Enterprise Institute pamphlet, survey several other studies on the effectiveness of savings incentives and find diverse and inconsistent empirical results, demonstrating a diversity of views and "proofs" on this important subject. An important practical point in this debate is that Hubbard, who believes in the efficacy of incentives to increase savings, was the chairman of President Bush's Council of Economic Advisors at the time of the most recent Bush Treasury Proposal and a driving force behind the Proposal. He is reported to be a strong proponent of a consumption tax.

<sup>&</sup>lt;sup>129</sup>I.R.C. § 1(h) (maximum capital gain rate and dividends). *See* I.R.C. § 1222(11) (net capital gain defined).

<sup>&</sup>lt;sup>130</sup>See Alvin Warren, Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 HARV. L. REV. 931 (1975).

<sup>&</sup>lt;sup>132</sup>JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY (9th ed. 1886).

accordance with one of the three alternative consumption tax methods. For example, one could employ a value added tax for businesses and a cash flow consumed income or yield exemption method for individuals. Indeed, that was the approach taken in the USA (Unlimited Savings Account) Tax proposed by Senators Nunn and Domenici several years ago.<sup>133</sup>

Even more eclectically, one could vary the approach among individual items. For example, ownership of corporate stock could be treated under a yield exemption approach, excluding from income dividends and capital gains on sale, but allowing no deduction for purchase price. At the same time, ownership of real estate or other business assets could be treated under a cash flow method, allowing a deduction for its purchase price. Such an approach makes it more difficult to understand any unifying theory of the tax, but may be more feasible politically, easier to administer or more amenable to transition. For example, adopting yield exemption for current stockholders would be a welcome improvement; whereas adopting a cash flow approach to stock may be viewed as a day late and a dollar short by the stockholder who had paid for his shares previously with after-tax dollars. Change is much easier to accomplish politically by bestowing benefits on everybody, both current stock owners and future stock owners, as under a yield exemption enactment, than on only some people (i.e., new purchasers), as under a cash flow model. But even under the cash flow model, it is possible to construct transition rules that would allow a stock seller to offset sales proceeds by historical basis in determining gain, but deduct completely the reinvestment of the sales proceeds. And, in all cases, owners should expect the value of their holdings to be greater than it would have been absent the legislative tax change, resulting from the tax favored position that would be accorded stocks, although the market may not exhibit an immediate upward movement because of a myriad of other unrelated factors.

The current tax system represents, at least in theory, a system grounded in the income tax but replete with tax incentives in the form of special deductions, yield exemptions and special rates, to encourage expenditures and savings deemed worthy by Congress. In effect, these incentive provisions, each an element of a consumption tax when evaluated separately, hybridize the current system. As such, it has become difficult to characterize the current system as an income tax because, for many high income people, it functions much more like a consumption tax system. And, for low income taxpayers, who do not save significant amounts, there is not much difference between an income tax and a consumption tax.

For example, for a high bracket taxpayer whose wealth consists largely of assets in tax deferred retirement plans (corporate pension plans, Keogh plans, IRAs, 401(k)s), a personal residence and, to a lesser extent, investment assets the sale of which would give rise to long-term capital gain (or be subject to step

<sup>&</sup>lt;sup>133</sup>See Murray Weidenbaum, *The Nunn-Domenici USA Tax: Analysis and Comparisons, in* FRON-TIERS IN TAX REFORM, *supra* note 20, at 54, for an excellent explanation of the proposal.

up under section 1014 in the event of the death of the taxpayer), it is essentially earnings from personal services (and some interest and dividends) that would be subject to tax. Most of the taxpayer's capital is subject, in effect, to a consumption tax regime.

Recent tax legislation has shown a marked trend to shift the system even further toward a consumption base. Education savings accounts, and the other special provisions discussed earlier in this paper, all aimed at high income taxpayers, who have discretionary income and savings, clearly demonstrate this trend. Yet, we still refer to our system as an income tax.

Finally, current tax proposals for complete dividend exclusion and preferred savings accounts may take us the rest of the way to a consumption tax at the individual level. If enacted, they could complete the evolution.

### B. Critique of the Hybrid System

The above observations lead to the question of what is wrong with a hybrid system? Is it not advisable to combine an income tax with some consumption tax provisions designed to provide incentives for savings and in some cases spending in certain designated areas? Do we not get the best of both worlds of the income tax and the consumption tax, namely a tax system that accomplishes desirable economic and social purposes? Is any need served by slavishly following an academic's desire to have a pristine income tax or consumption tax?

# 1. Limitation of Tax Expenditure Analysis

Individual tax reform provisions that are enacted to encourage savings and investment are generally evaluated by tax policy analysts as tax expenditures and the costs of such provisions (lost revenue) are separately set forth in the Treasury's tax expenditure budget. The basic premise of this view rests on the current tax system being an income tax and income for these purposes being defined, consistent with the generally accepted Haig-Simons definition, as personal consumption plus increase in wealth (excepting imputed income and unrealized appreciation).

Tax expenditure analysis converts special tax provisions and tax incentive provisions, whether in the form of exclusions, deductions or credits, into their economically equivalent spending provisions. In that manner, those provisions can be analyzed and evaluated more clearly than if buried in the tax code. The process requires one to distinguish between structural provisions, which are inherent parts of an income tax and therefore acceptable on tax expenditure grounds, and special provisions, which should be analyzed as hidden expenditures built into the tax system and therefore should be presumptively suspect. For a provision presumptively suspect, one should require a compelling justification for inclusion of a tax expenditure in the tax system rather than as a separate budgetary item of expenditure.

Some critics of tax expenditure analysis acknowledge the usefulness of converting a tax rule into its fundamentally equivalent spending program in order to evaluate whether the assumed spending goal of the tax rule is important or trivial and to evaluate whether the costs of achieving the goal are commensurate with its benefits.<sup>134</sup> They argue, however, that to perform the conversion one need not first determine whether the tax rule qualifies as a tax expenditure. Rather, any attempt to categorize all rules in the tax law as either structural or special will inevitably devolve into an argument about whether a particular provision allowing an exclusion, deduction or credit is structural or special, and will deflect the attention of policy makers from the issue of whether the rule, structural or special, is a good rule.<sup>135</sup>

Other commentators view the conversion of a tax rule into an equivalent spending program as superfluous or irrelevant, because in order to accomplish a full accounting of these special tax rules in a tax expenditure budget, one must first construct an ideal or correct income tax structure. Only departures from such an ideal structure would be reflected as tax expenditures in the tax expenditure budget.<sup>136</sup> Presumably, the ideal income tax would be based on the Haig-Simons definition of income. However, it is hard to distinguish deviations from such a definition, regarded as back-door spending, from provisions that are regarded as structural. For example, a rate structure deviating from a flat rate could easily be viewed as a series of cross subsidies, if the base system were a uniform rate income tax.<sup>137</sup> If the tax expenditure budget were designed to bring to the attention of the public any change in the tax law designed to encourage or discourage particular activity, a lowering of the rate structure deviatine.

Finally, other critics object to the language of the tax expenditure advocates as denoting a tone of "moral absolutism."<sup>138</sup> Such a position belies the real circumstance that there is no correct or normative rule of federal income taxation.<sup>139</sup> Rather, the income tax should reflect the values of the public for which it is created. An exclusion for damages received for personal physical injuries, a denial of a deduction for illegal bribes or kickbacks and an exclusion for imputed income from services all reflect public value judgments, even though they may depart from the strict Haig-Simons ideal of an income tax.<sup>140</sup> Such a pristine system can only create "an illusion of value-free scientific precision in a heavily politicized domain."<sup>141</sup>

Yet, taking all of these critical views of tax expenditure analysis to their logical (some might say extreme) conclusion, leads one to the position that the

<sup>&</sup>lt;sup>134</sup>Michael J. McIntyre, A Solution to the Problem of Defining a Tax Expenditure, 14 U.C. DAVIS L. REV. 79 (1980).

 $<sup>^{135}</sup>Id.$ 

<sup>&</sup>lt;sup>136</sup>Boris I. Bittker, Accounting for Federal "Tax Subsidies" in the National Budget, 22 NAT'L TAX J. 244, 247-48 (1969).

<sup>&</sup>lt;sup>137</sup>*Id*. at 251-52.

<sup>&</sup>lt;sup>138</sup>Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES (TA) 1661, 1662 (1992).

<sup>&</sup>lt;sup>139</sup>*Id*. at 1661.

<sup>&</sup>lt;sup>140</sup>*Id*. at 1662.

<sup>&</sup>lt;sup>141</sup>*Id*. at 1663.

appropriate income tax for the society which is subject to it is the one that exists in any point in time, because that is the one that the duly elected legislature has selected. Under that position, no particular provision has any greater claim to legitimacy than any other provision as long as Congress has elected to include it in the current version of the tax code. Perhaps it is the ascendancy of this view in recent times that has resulted in the situation that a significant share of the benefits and subsidies now available to different segments of the public come from tax breaks.<sup>142</sup>

Tax expenditure analysis recognizes that taxes are used both to redistribute income and to influence behavior such as consumption, work, saving and investing.<sup>143</sup> Indeed, it has been observed that in some years the amount of expenditures through the tax code approximates between one-quarter and one-third of the entire expenditure budget.<sup>144</sup> Important public initiatives such as subsidized housing, welfare, health, and energy cannot be understood without looking at the tax code.<sup>145</sup> The tax expenditure budget allows the Treasury to keep track of this kind of spending and bring it to the public's attention. Given the number and amount of hidden expenditures in the tax code, it may be the only way to rationally account for this governmental intervention in the economic lives of its citizens, and, notwithstanding its imperfections and imprecision, the tax expenditure budget may very well be the best way to do it.<sup>146</sup> Moreover, this can be done without making a value judgment as to any particular special provision.

On the other hand, if one acknowledges that the system is not an income tax system but rather is a hybrid system, combining both income tax and consumption tax features, each being regarded as standard or structural in the system, then the battleground of the foregoing disagreement shifts. All special provisions that we now regard as tax expenditures that stimulate business activities such as the cash flow model provisions of the deduction for contributions to retirement accounts, fast depreciation and an exception from the requirement of capitalization, as well as yield exemption provisions that exempt earnings from current tax, would not be viewed as tax expenditures because they are structural in at least some form of consumption tax. Admittedly, some provisions could still be viewed through the tax expenditure lens, such as those that distinguish between profit-seeking expenditures regardless of timing, and personal consumption (e.g., charitable contributions, deductions for medical expenses and the like). Yet, under an acknowledged hybrid system, many of the tax expenditures contained in the tax expenditure budget would be eliminated and much of the accountability under the current form of the tax expenditure budget would be lost.

<sup>&</sup>lt;sup>142</sup>Gene Steuerle, Tax Expenditure Debate, 95 TAX NOTES (TA) 1521 (June 3, 2002).

 $<sup>^{143}</sup>Id.$ 

 $<sup>^{144}</sup>Id.$ 

 $<sup>^{145}</sup>Id.$ 

 $<sup>^{146}</sup>Id.$ 

Without a theoretical standard based upon fundamental principles of taxation uniformly applied, the system will be cast loose from its moorings. No provisions would have a stronger claim based on principle than any other provision motivated by a specific identified perceived benefit. Under such a system, future tax legislation will become simply a test of political power. Predictability and its stabilizing influence will be lost. As a result, efficiency will be sacrificed.

#### 2. Tax Simplification

One of the virtues attributed to a consumption tax is simplification. An important element of simplification involves record keeping for basis and the tax administrator's ability to confirm the taxpayer's records and assertions. Under a cash flow system, basis is an irrelevant concept, because all investments give rise to full deductions and all investment returns that are not reinvested are fully taxed. As a result, the concept of a basis in an investment asset becomes meaningless because it is essentially zero for all investments.

Under the yield exemption version of a consumption tax, basis is also irrelevant. That is because any return of the investment would not be subject to tax regardless of whether it represents yield on the investment, which would be exempted from tax, or return of principal, which would be exempt from tax even under the income tax as a recovery of basis. Thus, actual basis would become meaningless because basis would effectively be whatever is in the investment account—a constructive basis concept in income tax lexicon.

The tradeoff for this simplification in record keeping and computation under either consumption tax system is in the transition. Under the cash flow system, there is a need to keep track of the wealth the taxpayer had at the commencement of the system. Under a yield exemption system, there is a need to keep track of previously earned income at the corporate level that at least arguably should not give rise to exempted dividends, and appreciation inherent in property at the date of commencement of the new system, which presumably should not escape tax.

Under a system that employs a combination of cash flow and yield exemption provisions by means of allowing a deduction for some designated investments and yield exemption for others, there is a need to keep track of which assets are under which regime. It seems likely that this task is easier than keeping basis records, but it does not rise to the level of the simplicity promised by either of the pure systems.

### 3. The Treatment of the Business Taxpayer Separately from the Individual

Under a pure yield exemption system at the individual level, corporate income and partnership income would be exempt from tax. Neither exemption has been proposed to date. Rather, all preferential tax treatment is accorded only portfolio-type investment income, as it is defined in section 163, and at the investor level.

However, a true consumption tax would not be in force unless some form of it was instituted at the business level as well. Under a cash flow system, that could be accomplished by allowing all business expenses to be deducted and eliminating the income tax concept of capitalization. This choice has been the one employed in recently enacted business tax incentives discussed earlier.<sup>147</sup> Alternatively, it could be accomplished as a yield exemption system by not taxing income attributable to capital, but also not allowing a deduction for capital expenditures. Isolating from labor income that income derived from capital, however, is at best problematic and probably makes such a system unfeasible.<sup>148</sup>

Finally, a business level consumption tax could be accomplished by imposing a tax on business under a point of sale system like the retail sales tax or VAT described earlier in this article. Indeed, most consumption tax reforms that have been proposed deal separately with investors and business taxpayers and create two independent tax regimes.<sup>149</sup>

Reform at the business level can be accomplished independently of reform at the individual investor level, as discussed earlier. Michael Graetz has recently proposed a hybrid reform tax system that encompasses two separate taxes.<sup>150</sup> An income tax would be retained for those taxpayers earning in excess of \$75,000 or \$100,000. The tax rate would range between 10 and 15% of that amount. Taxpayers earning less than that would be completely exempt from the income tax. In addition, a value added tax, a consumption tax collected at point of sale, would be imposed at the rate of 10-15%, although other forms of consumption tax could be used as well. Graetz would also retain the corporate tax at a somewhat lower rate than the current rate and would retain some sort of a state tax as well, also at a lower rate than the currently prevailing one.<sup>151</sup>

The essence of Graetz's proposal, however, could be viewed as a combination of the separate income and consumption taxes, each accomplishing its own particular goal. By separating the taxes, the consumption element could be free from the burden of progressivity relative to income. That function would be in the exclusive domain of the income tax, which would contain a zero rate bracket extending up to \$100,000 of income. The consumption tax component, then, could be chosen solely for purposes of achieving efficiency in terms of both collection and impact on the market for goods and services. A credit method value added tax collected at point of sale, in my view, would be the method of choice.<sup>152</sup> Under the hybrid system encompassing the two distinct types of taxes, the tax expenditure analysis would be quite appropriate in evaluating special provisions of the income tax. Similarly, a tax expenditure analysis could also be

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<sup>&</sup>lt;sup>147</sup>See supra Part III.E.

<sup>&</sup>lt;sup>148</sup>See McClure and Zodrow, A Hybrid Approach to the Direct Taxation of Consumption, in FRONTIERS IN TAX REFORM, *supra* note 20, at 70, which discusses other disadvantages of a yield exemption approach at the business level.

<sup>&</sup>lt;sup>149</sup>See Robert E. Hall & Alvin Rabushka, The Flat Tax (2d ed. 1995); Murray Weidenbaum, *The Nunn-Domenici USA Tax: Analysis and Comparisons, in* FRONTIERS IN TAX REFORM, *supra* note 133.

<sup>&</sup>lt;sup>150</sup>Michael Graetz, 100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System, 112 YALE L.J. 261 (2002); MICHAEL GRAETZ, THE U.S. INCOME TAX 303 (1996).
<sup>151</sup>Id.

<sup>&</sup>lt;sup>152</sup>See Goldberg, supra note 111.

employed for the value added tax, in the event Congress could not withstand the impulse to exclude certain goods or services from coverage under the tax. Importantly, adoption of such a system requires acceptance of the wisdom of a hybrid system and the desire to achieve it in the most efficient way.

Graetz, however, has never adequately explained how the income tax rates could be kept at a level less than confiscatory when only a small fraction of the population would be subject to it. The pressure to reduce the VAT rate, funded by an increase in the income tax rate, would seem to be difficult for a popularly elected Congress to resist.

Perhaps more important, however, is that the overall consumption tax train for individuals seems to be leaving the station. The current administration's new yield exemption proposal, coupled with those consumption tax features that are currently in the tax law (and are not to be replaced), may have left the Graetz hybrid proposal in its wake, notwithstanding the merits it may have.

# VI. CONCLUSION

Americans tend to keep much of their wealth invested in qualified retirement plans and their homes. These are both treated under consumption tax regimes. Wealth maintained outside of those forms, if invested in appreciating portfolio assets like stock, which in general tend to pay modest, if any, dividends, enjoys the consumption tax features of appreciation without realization, nonrecognition on several types of exchanges, and stepped-up basis at death. Moreover, capital gains when realized and dividends are taxed at a lower rate than other income, in effect, according partial yield exemption. Further, a taxpayer can save for the education of his children, grandchildren, nieces, nephews, or even unborn great grandchildren, under the yield exemption consumption tax section 529 plans. And, if recent proposals for complete yield exemption dividend treatment and special savings accounts are enacted, even savings that generate current yields in the form of dividends and interest will enjoy consumption tax treatment. Finally, business taxpayer provisions that replace strict capitalization and deductions for economic depreciation with immediate write-off or fast depreciation, as under sections 179 and 168 (in particular 168(k)), approach consumption tax treatment as well. If the Bush Treasury's proposal is adopted in the future, the evolution of the U.S. income tax to the U.S. consumption tax will be virtually complete. But even if the proposal is not adopted or only adopted in part, the U.S. tax system would still best be described as a hybrid, with noticeable movement with each set of income tax code amendments to a consumption tax.