CORE
Metadata, citation and similar papers at core.ac.uk
Provided by Penn Law: Legal Scholarship Repository

University of Pennsylvania Carey Law School
Penn Law: Legal Scholarship Repository

Faculty Scholarship at Penn Law

2003

Simplifying the Transition to a (Progressive) Consumption Tax

Mitchell L. Engler
Cardozo School of Law

Michael S. Knoll
University of Pennsylvania Carey Law School

Follow this and additional works at: https://scholarship.law.upenn.edu/faculty_scholarship

Part of the Economic Policy Commons, Economics Commons, Law and Economics Commons, Taxation-Federal Commons, and the Tax Law Commons

Repository Citation

Engler, Mitchell L. and Knoll, Michael S., "Simplifying the Transition to a (Progressive) Consumption Tax" (2003). *Faculty Scholarship at Penn Law*. 1144.
https://scholarship.law.upenn.edu/faculty_scholarship/1144

This Article is brought to you for free and open access by Penn Law: Legal Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship at Penn Law by an authorized administrator of Penn Law: Legal Scholarship Repository. For more information, please contact PennlawIR@law.upenn.edu.

SIMPLIFYING THE TRANSITION TO A (PROGRESSIVE) CONSUMPTION TAX

*Mitchell L. Engler**
*Michael S. Knoll***

I. INTRODUCTION

THE existing United States personal income tax system is seriously flawed. It discourages work, thrift, and investment.[1] It is mind-numbingly complex, taking ordinary citizens with relatively simple finances an inordinate amount of time to complete their returns.[2] It is also riddled with loopholes that allow the wealthy to defer, reduce, and often avoid paying taxes while subjecting the poor and middle classes to tax on their full incomes and sometimes more.[3]

The root cause of all of these criticisms is that the income tax is technically not a tax on income, but rather a hodgepodge of conflicting tax rules that well-to-do and well-advised taxpayers can exploit to lessen their tax burdens.[4] Congress has responded to this situation by writing even more technical rules to hamper such tax planning, but these rules increase complexity, trap the unwary, and appear to do little to shut down tax avoidance and evasion.[5]

* Associate Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University.

** Professor, Law School and the Wharton School, University of Pennsylvania. We thank Joseph Bankman, Reed Shuldiner and workshop participants at the University of Pennsylvania for their comments and suggestions. We also thank Alvin Dong for assistance with the research.

1. *E.g.*, LAURENCE J. KOTLIKOFF, SAVING AND CONSUMPTION TAXATION: THE FEDERAL RETAIL SALES TAX EXAMPLE IN FRONTIERS OF TAX REFORM 160, 170, 179 (Michael J. Boskin ed., 1996) (shifting to consumption tax could reduce current distortions of labor supply and increase savings rate).

2. *See* MICHAEL J. BOSKIN, INTRODUCTION IN FRONTIERS OF TAX REFORM xii (Michael J. Boskin ed., 1996) (approximately half the taxpayers filing the simple 1040EZ tax form used professional assistance to figure out their taxes).

3. *E.g.*, EDWARD J. MCCAFFERY, FAIR NOT FLAT 1-2, 24 (2002).

4. The current tax system contains some income tax features, such as the original issue discount rules for debt instruments, and some consumption tax features, such as the ability to defer tax on qualified retirement savings. It also has other features, such as the realization requirement, that are consistent with neither ideal, but generally fall somewhere between them. Thus, the current tax system has been called an inconsistent hybrid income/consumption tax. *E.g.*, Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1146 (1992). Nonetheless, the current structure typically will sometimes be referred to as an "income" tax, consistent with its ordinary characterization.

5. *E.g.*, David Cay Johnston, *Big Accounting Firm's Tax Plans Help the Wealthy Conceal Income*, N.Y. TIMES, June 20, 2002, at A1 (describing a variety of tax avoidance tech-

In the current environment—where numerous highly visible tax scandals are eroding what little respect remains for the current tax system[6]—the benefit of shifting to an alternative tax system, such as a consumption tax, with fewer opportunities for avoidance and evasion, is obvious. Nonetheless, a consumption tax has not yet replaced the seriously flawed income tax. Complexities in shifting from the current tax system to the leading consumption tax alternative—a conventional cash flow tax—help to explain this failure.[7] By deferring the tax on saved wages from the wage date until the consumption date,[8] the cash flow tax opens up a Pandora's box, significantly complicating a shift from the current regime to a consumption tax.

A recent article sets forth a modified cash flow consumption tax that maintains the current system's tax on wages.[9] This article advances that proposal by describing how retention of the wage tax greatly simplifies the transition to a consumption tax by avoiding the contentious transition issues opened up by a conventional cash flow tax.

This article proceeds as follows. Section II shows how a conventional cash-flow consumption tax eliminates the most serious income tax avoidance possibilities embedded in the existing tax structure. Section III highlights the concerns that complicate the transition from the current tax system to a conventional cash flow tax. Section IV then demonstrates how maintenance of the wage tax component simplifies the transition to a consumption tax.

II. PRIMARY INCOME TAX AVOIDANCE POSSIBILITIES

Section II.A briefly describes the core difference between an income tax and a consumption tax. Section II.B then demonstrates the primary tax avoidance possibilities under the current tax structure. Section II.C shows how these tax avoidance techniques are eliminated by a cash flow consumption tax.

---

niques under the current income tax structure); David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339, 1341 (2000) (quoting Martin Ginsburg's statement that "[e]very stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part").

6. *E.g.*, *Statement of Mark A. Weinberger, Treasury Assistant Secretary for Tax Policy, Before Committee on Finance, United States Senate*, 2002 TAX NOTES TODAY 56-21 (2002).

7. This is the leading consumption tax proposal with a progressive rate structure; i.e., one that applies increasingly higher tax rates to individuals with higher consumption levels for the tax year. A consumption tax without progressive rates (e.g., a retail sales tax) is unlikely to generate a consensus on distributional grounds.

8. As discussed *supra* note 4, qualified retirement savings already receive this cash flow treatment under the current structure. The cash flow tax would significantly expand this treatment to all savings.

9. Mitchell L. Engler, *A Progressive Consumption Tax for Individuals: An Alternative Hybrid Approach*, 54 ALA. L. REV. (forthcoming 2003).

A. Core Difference Between an Income Tax and a Consumption Tax

The core difference between an income tax and a consumption tax is the tax treatment of the return from savings. There are three components to that return: the risk-free return, a return to risk, and a residual. The second and third elements are treated the same under both an income tax and a cash flow consumption tax. The second element—the return to risk—can be avoided under both taxes through portfolio adjustments.[10] The third element—the residual—is taxed by both tax systems.[11] The difference is the tax treatment of the first element—the risk-free return. An income tax subjects the risk-free return from savings to tax.[12] In contrast, a cash-flow consumption tax implicitly exempts that return from tax.

To illustrate this core difference, assume a taxpayer (*T*) receives a $200,000 salary on December 31, 2002. *T* saves the salary for consumption one year later, investing in a U.S. Treasury note with a 10 percent interest rate. The tax rate is a constant 40 percent. Under the cash-flow consumption tax, *T* does not owe any tax in 2002 since he consumes nothing and saves everything. *T*, therefore, has $200,000 to purchase a one-year Treasury note, which will pay him $220,000 on December 31, 2003. *T* owes $88,000 in taxes in 2003 when the (after-tax) proceeds will be consumed, allowing $132,000 of after-tax consumption.[13]

In contrast, under the income tax, *T* pays $80,000 tax upon receipt of the $200,000 wages on December 31, 2002. *T* invests the remaining $120,000 in a one-year Treasury note, receiving $132,000 on December 31, 2003. The $12,000 of investment income generates additional tax of $4,800 on December 31, 2003, leaving $127,200 of after-tax consumption. This is $4,800 less consumption than is available to *T* under a cash flow consumption tax. The $4,800 of reduced consumption under the income tax reflects the 40 percent tax on the $12,000 interest earned in 2003 on *T*'s $120,000 of after-tax earnings in 2002. Thus, the difference between

10. In particular, taxpayers must increase their risky investments in response to the tax. Complete elimination of the tax on risky returns requires certain conditions including constant tax rates and a lack of price changes in response to the portfolio adjustments. For a more detailed discussion, see Engler, *supra* note 9. If no adjustment is made, the risky return is captured by both taxes. If the holding of risky assets is not identical under the two taxes, the result is more complicated. *See* Michael S. Knoll, *Designing a Hybrid Income-Consumption Tax*, 41 UCLA L. Rev. 1791 (1994) (If the deferred tax with a consumption tax is assumed to be invested in a risky asset, then the difference between an income tax and a cash flow tax is that the latter exempts both the risk-free and risky returns.).

11. In contrast to normal risky returns, taxation of the residual cannot be avoided through portfolio adjustments. Residuals, sometimes called inframarginal returns, are special limited opportunities with an above-market return, after adjustment for risk.

12. This is the source of the so-called "double tax" on savings: (i) "income" is taxed upon receipt even if saved for future consumption, and (ii) an additional tax is imposed on the return earned on the investment. In contrast, with a cash flow consumption tax all receipts (including wages and investment return) are taxed only at the time of consumption.

13. The 40 percent tax rate is a tax-inclusive rate; i.e., the tax base is not reduced for taxes paid.

an income tax and a consumption tax is that the latter exempts the $12,000 risk-free interest *T* earned in 2003 from tax.[14]

In the first example, the return was all risk free. The same difference results—reduced consumption of $4,800—even if *T* invests in risky assets. Assume *T* decides to invest $100,000 in non-dividend paying common stock on December 31, 2002, which he sells one year later for $150,000 when he cashes out all of his investments and consumes everything.

Under the cash flow tax, *T* does not owe any tax in 2002. He invests $100,000 in common stock and $100,000 in Treasury securities. One year later, he has $260,000 – $150,000 from the stock and $110,000 from the Treasury securities—when he cashes out. He pays $104,000 in taxes and is left with $156,000 to consume.

Under an income tax, *T* pays $80,000 in taxes in 2002, which leaves him with $120,000 to invest. He buys $100,000 of stock and $20,000 of Treasury securities. One year later he has $172,000—$150,000 from the stock and $22,000 from the Treasury securities. He pays $20,800 tax (40 percent of $52,000), and is left with $151,200. The difference is again $4,800.[15]

B. Tax Avoidance Possibilities Under Current Income Tax Structure

Paradoxically, the problems with the income tax stem not from the attempt to tax the risky return or the residual (positive or negative) on an investment,[16] but from the attempt to tax the risk-free return. Because the income tax subjects the risk-free return to tax, it requires one to value all assets at the end of each year.[17] In contrast, one does not have to be value assets under a consumption tax until they are liquidated for

14. The consumption tax's implicit exemption of the risk-free return also is evidenced by the equivalency of (i) the $132,000 available for consumption under the consumption tax, and (ii) the $132,000 of pretax proceeds under the income tax on December 31, 2003 (i.e., before imposition of tax on the risk-free return).

15. Again, the $4,800 equals the 40 percent tax on the $12,000 "risk-free" return *T* earned in 2003 on the $120,000 that was available for him to invest in 2002 after taxes. As shown by the two textual examples, the difference generally remains the same even where *T* invests in risky assets. Additional differences could arise, however, if *T* were to invest the deferred tax on the wages in a risky asset. *Compare* discussion *infra* note 74. For a more detailed discussion, see Engler, *supra* note 9.

16. As the most recent example above illustrates, tax is collected on the risky return under both the income and cash flow taxes. As discussed *supra* note 10, however, it is possible that *T* avoided the tax burden on such return through portfolio adjustments. In particular, *T* might have made the $100,000 risky investment only after taking into account the tax (i.e., *T* would have invested less than $100,000 in a tax-free world). For a deeper discussion, see Engler, *supra* note 9.

17. In addition to the explanations below in the text, the need for annual valuations can be seen through a deeper understanding of the consumption tax. As discussed *infra* note 74, the consumption tax implicitly taxes all wealth as it accrues with an exemption for the risk-free return. Accordingly, the income tax must tax all wealth as it accrues for it to tax the risk-free return. (Accrual taxation generally is needed to keep pace with the consumption tax's implicit accrual tax; inclusion of the risk-free return establishes the excess burden on such component.)

consumption.[18]

That the income tax requires the annual valuation of all assets can be illustrated by the earlier textual example where *T* purchased both Treasury securities and common stock. The earlier discussion implicitly assumed that all of the appreciation on the common stock occurred in 2003. That was a reasonable assumption because the stock was bought on December 31, 2002. Assume, however, that the stock was bought that morning as part of an initial public offering (IPO) and that the shares skyrocketed immediately thereafter. By the close of trading that day the shares were worth $136,363. Their value increased by an additional 10 percent to $150,000 by the end of 2003. Since $36,363 of the appreciation occurred in 2002, *T* owes additional tax of $14,545 in 2002. *T* also owes $5,454 of tax in 2003 on that year's gain of $13,636. Thus, over 2002 and 2003, *T* owes the same $20,000 tax from his stock investment that he owes if all the appreciation occurred in 2003.[19] The difference, of course, is timing. The tax burden is greater if some appreciation occurs in 2002 since some of the tax is paid sooner.[20] If not, the income tax is inconsistent in its treatment of the risk-free return, burdening some, but not all, savings.[21]

Taxing the accrued gain of $36,363 in 2002 will tax the risk-free return on *T*'s entire savings. In contrast, taxing the gain in 2003 when a portion accrued in 2002 taxes the risk-free return only on *T*'s $120,000 of after-tax wages. Yet *T*'s savings as of the end of 2002 include not only $120,000 of after-tax wages, but also $36,363 appreciation on the stock.[22] The risk-free return on the appreciation that occurred in 2002 will go untaxed in 2003 if *T* can defer paying taxes on the appreciation until the end of 2003.

An assumed sale of the stock by *T* late in the day on December 31, 2002 further demonstrates the inconsistent application of the risk-free burden under an income tax without annual valuations. The sale would increase the burden to the risk-free return on all savings: the after-tax investment return and the saved wages.[23] Consistency requires that *T*'s tax burden should depend not solely on the purchase and sale price of his

18. *See* discussion *infra* note 74 and accompanying text on how the cash flow consumption tax implicitly taxes all wealth, other than the risk-free return, as it accrues without annual valuations.

19. The miniscule $1 differential ($19,999 versus $20,000) is attributable to rounding.

20. For a calculation of the differential, see *infra* note 24.

21. In addition to the structural inconsistency, as discussed *infra* notes 31-41 and accompanying text, such uneven application raises equity, efficiency, and tax avoidance possibilities.

22. Appreciated assets implicitly contain new savings; i.e., an implicit reinvestment of the unrealized investment return into the asset. *Compare* the discussion *infra* note 23 regarding the current taxation of reinvested interest income through a savings account.

23. The sale in 2002 generates an additional $14,545 liability in 2002. Assume *T* pays such tax by using the money he otherwise would have invested in the Treasury security. This costs *T* $1,455 in pretax interest, or $873 after taxes (i.e., he loses $1,455 in interest income which reduces his tax bill by $582). The additional $873 cost to *T* equals a 40 percent tax on the product of the 10 percent risk-free rate and the $21,818 of additional after-tax savings (i.e., the $36,363 investment return savings less the $14,545 tax thereon). Similarly, the inconsistency of an income tax without annual valuations is evidenced by the

assets, but also on their time path.[24] The income tax therefore requires annual valuations because each taxpayer's tax burden is sensitive to the time paths of his assets.[25]

Despite its theoretic appeal, such an "accretion" or "accrual" income tax has never been implemented.[26] The existing tax system instead contains a realization requirement,[27] under which most changes in asset value are disregarded until a sale or exchange of the asset. Although there are valid reasons for rejecting an accretion income tax, including liquidity concerns[28] and administrative difficulties in annually valuing all assets,[29] the realization requirement raises several very serious concerns, leading to its apt characterization as the "Achilles Heel" of the income tax.[30]

These concerns can be grouped into three categories. First, the realization requirement encourages taxpayers to hold onto appreciated assets to reduce the present value of their tax by deferring payment. Deferring realization dramatically reduces the true cost of a tax liability because taxpayers are not charged interest for the resulting deferral of their tax payments.[31] This deferral introduces discrimination across assets. Assets

---

application of the risk-free burden to new savings in the form of reinvested interest income (e.g., interest credited to a bank savings account, but not withdrawn).

24. Reduced to a present value at the time of purchase and using a 6 percent after-tax discount rate, the tax burden on the textual example should be $18,868 ($20,000 / 1.06) if the appreciation occurs solely in 2003, but should be $19,690 if $36,363 of the appreciation occurs in 2002 ($14,545 + $5,454 / 1.06). Under the realization income tax, however, *T*'s tax burden would be the same regardless of when the gain occurred.

25. A consistent income tax could tax only upon sale provided that appropriate interest was charged from accrual until sale. A precise interest charge requires annual valuations, however. For a detailed discussion of interest charge problems under the income tax, see Mitchell L. Engler, *Partial Basis Indexation: An Implicit Response to Tax Deferral*, 53 TAX L. REV. 177, 180-82 (2000).

26. The current structure does provide for accretion taxation in very limited areas (where the underlying concerns arguably are inapplicable). *E.g.*, I.R.C. § 475 (2002) (applying to securities dealers).

27. I.R.C. § 1001 (2002) (providing for realization).

28. There is a reluctance to impose tax liabilities in the absence of cash receipts.

29. *But see* David Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986) (arguing that the administrative problems in measuring unrealized appreciation are manageable).

30. William T. Andrews, *The Achilles Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S, 278, 280-85 (Charls E. Walker & Mark A. Bloomfield eds., 1983).

31. To see how a realization income tax encourages taxpayers to hold onto appreciated assets, consider the portion of the textual example where *T* purchased $100,000 of growth stock on December 31, 2002, which appreciated to $150,000 on December 31, 2003 (and assume all of the appreciation occurred in 2003). Further assume that the stock appreciates at the 10 percent risk-free rate for each subsequent year it is held. Consider first a simple one-year deferral example where *T* sells the stock for $165,000 on December 31, 2004 ($150,000 × (1.1)). *T* pays $26.000 in tax, leaving $139,000 of after-tax proceeds. Compare the result if *T* sold the stock at the end of 2003 and invested in risk-free bonds (or under an accrual system). *T* would owe $20.000 tax in 2003, leaving only $130,000 for investment in 2004. Tax of $5,200 would be due in 2004 on the $13,000 pretax gain on the $130,000 investment, leaving $137,800 for investment in 2005. By holding the stock under the realization requirement, *T* increased his after-tax return by $1,200. This results from the failure to charge interest on deferred tax liabilities. The difference is attributable to the deferral of tax on the original $50,000 gain in 2003. If the system charged interest on

that produce returns that are taxed currently are taxed more heavily than assets that do not produce current tax. Accordingly, competition among taxpayers for assets raises the price of the latter relative to the former.

The deferral also introduces discrimination across taxpayers. Taxpayers who can hold onto appreciated assets can reduce their income tax burdens. Thus, taxpayers who are in a better position to defer realization of their income (including earned income) disproportionately reduce their income tax burden relative to those with lesser deferral opportunities.[32] This discrimination raises obvious fairness issues.[33]

Second, the realization requirement provides taxpayers with an incentive to sell assets selectively. Whereas the tax burden on appreciated assets is reduced by holding onto them, the tax benefit on assets that have fallen in value is increased by selling them sooner. The same failure of the tax system to charge interest on deferred taxes that made deferring tax liabilities attractive also makes accelerating tax refunds and reductions attractive.[34] Under a realization income tax, taxpayers generally control the time of asset disposition. Savvy taxpayers can selectively sell

---

deferred tax liabilities at the (after-tax) interest rate of 6 percent (10 percent × (1 - 40 percent tax rate)), *T* would owe $1,200 of interest on the deferred tax on the $50,000 gain (6 percent interest for one year on $20,000 tax).

The deferral benefit becomes more dramatic the longer the deferral. Assume the same facts except *T* retained the stock until December 31, 2015. Under a realization regime, *T* would have $282,456 after taxes. (Pretax value of $470,760 ($150,000 × $(1.1)^{12}$). After taxes, *T* would have $282,456 (60 percent × $470,760).) Under an accrual regime, *T* would have only $261,586 ($130,000 × $(1.06)^{12}$), a difference of over $20,000. In particular, the present value of the tax on the 2003 gain would be approximately cut in half. (The present value of a $1 payment in 12 years at a 6 percent (after-tax) rate is 0.4970.)

32. Consider, for example, someone performing services for a wholly-owned business. Such person might attempt tax deferral by drawing a below-market salary. *See, e.g.*, Engler, *supra* note 9.

33. Bill Gates, for example, has so far paid tax on only a small portion of the roughly $100 billion in income he has received since he founded Microsoft.

34. Consider again the $100,000 growth stock purchased on December 31, 2002. Assume now that the stock declines in value as of December 31, 2003 to $50,000. Assume additionally that *T* receives $50,000 of other taxable proceeds on December 31, 2003, *T* saves all assets owned on December 31, 2003 for consumption on December 31, 2004, *T* makes a 10 percent return on all investments during 2004 (including the stock, if retained), and *T* receives $42,000 of other taxable proceeds on December 31, 2004. If *T* holds the stock until 2004, *T* will owe $20,000 tax in 2003 on his other 2003 proceeds. This leaves $30,000 additional proceeds to invest along with the continued $50,000 investment in the stock. *T*'s pretax proceeds are $130,000 as of December 31, 2004: $88,000 from his investments ($80,000 × 1.1) and $42,000 proceeds from an outside source. *T* owes no tax in 2004 since the $45,000 stock loss ($55,000 proceeds less $100,000 purchase price) exactly offset the $45,000 of income items ($3,000 gain from new $30,000 investment plus $42,000 from outside source). Thus, *T*'s after-tax consumption equals $130,000 as well. Compare the results if *T* sold the stock on December 31, 2003. *T* would owe no tax in 2003 since the $50,000 stock loss ($50,000 proceeds less $100,000 purchase price) exactly offsets the other income, allowing total investments of $100,000. *T*'s pretax proceeds one year later would be $152,000: $110,000 investment proceeds ($100,000 × 1.1) plus $42,000. *T*'s tax would be $20,800 (($42,000 + $10,000) × 40 percent), leaving after-tax consumption of $131,200. The $1,200 increase occurs because *T* was not compensated for the deferred use of the tax loss in the first scenario. ($1,200 equals 6 percent (after-tax) interest rate times the $20,000 tax savings from the 2003 stock loss.)

losing investments while retaining investments with built-in gains.[35] Such losses are then utilized to offset otherwise taxable income.[36] The recent proliferation of tax avoidance schemes dramatically demonstrates the ability, and willingness of certain taxpayers, to avoid the income tax through the creation of phantom (non-economic) tax losses.[37]

Third, the realization requirement arguably supports a lower tax rate for capital gains.[38] Consider someone who, but for taxes, would sell an appreciated asset for reinvestment in a new asset. Under a realization income tax, such a taxpayer might retain the appreciated investment in order to defer further the tax liability on the gain. A lower capital gains rate arguably is beneficial under a realization income tax since it reduces the tax incentive to retain appreciated assets.[39] While such "lock-in" concerns perhaps justify the preference under the realization system,[40] new tax avoidance problems arise from the difference in tax rates. As recently reported on the front page of *The New York Times*, the lower capital gains rate encourages sophisticated taxpayers to convert other income, such as wages, into capital gains.[41]

C. Consumption Tax's Elimination of Primary Income Tax Avoidance Possibilities

The cash flow consumption tax addresses the three realization-based problems discussed above.[42] First, the cash flow consumption tax eliminates the tax benefit of holding onto appreciated assets. The cash flow tax makes realization irrelevant since tax is imposed only upon consumption even if there is an earlier realization event. For instance, a sale of appreciated stock for reinvestment would not trigger any tax under the

35. George M. Constantinides, *Capital Market Equilibrium with Personal Tax*, 51 ECONOMETRICA 611 (1983); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1819 (1990). The purest form of this strategy was the tax straddles of the 1970s. Tax straddles were shut down by targeted anti-tax shelter provisions enacted as part of the Economic Recovery Act of 1981. These provisions are contained primarily in §§ 1092, 1256, and 263(g) of the Internal Revenue Code.

36. The tax code imposes limits on the ability to use losses in response to these concerns. Such limitations do not solve the problems since they are avoided by some, unduly penalize others, and add significant complexity.

37. Again, the losses offset otherwise taxable income. Even if the realized phantom loss is matched by an equal amount of gain, such offsetting gain can be deferred by the taxpayer. As discussed above, this reduces the true tax cost under time value of money principles.

38. I.R.C. § 1(h) (2002) (generally setting a maximum capital gains rate of 20 percent).

39. Other arguments made in support of the preference are less convincing. For instance, it has been argued that the preference offsets the inclusion of the full nominal gain on sale, including the portion attributable to inflation. Applying a reduced rate to all capital gains, regardless of the amount due to inflation, is an extremely poor response to the problem. *E.g.*, Noël B. Cunningham & Deborah H. Schenk, *The Case for the Capital Gains Preference*, 48 TAX L. REV. 319, 337-40 (1993).

40. Cunningham & Schenk, *supra* note 39, at 321.

41. *See* Johnston, *supra* note 5, referencing the technique of converting salary to lower-rate capital gains.

42. Opting for a single tax at consumption obviates the need to value assets annually. Accordingly, the failure to tax appreciation annually is no longer a deviation. *Compare* discussion of the income tax *supra* notes 19-25 and accompanying text.

cash flow tax.[43]

Second, a cash flow consumption tax eliminates the problems brought about by the selective realization of loss assets.[44] Tax losses are not possible under the cash flow consumption tax since asset sales, even at a loss, can only increase the tax base.[45] Sales proceeds increase the base when used for consumption; they generally do not impact the tax base when reinvested.[46]

Finally, a cash flow consumption tax also eliminates the capital gain conversion concerns. As discussed in Section II.B, the lock-in concern on sales for reinvestment is the leading justification for the capital gains preference under the realization income tax. As discussed above, a sale for reinvestment generally does not trigger any tax liability under the consumption tax.[47] The elimination of the need for the preference should remove it from consideration under the consumption tax.[48]

43. At a deeper level, the realization neutrality of the cash flow consumption tax can be explained by its implicit exemption of the risk-free return. As discussed *infra* note 76, the risk-free exemption appropriately adjusts for timing differences in tax payments.

44. As discussed *infra* note 107, certain debt-financed investments might raise tax avoidance possibilities under the consumption tax. This potential is significantly narrowed relative to the realization loss problem under the income tax, in part due to the present value equivalency discussed *infra* note 74 and accompanying text. *See also infra* notes 122-23.

45. At a deeper level, because the time value of money differential is eliminated by the consumption tax, the incentive to sell loss assets quickly is generally eliminated. *See* discussion *infra* note 76. *But see* discussion *infra* notes 62-66 and accompanying text (some residual tax collection concerns under the cash flow consumption tax) and note 107 (possible tax avoidance possibilities through tax deferral).

46. While the sales proceeds would be included in the base in either event, a reinvestment generally would create an offsetting deduction. As discussed *infra* notes 101-07 and accompanying text, purchases of consumer durables would not be deductible. Thus, a sale for reinvestment in a consumer durable could increase the tax base as well.

47. A sale for reinvestment in a consumer durable could increase the current year's tax base since consumer durable purchases would not be deductible. *See* discussion of durables *infra* notes 101-07 and accompanying text. This possibility does not restore the justification for the preference. The problem under current law arises since taxpayers lose the benefit of interest-free deferral of the tax when they reinvest more generally (i.e., in regular investment assets). Accelerating the tax payment under the consumption tax upon reinvestment in a consumer durable would not generate such time value of money detriment. The accelerated tax payment would be offset by the failure to include each subsequent year's actual consumption use. *See* discussion *infra* note 105 regarding the present value equivalency. Furthermore, the consumer durable reinvestment scenario is a much more limited possibility than the lock-in concern under current law which arises for regular investments. Finally, the possibility under the consumption tax could be even further limited by a tax-free rollover rule when the sales proceeds from one durable are reinvested in another durable.

48. The consumption tax also eliminates any inflation justification for the preference. As discussed above, a consumption tax exempts the full normal interest return and not just the inflation component.

Elimination of the preference under the realization income tax would leave the lock-in problem unaddressed.

III. COMPLICATIONS IN SHIFTING TO THE CONVENTIONAL CASH FLOW CONSUMPTION TAX

Commentators have long recognized that a sales tax is a very simple means of implementing a consumption tax. A sales tax, however, cannot reliably be made progressive because many items are consumed by the poor, the middle class, and the wealthy.[49] Accordingly, for many years it was thought that a progressive consumption tax was impractical because it would require tracking every expenditure for each taxpayer. However, about 30 years ago, Professor William Andrews showed that a consumption tax could be implemented without measuring consumption directly, by providing unlimited deductions for savings and including dissavings in the tax base.[50] This cash flow consumption tax was more flexible than a sales-type consumption tax because it could incorporate progressive tax rates based on each individual's total consumption for the tax year.[51]

Since then, the cash flow tax has been the leading contender as a replacement for the income tax. Another one of the principal arguments in its favor is that it would be relatively easy to switch from the existing tax regime to the cash flow consumption tax. The principal change required to the existing tax base is the expansion of the current tax treatment of qualified accounts—such as IRAs, 401(k)s, etc.[52]—to all investments, in effect providing an unlimited deduction for new savings. A corollary rule would include all withdrawals from savings in the base.

Moving from the current system to a cash flow consumption tax therefore appears to require for most taxpayers only a simple change: the deferral of tax on saved wages from the wage date to the consumption date.[53] As discussed below, however, this one change opens up a series of contentious transition issues that have not been resolved in nearly 30 years.

The first and most important concern is that deferring tax on saved wages from the wage date until the consumption date will impose a second level of tax on previously taxed wages. Return to the example where *T* purchased a Treasury security on December 31, 2002 using $120,000 of

49. *See* McCAFFERY, *supra* note 3, at 53-60, 89, 130, 139.

50. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). For an earlier analysis of a cash flow tax, see NICHOLAS KALDOR, AN EXPENDITURE TAX (1955). The 1974 article by Professor Andrews popularized the cash flow concept in the United States. *See* McCAFFERY, *supra* note 3.

51. Progressive rates satisfy the general desire to impose higher rates on persons with greater resources. While some favor proportionate tax rates, there is a general consensus favoring progressive rates on distributional grounds. Even the most highly publicized proponents of a "flat" tax rate system decided, upon further reflection, to present their flat tax as containing progressivity (arising from a limited exemption for low levels of consumption). ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX: A SIMPLE, PROGRESSIVE CONSUMPTION TAX, IN FRONTIERS OF TAX REFORM (Michael J. Boskin ed., 1996).

52. I.R.C. § 219 (2002) (deductibility of qualified retirement contributions). *See also* I.R.C. § 402(b) (2002) (requiring employees to report as income contributions to non-qualified plans).

53. The tax on consumption funded by borrowing would be accelerated from when the borrowing was repaid to when the consumption took place.

after-tax wages. The security was worth $132,000 at the end of the following year. If the tax system switches to a cash flow consumption tax in the intervening year, *T* will pay tax on the full $132,000 when the security matures and the proceeds are consumed at the end of 2003. Assuming the tax rate with the cash flow tax is the same 40 percent as the existing tax, then *T* will pay $52,800 in tax and be left with $79,200[54]—much less than what he would have with either a consistent income tax ($127,200) or a consistent cash flow tax ($132,000). Thus, as the example illustrates, replacing an income tax with a cash flow tax, shifts the timing of the tax assessment from when the wages are earned until when the proceeds are consumed and subjects previously taxed savings to a second level of tax.[55] This is almost universally viewed as unfair because any consistent alternative would impose only one level of tax.[56]

The most obvious response to this double collection of taxes raises a second concern—a significant reduction in government tax revenues in the early post-transition years. As discussed above, the government would no longer collect any tax on wages saved for future consumption. In the long-term, tax collections on consumption funded from savings withdrawals would offset this revenue loss.[57] In the interim period, however, much consumption funded from savings also should be exempt from tax since saved wages generally would have been taxed already under the current income tax regime. A straightforward response would allow individuals tax-free consumption after enactment equal to their already-taxed savings held at transition. This raises tax revenue concerns in the transition period, however, since neither dissavers (to the extent of their transition allowances) nor savers would pay current tax.[58]

In theory, the government could borrow during the interim period to cover the revenue shortfall. Political difficulties make the new issuance of significant government debt an unlikely solution to the revenue loss

54. *T* pays $80,000 in tax on his $200,000 in wages in 2002 and he pays an additional $48,000 in tax on his consumption of $120,000 in previously taxed savings in 2003. He also pays $4,800 tax on $12,000 earned on his investment and consumed in 2003. Thus, in total, *T* pays $132,800 in tax and is left with $79,200.

55. In contrast with the earlier discussion of the double tax imposed by the income tax *supra* note 12, the double tax imposed by shifting from an income tax to a cash flow consumption is two levels of tax on saved earnings held at the transition.

56. Most commentators favor transition relief for this potential tax. *E.g.*, Louis Kaplow, *Recovery of Pre-enactment Basis Under a Consumption Tax: the USA Tax System*, 95 TAX NOTES TODAY 171-47 (1995); DANIEL SHAVIRO, WHEN RULES CHANGE (2000); DAVID BRADFORD, CONSUMPTION TAXES: SOME FUNDAMENTAL TRANSITION ISSUES IN FRONTIERS OF TAX REFORM (Boskin ed., 1996). For an excellent analysis of the distributional impact of a shift without transition relief, see Joseph Bankman & Barbara H. Fried. *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 565-68 (1998).

57. Under current law, savings withdrawals for consumption are taxable only to the extent of the appreciation on the asset sold for consumption.

58. *E.g.*, George Mundstock, Comment, *What's on Second*, 51 U. MIAMI L. REV. 1079, 1081 (1997) (Current deductions would "break the bank."). *Cf. USA Tax System: Description and Explanation of the Unlimited Savings Allowance Income Tax System*, 66 TAX NOTES 1482, 1517 (Supp. 1995) (delaying basis recovery out of revenue shortfall concerns).

problem, however.[59] In addition, the lack of any tax payments by many wealthy taxpayers for an extended period raises related concerns.[60] Proposed alternatives to conventional debt under the cash flow tax have failed to adequately address the problem or have raised new concerns.[61] Thus, the transition from the income tax to the cash flow tax raises revenue timing concerns without a ready solution.

The preceding discussion assumed ultimate payment of the deferred tax on saved wages. An additional area of concern under the cash flow tax regards the correctness of this assumption. Particular concerns have been expressed that deferring collection increases exposure to expatria-

59. Most commentators therefore assume that transition relief must be provided through an alternative means. *E.g.*, Kaplow, *supra* note 56 (noting lack of political feasibility in increasing conventional debt due to "excessive attention to the current deficit or the five-year scoring window"). For a discussion of some prior alternatives under the cash flow tax and their weaknesses, *see infra* note 61 and accompanying text.

60. *See* Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1654 (1979) (A prior proposal presumably rejected the straightforward transition relief due to a concern that wealthy taxpayers would use their transition allowances to pay no tax for an extended period.); *compare also* Shounak Sarkar & George R. Zodrow, *Transitional Issues in Moving to a Direct Consumption Tax*, 46 NAT'L TAX J. 359, 363 (1993) (The ability to "zero out" under a business cash flow tax raises potential perception problem.).

61. A legislative proposal attempted to alleviate such concerns by allowing the transition allowance to offset only consumption funded by savings. Subsequent commentary demonstrated, however, an ability to avoid such limitation by a one-year wage deferral strategy. Martin D. Ginsburg, *Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving, and Consuming in Nunn-Domenici's Tax World*, 48 NAT'L TAX J. 585, 596 (1995). Even if such limitation could be enforced, the government still would not collect any tax on saved wages or significant amounts of consumption.

An alternative suggested approach would allow taxpayers to use only a certain percentage of their overall transition allowance each year. Unused amounts would carry forward to subsequent years with interest. *E.g.*, Kaplow, *supra* note 56; *compare* David F. Bradford, *Transition to and Tax-Rate Flexibility in Cash-Flow-Type Tax in* TAX POLICY AND THE ECONOMY 150, 157-58 (Poterba ed., 1998) (discussing various forms of delayed recovery with interest in the context of a business-level consumption tax). If tax rates are flat, interest is paid at the market rate (the government's short-term borrowing rate), and any excess can be used at death, then this will provide full relief from the double tax. The problem with such approach depends on the designated percentage. A low percentage increases the probability of an unfair double tax for taxpayers consuming a significant percentage of transition savings in the early post-transition years. Such taxpayers could die with unused transition balances. Any corrections to this possibility likely would have imperfections (*compare* discussion of a similar, but less likely issue under the new proposal analyzed in Section IV at note 116). On the other hand, a higher percentage allowance would have limited effectiveness on the initial stated problems. This approach is similar to the new proposal analyzed in Section IV. The new proposal differs, however, in that it (i) applies to both previously earned and future wages, not just previously earned wages, and (ii) does not limit the use of transition basis against savings-funded consumption. This establishes several advantages to the new proposal analyzed in Section IV. By allowing unlimited use of transition basis against savings-funded consumption, the new proposal avoids any possibility of an unfair double tax on transition savings. By taxing saved wages at the wage date, the new proposal maintains tax collections from savers. The new proposal also addresses other transition concerns; *see* discussion of expatriation/tax evasion concerns at notes 62-66 and accompanying text, and progressivity transition concerns at notes 110-18 and accompanying text.

tion and/or tax evasion.[62] Expatriation concerns arise since U.S. wage earners who defer consumption until after expatriation would be outside the U.S. taxing regime at collection time.[63] The tax deferral on saved wages under the cash flow tax therefore could become a permanent exclusion.[64] Separate from the expatriation possibility, deferral raises concerns about tax evasion more generally. Under the current structure, the employer has an obligation to report wages to the IRS and withhold taxes from the recipient's paycheck. Shifting to the cash flow tax would relinquish withholding on wages since there would not be any tax liability on the wage date. Experts have expressed concern over the increased need to monitor financial transactions and/or impose withholding at some time.[65] Thus, before the cash flow tax can be enacted, comfort must be reached that the tax system can appropriately adjust to the increased tax collection pressure on investment sales.[66]

IV. A SIMPLIFIED TRANSITION TO A CONSUMPTION TAX

As shown in Section III, the shift to a conventional cash flow consumption tax raises three transitional difficulties. The question therefore arises whether an alternative consumption tax scheme can maintain the benefits of shifting to a cash flow tax without raising the same transitional concerns. A recent article provides an "alternative hybrid approach."[67] Building on this general work, this article specifically focuses on how this new proposal greatly simplifies the transition to a consumption tax. Section IV.A demonstrates that, under certain circumstances, the burden imposed by the hybrid is economically equivalent to that imposed by a conventional cash flow tax. Section IV.B sets forth the basic workings of the recent proposal. Section IV.C shows how the hybrid approach pro-

62. *E.g.*, Michael J. McIntyre, *The Design of Tax Rules for the North American Free Trade Alliance*, 49 TAX L. REV. 769, 769 n.14 (1994) ("[A] good percentage of saved income would escape taxation entirely due to . . . expatriation and tax evasion.").

63. For commentary expressing such concern, see BROOKINGS INSTITUTION, WHAT SHOULD BE TAXED: INCOME OR CONSUMPTION 323 (Joseph A. Pechman ed., 1980) (emigration "acknowledged to be extremely troublesome"); McIntyre, *supra* note 62; Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX J. 619, 640 (1995) (noting emigration problem).

64. A comparable, but much more limited, problem arises under the current structure. Since taxpayers can defer the tax on investment return until realization under current law, expatriation concerns arise when taxpayers hold assets with unrealized gains. The cash flow tax significantly escalates the issue relative to the current income tax structure as the concern arises even on the underlying saved wage amount plus the entire investment return thereon. The current anti-avoidance response has been deemed ineffective. Reuven Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329, 1338 (1996).

65. For concerns on monitoring financial transactions, see BROOKINGS INSTITUTION, *supra* note 63, at 316-17; McIntyre, *supra* note 62; Richard Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731, 734 (1996). For questions over the ability to impose comparable withholding and information reporting on savings withdrawals for consumption, see Graetz, *supra* note 60, at 1596.

66. This is not strictly a transitional concern because it does not go away over time as dissavings from previously taxed wealth are exhausted.

67. Engler, *supra* note 9.

vides a nearly seamless transition from the existing income tax to a consumption tax. Section IV.D demonstrates how this new proposal maintains the benefits of shifting to a consumption tax.

A. The Economic Logic Behind the Hybrid Approach

From the discussion above, we know that the cash flow tax responds to the realization-based problems of the current tax system.[68] We also know that the cash flow tax's problems stem from its deferral of collection on saved wages until consumption.[69] Together, these conclusions lead to an obvious suggestion—design a tax that generally imposes the same economic burden as a cash flow consumption tax[70] but collects taxes on saved wages when earned.[71] A simple way to do this (with constant tax rates)[72] is to tax consumption, and require taxpayers to prepay their taxes when they receive their wages. Because accelerated taxes are increased taxes, taxpayers must receive interest on their prepaid consumption taxes for the economic burden of the alternative tax to equal that of a conventional cash flow tax.[73]

A deeper understanding of the cash flow tax further illuminates the equivalency between a cash flow consumption tax and the alternative hybrid approach. Recall that the cash flow tax differs from the income tax in that it exempts the risk-free return on after-tax savings.[74] A more ob-

68. *See* discussion *supra* Section II.C.

69. *See* discussion *supra* Section III.

70. Commentators have long recognized that tax systems that look very different on their face can impose the same economic burden. That is also true for a cash flow consumption tax, which can be implemented in a variety of ways. David F. Bradford, *What are Consumption Taxes and Who Pays Them*, 39 TAX NOTES 383, 384 (1988); Knoll, *supra* note 10.

71. *See* discussion *infra* Section IV.D (The new hybrid approach preserves the benefits of shifting to a consumption tax.). *See also* discussion *supra* notes 19-25 and accompanying text on how the income tax problems stem from the attempt to tax the risk-free return.

72. As discussed below, the economic burdens under the alternate consumption tax forms can vary due to progressive rates (or other rate changes). Nonetheless, the consumption tax alternatives respond to the time value of money realization concerns. *See* discussion *supra* Section II.C.

73. The equivalency of the hybrid and a conventional cash flow consumption tax requires certain assumptions. The most prominent assumption is constant tax rates. *See* discussion *infra* notes 110-18 and accompanying text regarding disparate discrepancies under a progressive rate structure. The deferred tax collection also might remain significant for other reasons such as expatriation or tax evasion. *See* discussion of the transition difficulties of the cash flow tax *supra* Section III.

74. *See* discussion *supra* Section II.A. This follows from the present value equivalency of the cash flow tax to a tax on all wealth as it accrues with an exemption for the risk-free return on after-tax savings. The lack of tax collections prior to consumption are appropriately offset by an implicit interest charge on the deferred tax payment at the risk-free rate. The deferral period runs from accrual until consumption. The embedded tax liability therefore grows at the risk-free rate, establishing the present value equivalency of the cash flow tax and the accrual wealth tax under certain assumptions. The equivalency is most readily apparent when the taxpayer invests the unpaid tax in risk-free government treasuries. Recall the earlier example where *T* invested his entire 2002 salary for one year at the 10 percent risk-free rate. Under the cash flow tax, *T* paid $88,000 tax in 2003 on the $220,000 investment proceeds, leaving $132,000 available for consumption. Under an accrual wealth tax with risk-free exemption, *T* would owe $80,000 tax in 2002. The $12,000

vious and direct means of exempting the risk-free return than to provide an immediate deduction for savings is to tax all wages (including saved wages) currently and increase the taxpayer's basis in such after-tax savings at the risk-free interest rate.[75] Because basis is after-tax dollars, increasing the bases of all assets by the risk-free interest rate exempts the risk-free return on after-tax savings from tax.[76] This is the idea that motivates the recently introduced alternative hybrid approach.

In sum, there are two ways to understand the hybrid approach's consumption tax equivalency. First, the hybrid approach is economically equivalent to the cash flow tax because it compensates taxpayers for the earlier taxation of saved wages by paying them interest through increases to the basis offset account.[77] Second, the core difference between an income tax and a cash flow consumption tax is that the latter exempts the risk-free return on after-tax savings. The conventional cash flow tax ex-

---

investment return on the 120,000 investment is tax exempt since it matches the risk-free rate. This leaves identical after-tax proceeds of $132,000. *See* discussion *supra* note 14. Similarly, the $88,000 cash flow tax payment in 2003 is equivalent to the $80,000 payment in 2002 under the accrual wealth tax at the assumed 10 percent risk-free rate.

The equivalency between a cash flow tax and an accrual wealth tax with an exemption for the risk-free return also generally holds where the deferred tax is invested in a risky asset. Recall the earlier example where *T* invested $100,000 in growth stock, but now assume that *T* would have invested $200,000 in growth stock under the cash flow tax. *T*'s $200,000 investment in 2002 grows to $300,000, generating $120,000 tax in 2003. Under the accrual wealth tax, given *T*'s appetite for risk, *T* would have to borrow $80,000 to make the $200,000 stock investment. *T* owes $32,000 tax in 2002, if *T* can borrow at the risk-free rate. (40 percent × $80,000: $100,000 gain - ($8,000 interest expense + $12,000 (exempt risk-free return).) The $120,000 cash flow payment in 2003 is a present value equivalent to the $80,000 in 2002 plus $32,000 in 2003 under the accrual wealth tax. *T* has $180,000 available for consumption in both cases. The equivalency makes an unrealistic assumption that *T* could always borrow at the government's risk-free rate. The cash flow tax, therefore, deviates from the wealth accrual tax to the extent *T* would need to borrow for risky investments under an actual accrual tax. Any imprecision under the cash flow tax, nonetheless, is greatly reduced compared to current law, which generally lacks any interest charge.

75. This approach—explicit current taxation, explicit risk-free exemption—could be extended beyond saved wages to all savings. Limiting the approach to wages, however, avoids the need to value all savings assets. In addition, it lessens the chances that the taxpayer would not receive full interest compensation due to an unusable basis offset account balance. *Compare* discussion *infra* note 116.

76. There is a second and more profound way of understanding how the hybrid operates. A cash flow consumption tax, or any tax system that imposes an economically equivalent liability, charges interest on embedded, but untaxed gains. This interest comes from the risk-free portion of the expected appreciation of the asset over time. Because the appreciation would not be taxed if the embedded gain on the asset were already taxed, the appreciation included in the tax base is effectively an interest charge. In contrast, an income tax does not charge interest on embedded gains because the expected appreciation should be included in the tax base, even assuming taxation of all gain upon accrual. Thus, because this appreciation should be included rather than excluded from the tax base, it can no longer serve to provide interest on embedded gains that have not yet been taxed. At a deeper level, this is why the income tax encourages time shifting games, but the consumption tax does not.

This insight is the source of the timing flexibility that cash flow consumption taxes provide. In theory, taxpayers should be indifferent to when they are taxed so long as they receive interest on that tax that they can use to offset any future tax liability against consumption.

77. As discussed *supra* note 73, this is based on certain assumptions.

empts this return implicitly; the hybrid approach exempts the risk-free return to saved wages explicitly through the risk-free interest increase to the basis offset account.[78] A consumption tax therefore can tax saved wages at the wage date and subsequent investment return, provided that an exemption is given for the risk-free return.[79]

B. The Recent Proposal: An Alternative Hybrid Approach

The recent proposal is called an alternative hybrid because it combines elements of the existing tax structure and a cash flow consumption tax. In form, the hybrid resembles the current system because it taxes wages when earned and gives investors a cost basis in their assets. It also resembles the cash flow tax since investment return is included only when used for consumption.[80] In substance, the approach is a cash flow consumption tax because it exempts the risk-free return from tax.

The tax base under the alternative hybrid approach has two components. The first component maintains the current tax on wages at the wage date even if saved for future consumption.[81] The second component, like the cash flow tax, includes consumption funded from non-wage sources (e.g., savings withdrawals). This cash flow component differs from the cash flow tax, however, in that non-wage consumption would be tax exempt to the extent of previously saved wages plus interest calculated at the government's borrowing rate. This would be accomplished by a basis offset account that could be deducted against inclusions other than wages. The basis offset account simplifies administration by combining the bases of all assets into a single account. The basis offset account would be (i) increased by saved (after-tax) wages and (ii) decreased as

78. This results in the typical case where wages are paid in the year of accrual (or if the taxpayer is on the accrual method). The principle still holds even where wages are paid after the year of accrual but prior to the consumption year. As discussed *infra* note 121, the cash flow tax more generally is equivalent to a tax on wealth at any point prior to consumption with an exemption for the risk-free return on after-tax savings from such point.

79. Note that a wage tax by itself would yield the same results on the textual example which included flat tax rates and only a risk-free investment. The hybrid approach and the stand-alone wage tax could provide different results, however, where the investment return exceeded the market interest rate, especially under a progressive rate structure. For a deeper comparison of the hybrid approach to the stand-alone wage tax, see Engler, *supra* note 9.

80. Similarly, like the cash flow tax, loan proceeds generally would be included in the tax base while debt repayments (principal and interest) would be deductible. An alternative present value equivalent would exclude loan proceeds from the tax base with a corollary denial of a deduction for the debt repayments. Such a general broad-based exclusionary approach, however, exacerbates tax collection concerns by deferring tax payments even beyond the consumption date (i.e., until the debt repayment). *Compare* discussion *supra* Section III (regarding how the cash flow tax's shift of tax collections from the wage date to the consumption date raises tax collection concerns). *See also* discussion *infra* note 107 (regarding a limited application of the exclusionary regime to home acquisition indebtedness).

81. Like current law, a limited dollar exception could be made for qualified retirement savings.

deductions were utilized. Unused balances would carry forward to subsequent years, increased by the government's interest rate.

Consider again the example of *T* investing solely in Treasury securities to see the particular workings of the hybrid approach. Like current law, *T* would pay $80,000 tax in 2002 under the wage tax component even though he consumes nothing.[82] Unlike current law, *T* would owe no further tax in 2003. Mechanically, *T*'s $132,000 basis offset account would fully offset the inclusion of the $132,000 savings withdrawal in the cash flow component base. The basis offset account consists of (i) the $120,000 after-tax savings investment on December 31, 2002, and (ii) the $12,000 interest adjustment on such original $120,000 balance.[83] *T*, therefore, has $132,000 proceeds available for consumption on December 31, 2003, again matching the results for the conventional cash flow consumption tax.[84]

C. The Simplified Transition

By maintaining the current tax on wages and by paying taxpayers interest on their prepaid consumption taxes, the hybrid approach greatly simplifies the transition to a consumption tax. Section IV.C.1 first shows the hybrid approach's response to the three transition problems raised by the conventional cash-flow tax.[85] Section IV.C.2 then explains why transition simplification remains even after addition of the interest-adjusted basis

82. Technically, *T* generates a savings deduction when he makes the investment in the Treasury note. This deduction, however, can be used only against tax base inclusions other than wages (e.g., saving withdrawals).

83. Interest is calculated as the 10 percent market interest rate on the $100,000 original basis offset account for one year.

84. The results also would be the same for the risky investment scenario. Under the hybrid approach, *T* would invest $100,000 of his after-tax wages in the stock and $20,000 in treasury securities. One year later, his investments are worth $172,000 ($150,000 from the stock and $22,000 from the treasuries). *T*'s taxable base would be $40,000 ($172,000 proceeds less the $132,000 basis offset account). *T* would owe $16,000 in taxes ($40,000 × 40 percent). This leaves the same $156,000 of consumption as under the cash flow tax.

85. The hybrid approach also provides more flexibility to deal with another set of potential transition issues. As discussed *supra* Section IV.A, moving to a consumption tax would exempt the normal interest return from tax. This shift would reduce the value of the preferential tax treatment granted to certain assets under current law, thereby making such assets less valuable. For instance, state and local bonds would become relatively less attractive because the current interest exemption would no longer be as tax favored (since the risk-free interest return would become tax exempt on all investments). The holders of such assets arguably are entitled to transition relief. The hybrid approach could provide such relief through a staggered phase-in of the interest rate adjustment to the basis offset account. For example, the transition could take place over ten years, by increasing the basis offset account at ten percent of the treasury bill rate in the first year, and by increasing by ten percent each year the percentage of the treasury bill rate applied to the basis offset account. Thus, if the treasury bill rate were ten percent over the entire ten-year transition period, the basis offset account would increase by one percent in the first year, two percent in the second, and finally reach ten percent in the tenth year. The cash flow approach has no such ready response to this issue. Of course, such phase-in comes at the cost of deferring some of the benefits of the movement to the consumption tax. Also, there is far less agreement that transition relief is appropriate for such tax-favored assets. *E.g.*, SHAVIRO, *supra* note 56, at 181; Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 607 (1986). However, a phase-in period might be important

offset account. Finally, Section IV.C.3 demonstrates why two areas of imprecision under the hybrid approach do not complicate, and in some ways further simplify, the transition from the income tax.

1. *Responsiveness to the Cash Flow Tax's Transition Complexities*

As described above, the switch from the existing tax system to a conventional cash flow consumption tax imposes a second level of tax on individuals with previously taxed wealth. That problem arises because the cash flow tax shifts the date when tax is collected on saved wages from the date of receipt to the date of consumption, in effect wiping out the bases of all assets. Individuals who paid tax on their accumulated wealth as it arose under the existing tax system (and thus have basis) are subject to a second tax when they consume that wealth. In contrast, individuals who have not yet paid any tax on their accumulated wealth (and thus do not have basis) are still subject to only one level of tax.[86]

The hybrid approach avoids this problem because it preserves basis through the basis offset account. At the time of transition, each taxpayer's basis offset account is set equal to the accumulated bases of all of the taxpayer's assets.

The second transition problem stems from the transition relief that would be necessary to overcome the first problem. As discussed above, the double taxation of previously taxed wealth has made a simple switch to a traditional cash flow consumption tax politically unacceptable. To facilitate such a change, commentators have proposed various forms of transition relief. The trouble with these reforms is that they would produce a revenue shortfall in the early years following the switch. As discussed above, a dramatic revenue shortfall could be expected due to the combination of (i) the new delay in tax collections on saved wages and (ii) the need to exempt consumption equal to already-taxed savings held at transition.

In contrast, the hybrid approach does not produce as sharp of a decline in tax revenue because it would maintain tax collections on saved wages at the wage date after transition. The government's tax collections from savers would offset the lack of tax collections on consumption attributable to transition allowances. Conceptually, the allowance of tax-free con-

---

for creating a political consensus in favor of a consumption tax because it reduces the loss suffered by holders of tax-advantaged investments.

86. It might be possible for some individuals to avoid tax completely by borrowing and consuming against accumulated wealth before the transition and then after the switch liquidating their assets and repaying their obligations. This highlights an additional transition problem of existing debt held at the time the system shifts to the cash flow tax. Under the cash flow tax, borrowings generally would be included in the tax base while repayments generally would be deductible. Absent an adjustment, existing debt at transition creates the problem that a taxpayer who borrows under the current regime could receive an unjustified deduction on the repayment of the debt (since the proceeds were not included under the old regime). The appropriate adjustment is to deny deductions for the repayment of existing debt (or if transition relief is granted, reduce the transition basis allowance by the amount of existing debt).

sumption from transition savings fits more comfortably into the hybrid taxing scheme. Apart from transition savings, the hybrid approach allows taxpayers tax-free consumption from post-transition savings to the extent of their basis offset accounts. The hybrid approach, therefore, would treat saved wages the same regardless of whether made before or after transition: an initial tax at the wage date with an offsetting exemption when withdrawn for consumption. This simplified transition under the hybrid approach is evidenced by the ability to consolidate a taxpayer's transition basis allowance with the post-transition basis offset account.[87]

Consider also the interim revenue concern that shifted the focus from the government's aggregate revenue loss to payments by wealthy taxpayers. Allowing tax-free consumption from transition savings under the cash flow tax raised the perception problem that wealthy taxpayers would become tax exempt for an extended period. In favorable contrast, even wealthy taxpayers holding significant savings at transition would owe current tax on post-transition wages.

Finally, recall how the cash flow tax complicated the transition by placing greater tax collection pressure on investment sales. This shift raised concerns regarding the system's increased exposure to expatriation and/or more general tax evasion. In this area as well, the hybrid approach provides a more seamless transition from the current structure. Like current law, someone expatriating with savings generally would have paid tax already on saved wages at the earlier wage date.[88] The hybrid approach similarly avoids the dramatic increase in tax collection pressure on investment sales by taxpayers remaining in the United States. Once again, taxes on saved wages would be due at the wage date, rather than shifting to the time when investments are sold for consumption.[89] Along

87. Transition basis allowances that cannot be used in the first transition year also should carry forward indefinitely with an interest adjustment to prevent dilution under time value of money principles. *See, e.g.*, Kaplow, *supra* note 56.

88. Some concern would remain under the hybrid approach since investment return in excess of the normal interest rate could avoid tax. By limiting the concern to the tax on such investment return, the hybrid approach bypasses the significant escalation of the expatriation exposure presented by the cash-flow tax. *See* discussion *infra* notes 62-64 and accompanying text. The exposure under the hybrid approach would be roughly comparable to that under the income tax, although the two approaches have some differences. The potential exposure under the hybrid approach concerns investment return in excess of the normal interest return; the current law problem is limited to unrealized investment return. Thus, the potential problem could be somewhat increased or decreased by a move to the hybrid approach. The key point is that any change from current law is significantly narrowed relative to the cash flow approach and, as discussed in the preceding sentence, the hybrid approach would reduce the concern for certain assets relative to current law (i.e., those with relatively little or no realized return).

89. Additional tax would be due under the cash flow tax to the extent that the investment return exceeded the normal interest return. This is much more comparable, however, to current law. Under current law, additional tax is owed on investment sales to the extent of the previously-unrealized investment return. Thus, while the hybrid approach could change the amount of tax due on investment sales, the significant escalation that would occur under the cash flow tax is avoided. *See* BROOKINGS INSTITUTION, *supra* note 63, at 316 (cash flow tax enhances collection concerns since entire proceeds would become taxable). Also compare the discussion of the greatly reduced change to the expatriation exposure in note 88.

these lines, wage withholding would remain fully applicable on saved wages under the hybrid approach.

2. *The Interest-Bearing Basis Offset Account*

The hybrid approach provides significant transition simplification despite the addition of the interest-adjusted basis offset account. There are several reasons for this.

First, transition to a conventional cash flow tax would likely require a similar interest-adjusted account to deal with transition allowances.[90] Thus, adoption of the hybrid approach cannot be unacceptable because its transition is more complicated than one to a conventional cash flow tax because the latter would also require such an account. The areas of simplified transition under the hybrid approach discussed above significantly outweigh any complications from the enhanced role for the interest-adjusted account.[91]

Second, the basis offset accounts would be simple to implement because all taxpayers would receive interest at the same rate—the government's borrowing rate. Selection of the government's borrowing rate is not simply a matter of convenience. Compared to a conventional cash flow tax, taxpayers are in effect lending to the government by prepaying taxes on saved wages for consumption that has not yet occurred.[92] Accordingly, to compensate them for the prepayment of their taxes, taxpayers should receive interest at the same rate that the government pays to voluntary creditors.[93]

---

90. As discussed *infra* notes 57-58 and accompanying text, taxpayers should be allowed tax-free consumption after a shift to the cash flow tax in an amount equal to already-taxed savings held at transition. To the extent such tax-free allowance exceeded consumption in the first post-transition year, such excess allowance should carry forward to subsequent years with an interest adjustment. *See* discussion *supra* note 87 and accompanying text for how such allowance could be consolidated with newly-generated carry forward investment deductions under the hybrid approach.

91. The more limited basis account under the cash flow tax would avoid in-year difficulties on new savings. The cash flow tax, however, has other in-year precision difficulties. See Engler, *supra* note 9 for a lengthier discussion of in-year complexities under the alternative tax structures.

92. An alternate way to see this focuses on the present value equivalency of the cash flow tax to an accrual tax on wealth, other than the risk-free return on after-tax savings. *See* discussion *supra* note 74. The hybrid approach makes the accrual wealth tax more explicit for saved wages. Restated, the hybrid approach collapses the cash flow tax's implicit accrual tax payment with an offsetting implicit loan to the taxpayer into an actual tax payment on saved wages. To maintain consumption tax status, the exemption for the risk-free return on saved wages likewise must be made more explicit under the hybrid approach. (An accrual wealth tax without an exemption for the risk-free return would be an income tax. This would restore the need to value all assets annually. *See* discussion *supra* notes 19-25 and accompanying text.) Interest adjustments at the risk-free rate provide such explicit exemption for the risk-free return.

93. The loan is repaid to taxpayers through the basis offset account allowance, including interest increases. It might be thought that the taxpayer's borrowing rate should be used since the taxpayer is being forced to pay earlier than under a conventional cash flow consumption tax. However, in order to compensate a creditor who has been forced to lend funds to a borrower, interest should usually be assessed at the interest rate the borrower pays voluntary lenders. For this argument in the context of litigation, see Michael Knoll, *A*

Third, the hybrid approach's new basis offset account would be less complicated than comparable aspects of current law that would be eliminated. Under current law, taxpayers must record the purchase price of each asset because gain or loss is calculated on an asset-by-asset basis.[94] The hybrid approach would simplify tax accounting by eliminating the separate tracking of each asset by consolidating that tracking into the single basis offset account.[95] Additional simplification benefits arise from the determination of the basis offset account balance on each year's tax return.[96] These simplification benefits offset the added complexity of

---

Primer on Prejudgment Interest, 75 TEX. L. REV. 293, 308-11 (1996) (describing why an award of prejudgment interest at the defendant's borrowing rate will compensate plaintiffs). *But see* Engler, *supra* note 9, for an alternative tax policy perspective suggesting that the taxpayer's borrowing rate should be used in certain circumstances if the goal is to maximize the taxpayer's ability to avoid the tax burden on risky returns under the consumption tax. For a similar point in the context of a business level consumption tax with tax payments accelerated relative to the cash flow tax, see Bradford, *supra* note 61, at 163 (use of the government's rate on accelerated payments "merit[s] exploration" as the initial assumption of available risk-free credit to business is relaxed). On the other hand, the alternative perspective of the cash flow tax as an accrual wealth tax with risk-free exemption suggests that it is the cash flow tax which has the interest rate distortion. See discussion *supra* note 74 regarding the breakdown of the equivalency since the cash flow consumption tax allows taxpayers to implicitly borrow from the government at the government's low rate rather than the taxpayer's (higher) borrowing rate.

94. As discussed above, saved wages generally are taxed on the wage date. Subsequent investment return is taxed as well; taxing investment return requires an allowance for the original investment amount.

95. A limited exception would require separate tracking for consumer durables. *See* discussion of durables *supra* notes 101-08 and accompanying text. Some commentators argue that transfers of wealth should not be taxed as consumption by the transferor. *E.g.*, MCCAFFERY, *supra* note 3, at 62-77. In that case, a question would arise as to how much of the transferor's basis offset account would shift to the transferee in connection with the transferred asset. If no basis shifted, high-bracket taxpayers could significantly lower their tax burdens by shifting assets to low-bracket beneficiaries. To limit such potential, a regime that did not treat the transfer as consumption might want to keep track or reconstruct bases for individual assets transferred to other taxpayers as gifts. Even with such tracking, there would be an incentive to transfer assets whose gain exceeds the risk-free return to lower-bracket taxpayers and other assets to higher-bracket taxpayers. Note that this problem would be even greater for a conventional cash flow tax because basis is always zero. That would provide taxpayers with a strong incentive to transfer assets to lower-bracket taxpayers, even immediately after purchase. Treating wealth transfers as consumption to the transferor addresses these tax avoidance concerns since the tax stays with the transferor (although a valuation issue arises where the transferred property is not publicly traded). If the system wanted to avoid a double tax on wealth transfers, the transferee would need to be allowed to increase his basis offset account by the fair market value of the transferred property. Note the ambiguity of current law regarding the levels of tax imposed on wealth transfers. Wealth transfers currently can face a double (and even triple tax) due to a combination of the income and estate/gift taxes. The estate and gift taxes, however, have a generous allowance and are scheduled to be eliminated in 2010, albeit with reinstatement the following year.

96. The basis offset account tracks the amount taxpayers can consume tax-free from the sale of assets. Long-held assets can raise particular difficulties under current law. Taxpayers must determine their original purchase price upon the sale of every asset. Further complexities can arise where the original purchase price requires adjustment for subsequent events (e.g., a later capital improvement to property). In favorable contrast, the current year's basis offset account balance would be determined by adjusting the prior year's ending balance only for current year transactions.

making interest adjustments.[97] Furthermore, the capital gains conversion and realization deferral incentives under current law generate tremendous complexity as sophisticated planners manipulate around the latest government anti-abuse provisions. As discussed below, the hybrid approach would eliminate the capital gains preference and the realization significance for investment assets.[98]

3. *Two Areas of Imprecision*

The alternative hybrid approach represents a substantial improvement over both the existing income tax and a conventional cash flow consumption tax. It is not, however, the perfect tax. There are imperfections (imprecisions) that it cannot eliminate. These imperfections fall into two broad categories: consumer durables and progressivity.[99] The imperfections are no larger with the alternative hybrid than they are with either the existing tax system or a conventional cash flow tax.[100]

The first imprecision concerns purchases of consumer durables (e.g., a home or car). Under an ideal income tax, the purchase of a consumer durable is not deducted and the net value of services consumed from the durable should be included in each year's tax base.[101] That, however, is

---

97. Absolute precision on the interest adjustment for transactions occurring within the current tax year would present unacceptable complexity. Some precision on in-year transactions therefore would have to yield to rules of convenience. This does not favor retention of the income tax since comparable trade-offs arise under the income tax (e.g., determination of depreciation allowance on property placed in service during the tax year). *See* Engler, *supra* note 9 (discussing in-year imprecisions under the two regimes).

98. The hybrid approach addresses the realization significance for saved wages through the interest adjustment to the basis offset account. *See* discussion *infra* Section IV.D.

99. Interestingly, the imprecisions with inflation indexation that Reed Shuldiner identifies and describes in Reed Shuldiner, *Indexing the Tax Code*, 48 TAX L. REV. 538 (1993), generally disappear when the risk-free interest rate replaces the inflation rate.

100. *Compare* David F. Bradford, *What's in a Name? Income, Consumption, and Sources of Tax Law Complexity*, 76 N.C. L. REV. 223, 225-26 (The consumption taxes failure to tax leisure is "hardly a particular shortcoming of consumption taxes relative to income taxes."). There is also an imprecision inherent in any tax system that subtracts the expenses of producing income or consumption from the tax base. That imprecision—how to divide an expenditure between consumption and investment (e.g., education and meals in restaurants on business trips)—is not eliminated by any of the alternatives under consideration and is no greater under the hybrid than under a conventional cash flow tax.

101. Consider the following example. Owner (*O*) and Renter (*R*) each have $100,000 of savings on December 31, 2000 after paying a 40 percent tax on $166,667 of wages. On December 31, 2000, *O* purchases a $100,000 car for personal use. For simplicity, assume the car has only a two-year useful life and that its annual rental value is $57,619. A comparison to *R* helps show why *O*, in theory, should include net rental value annually even though the car is not deductible. *R* invests his $100,000 savings at a 10 percent interest rate. He uses his savings to rent a similar car for $57,619 payable at the end of each of the next two years. The rental payments are nondeductible. In addition, *R* includes interest income of (i) $10,000 in 2001 (10 percent times $100,000 investment) and (ii) $5,238 in 2002 (10 percent times investment balance of $52,381 as of January 1, 2002—calculated as original $100,000 investment plus $10,000 investment return for 2001 less $57,619 rental payment made on December 31, 2001). Similarly, *O* should report the rental value each year less depreciation on the car. *O* would then have the same results as *R*, assuming depreciation was calculated under the theoretically correct sinking fund method. If so, *O*'s depreciation allowance for 2001 would equal the decline during 2001 in the present value of the

not done under the existing tax system. Instead, although it does not allow a deduction for the purchase, it excludes the flow of services produced by the durable from the tax base. As a result, consumer durables are tax favored. In theory, a conventional cash flow tax would allow a deduction for the purchase of the long-lived asset and would include in the tax base the gross services consumed each year.[102] A cash flow tax with a tax prepayment on saved wages could provide a different tax treatment, even in theory. As with an income tax, the purchase price would not be deductible against wages and so generates basis.[103] However, because this basis grows at the risk-free rate of interest, it fully shelters the consumption that would otherwise be included.[104]

For practical reasons, both the conventional cash flow tax and the hybrid approach likely would follow the current treatment—no deduction and no annual consumption inclusion in all cases. As indicated above, such treatment arguably would better approximate the theoretic ideal under a consumption tax than an income tax. Under a consumption tax, the failure to impute the annual consumption use can be justified as an approximate offset for the denial of an otherwise appropriate deduction.[105] Under an income tax, there is no justification for excluding the annual consumption value under the income tax since, as discussed above, that value should be included and the deduction should be disal-

car's services. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 6.09 (9th ed. 2002). The depreciation allowance, therefore, would equal the present value of $57,619 two years hence; i.e., $47,619 using a 10 percent discount rate (at the 10 percent rate, the present value of $1 two periods out is 0.8264). *O*, therefore, should include $10,000 in 2001: $57,619 rental value less $47,619 depreciation. Similarly, *O* should include $5,238 in 2002: $57,619 rental value less the remaining basis of $52,381 (i.e., the present value of $57,619 one period out at the 10 percent rate).

102. Consider the immediately preceding example. In theory, the cash flow tax would allow *H* a $100,000 deduction against his salary in 2000. In addition, *H* would be required to report annually the full $57,619 rental value.

103. In theory, the purchase price of durables could be deducted against non-wage inclusions under the cash flow component of the hybrid approach. *See* discussion *supra* note 82. If the taxpayer had such non-wage inclusions, the hybrid approach, therefore, would follow the cash flow treatment described above in the preceding footnote.

104. Contrast the results under the hybrid approach on the prior example. Even in theory, the hybrid approach would not permit the car deduction to offset the wages. Instead, the purchase price would increase the basis offset account by $100,000. While the $57,619 imputed rental value still would be included in the tax base each year, the taxpayer could offset such inclusions with the interest-adjusted basis offset account. At the end of 2001, *O* would use $57,619 of the $110,000 basis offset account ($100,000 plus interest for one year), leaving a balance of $52,381. This would grow to $57,619 by the end of 2002 ($52,381 × 1.1), allowing a complete offset for the imputed 2002 rental value.

105. Under certain assumptions, the theoretic and practical approaches are equivalent for the consumption taxes. As shown in the prior footnote, the deduction for the durable exactly sheltered the imputed income under the hybrid approach, leaving no net effect on any other items. In addition, consider the present value equivalency under the conventional cash flow tax (and the hybrid approach to the extent durables were purchased in a year with non-wage inclusions). Utilizing the earlier example again, the practical approach would deny an appropriate $100,000 deduction in 2000 with an offsetting failure to include $57,619 in each of 2001 and 2002. *See* theoretic treatment *supra* note 102. The practical cash flow tax therefore taxes $100,000 in 2000 rather than $57,619 in the two later years. These two alternatives are present value equivalents at the assumed 10 percent discount rate. *See* calculations *supra* note 101.

lowed.[106] Accordingly, ignoring both the deduction and the imputed annual inclusions provides a more reasonable approximation under the hybrid approach.[107]

It is, however, only an approximation. The method would provide the exact answer if the future market price of durables could be perfectly forecast in advance. However, when prices change in ways that are not forecasted, the value of the services consumed changes, and this change is excluded from the tax base.[108] Once again, some imprecision on consumer durables does not raise transitional concerns in moving from current law. The income tax has similar imperfections; i.e., the failure to include consumption value each year deviates from the income tax ideal.

A second area of imprecision arises from progressive tax rates. Progressivity complicates the tax system because it raises questions about to whom income should be attributed and creates incentives to shift timing.[109] With progressive rates, taxpayers have an incentive to control when they pay tax so as to minimize their exposure to high marginal tax rates. Many commentators believe that lifetime income or consumption is a better gauge of ability to pay than a series of separate annual assessments. In theory, such a base can be approximated using lifetime averaging. The problem, however, is that averaging increases complexity. For

106. On the other hand, the cash flow consumption tax heightens the imperfections on mixed investment/consumption expenses like college tuition. The investment component should receive an immediate deduction under the consumption tax whereas it should be amortized over time under the income tax. Therefore, partial or full disallowance of such expenditures might be further from the theoretic ideal under the consumption tax than under the income tax. The hybrid and the conventional cash flow tax are equivalent in this regard, so they both exacerbate this imperfection.

107. Note that homes raise some tax avoidance concerns under the consumption tax. It is likely that home mortgages would not be included as taxable cash flow receipts under the cash flow tax or the cash flow component of the hybrid approach. This exception would avoid the undesirable significant lump sum inclusion upon the purchase of a home due to a mortgage. (A lump sum inclusion would remain on the down payment.) It has been suggested that such exception might lead to sophisticated tax avoidance strategies under the cash-flow tax (where the loan proceeds indirectly fund the purchase of deductible investments). Ginsburg, *supra* note 61. While raising some concern, specific tax avoidance rules could be adopted for this relatively narrow area. In addition, the wage tax component of the hybrid approach provides an additional layer of protection since investment deductions cannot offset wages. Finally, this very narrow area pales in comparison to the broader tax avoidance concerns under current law. For a more detailed analysis, see Engler, *supra* note 9.

108. The cash flow tax and the cash flow component of the hybrid approach likely would require the taxpayer to include nominal gain on disposition of durables; losses, however, would likely be disallowed. This might ameliorate the discrepancy to the extent the asset is sold after the change. For instance, if the value of the asset increases and the asset is sold, some or all of such additional value could be picked up. Precision would be achieved to the extent that the consumption use through the time of sale matched the risk-free rate. Possible imprecisions would remain where the consumption use deviated from the risk-free rate and/or the asset declined in value (since losses would be disallowed). As a transitional matter, note that the income tax also has imperfections on dispositions of durables, such as also possibly disallowing legitimate losses. For a more detailed discussion of consumer durable dispositions, see Engler, *supra* note 9.

109. Both the conventional cash flow consumption tax and the alternative hybrid approach generally eliminate the incentive to control realization in order to accelerate or defer tax. That result, however, assumed that the tax rate was flat.

that reason,[110] it is not part of the current tax law and averaging is unlikely to be implemented generally in any substitute.

To illustrate the imprecision that comes from progressive tax rates and annual assessments, consider first the conventional cash flow tax. In a significant change to current law, progressivity would be determined by consumption patterns.[111] Savings spent in an unusually high consumption year, therefore, could increase significantly the tax burden relative to current law (e.g., a car or home purchase).[112] This concern becomes more pronounced, assuming wealth transfers would be treated as consumption.[113] In the other direction, saving high wages could significantly reduce the tax burden relative to current law.[114] In sum, the degree of progressivity would turn significantly more on savings decisions under the cash flow tax.

Compare the progressivity shifts under the hybrid approach. Progressivity would be imposed on saved wages at the wage date. This avoids the most problematic shifts due to savings under the cash flow tax.[115] In exchange, however, offsetting concerns arise. Primarily, taxpayers whose

110. In addition, not all commentators favor lifetime averaging, even setting aside complexity concerns. *See* discussion in Engler, *supra* note 9.

111. Currently, progressivity on saved wages generally is determined by the level of wages in the wage year. An additional progressivity component is due to investment return and the realization requirement. Progressivity from investment return is muted, however, since capital gains generally (i) do not affect the tax rate on ordinary income and (ii) are taxed at a flat rate. *E.g.*, I.R.C. § 1(h) (2002).

112. This potentially undercuts support for a consumption tax since some consumption tax proponents rely heavily on the consumption tax's supposed tax neutrality on savings. *See, e.g.*, Alvin C. Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975). *See supra* notes 101-08 and accompanying text for a discussion of home and car purchases.

113. Some commentators couple advocacy of a consumption tax with a wealth transfer tax, effectively treating wealth transfers as consumption. *E.g.*, HENRY J. AARON & HARVEY GALPER, A TAX ON CONSUMPTION, GIFTS AND BEQUESTS IN OPTIONS FOR TAX REFORM (Joseph A. Pechman ed., 1984). This insures that wage earners pay tax on saved wages at some point during their lifetime. It also subjects wealth that is passed down from generation to generation to tax at each generation, unless the recipient receives basis equal to the fair market value of the wealth received. For the argument in favor of taxing wealth transfers as consumption, see Engler, *supra* note 9. An averaging provision applicable only at death would minimize concerns that excessively high progressive rates would apply in the year of death. The extent of any such relief for certain taxpayers would depend on the willingness to extend the averaging over many years.

114. This could occur where the consumption occurs over an extended period. This is likely to trouble commentators favoring progressive rates on high wage earners. For support of progressive rates on high wages, see Martin J. McMahon & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 51-52 (1998).

115. The basis offset account would eliminate the tax penalty when saved wages, plus the normal interest return, are consumed in a heavy consumption year. *Compare* Bradford, *supra* note 61, at 158-591 (Annual deductions equal to the sum of actual depreciation of business assets plus interest on unrecovered purchase price—in lieu of a full deduction in the acquisition year as per the cash flow tax—would avoid distortions from tax rate changes.). A greatly reduced concern would remain where investment returns significantly exceeded the normal interest return. Such limited "bunching" concern also arises under a realization income tax since investment income from different years can get "bunched" together in the year of sale. A flat 20 percent long-term capital gains rate mutes this problem. Bunching, however, is a poor justification for the preference. *See* Cunningham &

earnings are more volatile than their consumption face higher tax bills. Accordingly, high wage earners would have incentives to defer salary to a lower wage year.[116]

The comparison of the two consumption taxes highlights the inescapable progressivity tradeoff between savings shifts and wage variances. While neither is ideal, the hybrid approach's imprecisions raise fewer transitional concerns since they generally preserve the imperfections in the current law.[117] In contrast, the conventional cash flow tax carries a difficult transition burden: generating a consensus in favor of dramatically shifting the status quo on progressivity.[118] The hybrid approach, therefore, simplifies the transition path by avoiding significant new imperfections from progressivity.

In sum, consumer durables and progressivity do not complicate the transition to the hybrid approach, and in some ways further simplify it. As shown above, there are relatively simple ways for the hybrid approach to minimize imprecision in these areas. Any remaining imperfections are not transition barriers, given the comparable or greater imprecisions under current law.[119] Thus, the hybrid approach remains compelling as a

---

Schenk, *supra* note 39. For potential responses to the much more limited bunching problem under the hybrid approach, see Engler, *supra* note 9.

116. A lesser progressivity concern is that a taxpayer might not fully benefit from the basis offset account due to, e.g., varying tax rates or an unused balance at death. The latter, extreme version of the problem would occur only where the taxpayer's portfolio earned a return below the risk-free rate over time, however. Any remaining concerns might be lessened by (i) reimbursement payments for unused basis offset accounts, payable perhaps at death, (ii) requiring the government to pay interest currently on basis offset account balances (in lieu of the interest increase), or (iii) allowing unused balances to pass on to heirs like other assets. The less extreme version of the problem (e.g., utilization of the account in a low rate year) could be addressed by an election to defer use of the account. *See* Engler, *supra* note 9, for a more detailed discussion. Any remaining imprecisions are not problematic as a transitional matter. Similar to the discussion below on wage shifts, current law contains comparable excess taxation concerns. (Excess realized losses might never be used. In addition, they carry forward without interest compensation for any deferred use. *See* example *supra* note 34.)

117. A modified hybrid approach could address the wage variance by substituting an interest-adjusted tax paid credit carry forward for the basis offset account. This Article analyzes the regular hybrid approach, however, because such modified version, like the cash flow tax, complicates the transition by opening up the contentious area of progressivity timing. While the income tax structure has had varying degrees of progressivity over time, such progressivity has consistently been applied on saved wages at the wage date. After implementation of the regular hybrid approach, further consideration could be given to the difficult tradeoff between savings shifts and wage variance. That is, the regular hybrid approach could be modified if a consensus later forms in favor of savings shifts. A lack of current consensus for this contentious shift need not hold hostage the elimination of the core realization problems: i.e., time value of money deferral issues and capital gain conversions.

118. For possible objections to the saving shifts, see *supra* notes 112 and 114 and accompanying text.

119. A similar point can be made with regard to the corporate-level tax. In theory, a corporate-level tax appears to have no place under a cash flow tax. *See* Graetz, *supra* note 60, at 1634-42. Thus, concerns might arise in relinquishing the tax revenues from the current corporate tax. (This concern might be especially acute regarding foreign investors since the entity level tax might be the best way to insure tax collections on foreign investment in the United States. Under current law, foreigner investors generally are not taxed on capital gains and the 30 percent dividend withholding tax often is reduced by a treaty.)

replacement system despite some imperfections. The income tax has comparable imprecisions in each highlighted area in addition to its time value of money distortions.[120]

D. Hybrid Approach Maintains Benefits of Move to a Consumption Tax

The hybrid approach simplifies the transition while maintaining the benefits of the desired shift to a cash-flow consumption tax. Recall the three primary problem areas under the realization income tax: (i) deferral of tax by avoiding realization, (ii) selective realization of tax losses, and (iii) conversion of ordinary income to capital gains. The hybrid approach addresses all three problems.

Consider first the hybrid approach's response to the deferral of tax by avoiding realization. As with the cash flow consumption tax, the alternative hybrid approach eliminates the tax benefit from holding onto appreciated assets by making realization irrelevant. Tax is imposed only when assets are consumed; there is no tax when assets are sold and the proceeds reinvested.[121]

This does not favor the income tax, however, since the additional corporate tax also lacks theoretic support under the income tax. Thus, similar to the current income tax structure, a consumption tax scheme could have a corporate-level tax in addition to the individual hybrid tax despite the lack of theoretic precision. This suggestion differs from alternative proposals which combine an individual wage tax with a business tax. *E.g.*, Bradford, *supra* note 70. The business-level tax in these latter proposals can be justified theoretically since the individual tax applies only to wages (i.e., the business tax can be viewed as an analogue to the individual-level cash flow component under the hybrid approach). These latter wage/business proposals raise offsetting concerns, however, including the inability to apply progressive rates (except to wages).

120. The failure of the current system to address such time value of money concerns leads to distortion in its own right. In addition, the time value of money differential then provides the strongest support for the problematic capital gains preference. *See* discussion *supra* note 39 and accompanying text.

121. At a deeper level, the realization neutrality of the alternative hybrid approach can be explained by its exemption of the risk-free return from tax. Because this exemption implies that interest is charged on untaxed gains at the risk-free interest rate, a present value equivalency more generally exists between the cash-flow consumption tax and a tax imposed at any point prior to consumption which from that point on exempts the risk-free return on the after-tax savings. For instance, the cash flow tax is a present value equivalent to a tax collected at realization with an exemption for the risk-free return on post-tax savings after the realization event.

Consider the earlier example *supra* note 31, focusing on the simple one-year deferral period. *T* purchased growth stock with $100,000 of after-tax wages (i.e., $166,667 of pretax wages). The stock appreciated by $50,000 the first year (2003), and at the risk-free rate to $165,000 by the end of the two-year investment period (2004). As demonstrated in that note, holding onto the stock for two years, rather than selling after the first year and reinvesting at the risk-free rate, reduced the tax burden under the realization income tax. This would not be true under a consumption tax equivalent that taxed at realization, but then exempted the subsequent risk-free return on after-tax savings. If *T* sold at the end of 2003, *T* would have owed $16,000 tax (40 percent times the $40,000 gain which exceeded the risk-free return). An investment of the $134,000 after-tax proceeds for one year would grow at the risk-free rate to $147,400 ($134,000 × 1.1); since tax was paid on the risky return, the full risk-free return on the entire investment is exempt in 2004]. If *T* held onto the stock through 2004, *T* would owe $17,600 tax on the sale for $165,000, leaving the same $147,400. (The tax is 40 percent of $44,000 ($165,000 - ($100,000 × $(1.1)^2$)); since *T* deferred tax on

Second, like the traditional cash flow tax, the hybrid approach would eliminate the incentive for the selective realization of losses. Like the conventional consumption tax, the basis offset account deduction does not raise phantom tax loss concerns.[122] No deduction would arise upon the sale of an investment at a loss.[123] Loss sales for consumption would increase the tax base while loss sales for reinvestment would have no net effect on the base.[124]

A similar analysis applies regarding the capital gains preference. As discussed above, selling assets for reinvestment generally would not impact the hybrid tax base.[125] Like the cash-flow tax, the hybrid approach removes the lock-in justification for the preference.[126] The hybrid approach therefore maintains the elimination of the preference and its corresponding conversion concerns.

V. CONCLUSION

Deeply rooted and intractable problems with the current hybrid income-consumption tax[127] and the impossibility of constructing a consistent income tax compel movement to a consumption tax. The cash flow tax has long been the favorite consumption tax method because it allows for progressive rates and eliminates the problems caused by realization. The cash flow tax, however, has been unable to generate a clear consensus since its introduction nearly 30 years ago. In large part, this failure is due to the complicated transition from the status quo to the cash flow tax that would occur. In particular, transition to a conventional cash flow tax raises three serious concerns: the double taxation of previously taxed wealth, a temporary revenue shortfall, and the risk of large-scale expatriation and tax evasion. In addition, the cash flow tax would change the

---

the stock until 2004, only the compounded risk-free return on the $100,000 investment from saved wages is exempt.) Again, the present value equivalency assumes constant tax rates.

122. As discussed *supra* note 107, debt-financed purchases of consumer durables might raise tax avoidance possibilities under the cash-flow tax or the cash-flow component of the hybrid approach. As discussed therein, such concerns are significantly narrowed relative to the realization loss problem under the income tax. In addition, as discussed therein, the hybrid approach beneficially provides another layer of protection relative to the regular cash flow consumption tax. *See also infra* note 123.

123. At a deeper level, the time value of money neutrality of the tax collection under the consumption tax generally eliminates the concern even if losses could be claimed. *See* discussion of such neutrality *supra* note 45. As under the conventional cash flow tax, the general independence is based on certain assumptions. *See* discussion *supra* note 73.

124. As discussed *supra* note 46, a loss sale for reinvestment in a consumer durable could increase the tax base.

125. A sale for reinvestment in a consumer durable could increase the tax base. As discussed *supra* note 47, however, this possibility does not restore the lock-in justification for the preference.

126. The inflation justification also falls out since the full normal interest return, and not just the inflation component, would be exempt from tax under the hybrid approach.

127. *See supra* note 4 for a description of the current system as a hybrid income-consumption tax.

determinants of progressivity, thereby introducing significant new imprecisions.

The newly-introduced hybrid approach picks up the baton from the cash flow tax. It imposes a tax burden that is economically equivalent to that of a cash flow tax,[128] so it provides the same economic benefits as shifting to a conventional cash flow tax. The difference is that the hybrid approach does *not* defer all tax collections until consumption. This simplifies the transition to a consumption tax by minimizing changes to external areas.

The key elements of the hybrid approach are that it maintains the current tax on wages, preserves each taxpayer's current aggregate basis in her assets, and pays taxpayer's interest on their prepaid consumption taxes. Thus, by combining the most administratively desirable features of the current tax structure and the economics of the cash flow tax, the hybrid approach eases the way to solving the existing structure's realization-based problems through a smoother transition to a consumption tax.[129]

128. As discussed *supra* notes 72-74, the two taxes generally are equivalent when the tax rate is fixed. In addition, the cash flow tax implicitly allows taxpayers to borrow at the low, risk-free rate in a greater number of circumstances than the hybrid approach. *See supra* note 74.

129. The hybrid approach does not address the current law incentive for a high wage earner to defer salary to a lower rate year. As discussed *supra* notes 115-18 and accompanying text, this presents the unavoidable tradeoff between undesirable savings shifts and wage variance. If a consensus later forms in favor of the savings shifts, the hybrid approach could be modified at such time to address the wage variance issue.