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A PROGRESSIVE CONSUMPTION TAX FOR INDIVIDUALS: AN ALTERNATIVE HYBRID APPROACH

Mitchell L. Engler*

I. INTRODUCTION

There has been much recent academic and government interest in major structural tax reform.¹ Major tax reform involves two primary issues. The first concerns the tax base: should the U.S. shift from taxing income to a consumption tax?² The second issue involves the tax rate: should one “flat” rate apply or should higher rates apply to individuals with higher amounts of the chosen tax base (progressive taxation)? Current deadlock exists between (i) the seriously flawed existing income tax structure³ and (ii) the leading progressive consumption tax proposal—a cash flow tax.⁴ Despite addressing many flaws under the current structure, the cash flow approach raises serious offsetting concerns. The unsatisfactory income tax therefore remains in place by default. In order to break the current deadlock, I propose a new progressive consumption tax structure—a hybrid approach—to

* Associate Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. An earlier version of this Article was presented at the University of Pennsylvania School of Law Tax Policy Workshop in February 2002. I am grateful for the comments from the workshop participants, especially Michael Knoll and Reed Shuldiner. I also benefited greatly from the comments of Terrence Chorvat, Laura Cunningham, Noël Cunningham, Elia Fischer, Dan Shaviro, and Ed Zelinsky.

1. See Edmund L. Andrews, *White House Floats Idea of Dropping Income Tax*, N.Y. TIMES, Feb. 8, 2003, at C14; Daniel Halperin, *The Randolph W. Throver Symposium Tax Reform Perspectives: Fundamental Tax Reform*, 48 EMORY L.J. 809 (1999); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095 (2000); Richard W. Stevenson, *Bush Takes Aim at Tax Reform*, N.Y. TIMES, July 16, 2001, at A1, reprinted in 92 TAX NOTES 935 (Aug. 13, 2001).

2. This concerns the federal government’s primary tax revenue source. Less significant amounts of revenue are raised from taxes other than the current income tax regime (for example, excise taxes). WILLIAM A. KLEIN, JOSEPH BANKMAN, & DANIEL N. SHAVIRO, *FEDERAL INCOME TAXATION* 1 (12th ed. 2000). There also has been some recent scholarly interest in a wealth tax base. E.g., Deborah H. Schenk, *Foreword to Symposium on Wealth Taxes*, 53 TAX L. REV. 257 (2000). Nonetheless, the income and consumption bases remain the two primary choices under current consideration as annual taxing regimes. See KLEIN ET AL., *supra*, at 8, 15.

3. The current structure has some consumption tax features. See *infra* notes 100, 102 and accompanying text for a discussion of retirement savings. The system, therefore, has been called a hybrid income/consumption tax. See UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX (Henry J. Aaron, Harvey Galper et al. eds., 1988). Consistent with its more common characterization, the current structure is referred to as an income tax.

4. Despite receiving some support, a flat consumption tax is unlikely to generate a consensus due to distributional concerns. See *infra* notes 64, 67 and accompanying text.

substantially improve upon current law and existing consumption tax proposals.

The two components of the new hybrid structure achieve this significant advancement. First, consistent with the current income tax structure, wages generally would be taxed even if saved for future consumption. As discussed below, this wage component addresses the most serious concerns under the cash flow tax. Second, the hybrid approach would tax the excess of (i) savings withdrawals for consumption, over (ii) previously saved wages, increased by the risk-free interest return thereon. The structure of this non-wage component eliminates the most serious problems under the current income tax. The hybrid approach therefore captures the benefits of consumption taxation without the disabling problems of the cash flow tax.

This Article proceeds as follows: Part II briefly illustrates the basic differences among the income tax, the cash flow (consumption) tax, and the hybrid (consumption) approach. Part III explains why academics and government officials should reach a consensus to replace the current income tax with a progressive consumption tax. Part III first focuses on the serious practical shortcomings in income taxation, primarily related to the reporting of income and losses when "realized" through a sale or exchange. As shown therein, realization-based problems seriously distort the desired allocation of the income tax burden. In favorable contrast, both consumption tax alternatives—the cash flow tax and the hybrid approach—eliminate the most serious realization-based problems. As further discussed in Part III, these practical income tax problems combine with two theoretical points to establish a strong threshold case for consumption taxation. First, prior scholarship has shown, ignoring practical distortions, that taxing consumption rather than income does not substantially alter the relative tax burdens among individuals. Second, prior scholarship is inconclusive as to whether an income or consumption tax base is preferable in theory.

Notwithstanding this strong threshold case, a consensus has yet to form around progressive consumption taxation. Part IV explains this result by recapping the serious problems raised by prior commentary on the cash flow tax, the leading progressive consumption proposal. Part IV exhibits how the cash flow taxation problems primarily relate to the absence of tax collections on saved wages. Specifically, the lack of current tax on saved wages raises tax avoidance, transition, and revenue concerns. In addition, a progressive cash flow tax could impact savings decisions in undesirable ways due to the multiple tax rates.⁵ These problems have made the move to a consumption tax less attractive. As demonstrated in Part IV, however, the wage component of the hybrid approach favorably addresses each of these cash flow tax concerns. Part IV also evaluates why the consensus for a progressive consumption tax should finally emerge under the hybrid approach.

5. Under the cash flow tax, saved wages are generally taxed in the year of consumption rather than in the year earned. Thus, there would be a tax impact on savings where the consumption-year tax rate differs from the wage-year tax rate.

II. BASIC DIFFERENCES AMONG THE INCOME TAX, THE CASH FLOW TAX, AND THE HYBRID APPROACH

This Part contrasts the basic workings of the income tax, the cash flow tax, and the new hybrid approach. The basic differences among the three taxes is illustrated in the following example.

Example 1: *T* receives a \$100,000 cash salary on 12/31/01. *T* invests all after-tax wages in a one-year U.S. Treasury note paying the ten percent risk-free rate. *T* consumes all after-tax proceeds on 12/31/02. The tax rate is a flat fifty percent.

A. The Current Income Tax

Under the present income tax, income receipts are taxed even if saved.⁶ *T* therefore owes \$50,000 tax in year 01 on the \$100,000 wages.⁷ The remaining after-tax wages are used to purchase a \$50,000 treasury note on 12/31/01. *T* receives \$55,000 upon maturity of the note on 12/31/02.⁸ *T* owes \$2,500 tax on the \$5,000 of interest income in year 02, leaving \$52,500 of after-tax consumption.⁹

B. The Cash Flow Tax

The cash flow tax makes two primary adjustments to the income tax base: (i) an unlimited deduction for savings/investment and (ii) the inclusion of savings/investment withdrawals.¹⁰ These adjustments convert the income tax base into a consumption tax base. As discussed in greater detail below, this Subpart presents the cash flow tax as the leading existing consumption tax proposal due to the desire for progressive tax rates. Unlike other consumption tax models such as the retail sales tax, the cash flow tax can apply higher rates to individuals with higher consumption levels.¹¹

6. As discussed in Subpart III.A, income can be defined as the sum of consumption plus change in wealth for the relevant tax period, typically one year. Under current law, there is a limited exception for qualified retirement savings. See *infra* note 102 and accompanying text.

7. \$50,000 tax = 50% tax rate x \$100,000 wages.

8. \$50,000 principal plus \$5000 interest (10% x \$50,000).

9. *T*'s investment gain equals the \$55,000 investment proceeds less the \$50,000 purchase price. Tax for year 02 = 50% x \$5000. Investment proceeds of \$55,000 less \$2500 tax = \$52,500 of after-tax consumption.

10. Generally, borrowed funds also increase the cash flow tax base, while debt repayments reduce the tax base. See *infra* notes 110-13 and accompanying text for a discussion of a limited exception.

11. Under a retail sales tax, businesses collect tax on their sales. As discussed in Subpart IV.A, this prevents the application of progressive rates based on each individual consumer's collective consumption for the year. While Example 1 uses a flat tax rate, this assumption was made to focus initially on issues other than progressivity. See, e.g., Example 6 in Subpart IV.A (which discusses progressivity issues).

Under the cash flow tax, *T* owes zero tax in year 01 since *T* saves the entire wages (i.e., *T* consumes nothing).¹² *T* therefore purchases a \$100,000 treasury note on 12/31/01. *T* receives \$110,000 upon maturity of the note on 12/31/02. Because *T* will consume the proceeds on 12/31/02, the full \$110,000 is included in the year 02 tax base.¹³ *T* pays \$55,000 tax, leaving \$55,000 of after-tax consumption.¹⁴

C. The Hybrid Approach

The hybrid approach has two components: a current wage tax and an adjusted cash flow tax on consumption. The wage component would tax earned income regardless of whether saved or consumed.¹⁵ The adjusted cash flow component would tax the excess of (i) the current year's consumption, determined as above under the cash flow tax, over (ii) current wages. Prior years' saved wages, plus the risk-free return thereon, would be deductible under this adjusted cash flow component (to the extent not previously utilized). A general "basis offset account" would track this carry-forward amount from year to year on the tax return.

The basic workings of the hybrid approach are illustrated in Example 1; more detailed examples are discussed below in Part IV. *T* owes \$50,000 tax in year 01 under the wage tax component. *T* therefore purchases a \$50,000 treasury note. Like the income tax, *T* receives \$55,000 upon maturity of the note on 12/31/02. Unlike the income tax, however, *T* does not owe any additional tax in year 02. *T*'s \$55,000 basis offset account fully offsets the inclusion of the \$55,000 investment proceeds under the adjusted cash flow component. The basis-offset account equals \$55,000 as of year 02 since (i) *T* saved \$50,000 of after-tax wages in year 01, and (ii) the risk-free rate was ten percent for the one-year saving period.¹⁶ *T* can consume \$55,000 in year 02 (i.e., the full pretax proceeds from the treasury note), thereby matching the after-tax consumption under the cash flow tax.

12. Technically, the wages are included in the cash flow base while *T*'s saving's deduction fully offsets the wages.

13. As discussed above, savings withdrawals increase the cash flow base. *T* will consume less than \$110,000 after paying taxes. However, this is irrelevant for the tax base definition. The same result generally can be obtained regardless of whether taxes are included in the tax base; only the stated tax rate is impacted. For instance, a fifty percent "tax-inclusive" rate on the full pretax amount (i.e., no deduction for taxes paid) can be expressed as an equivalent 100% "tax-exclusive" rate (i.e., imposed on consumption less taxes). On the above example, applying the fifty percent tax inclusive rate to the full \$110,000 leaves *T* with consumption of \$55,000. Applying the higher 100% tax exclusive rate leaves the same result (*T* can consume only \$55,000 because that amount generates a tax liability of \$55,000). The tax exclusive rate (*E*) is derived from the tax inclusive rate (*I*) under the formula $E = I / (1 - I)$. On the above numbers, $1.0 = .50 / [1 - .50]$. As another example, a twenty percent tax inclusive rate can be expressed as a twenty-five percent tax exclusive rate. $E = .20 / (1 - .20) = .25$.

14. $\$55,000 \text{ tax} = 50\% \times \$110,000$. After-tax consumption = \$110,000 investment proceeds - \$55,000 tax.

15. The hybrid approach could continue the current limited exception for qualified retirement savings. See *infra* note 102 and accompanying text.

16. As discussed above, the basis offset account equals saved wages plus the risk-free return thereon. $\$50,000 \times 1.1 = \$55,000$.

In sum, the hybrid approach differs from the cash flow tax in two major ways. First, the hybrid approach blocks the use of new savings deductions against wages. New savings are deductible under the hybrid approach, but only against non-wage consumption (i.e., current consumption in excess of current wages).¹⁷ Similar to the cash flow tax (and the income tax), however, deductions other than new savings could offset wages.¹⁸

The second difference under the hybrid approach concerns its future allowance for the savings deductions blocked by the wage restriction. Under the hybrid approach, these savings deductions carry forward indefinitely to subsequent years, with interest, for use against subsequent non-wage consumption. The carry-forward deduction for previously saved wages avoids double taxation of such savings (once when earned under the wage component, again when withdrawn for consumption). The additional exemption for the risk-free interest return on saved wages preserves the hybrid approach's status as a consumption tax; i.e., the interest adjustment compensates taxpayers for the earlier taxation of saved wages relative to the cash flow tax.¹⁹ The hybrid approach, therefore, is a consumption tax in a meaningful sense even though it does not strictly tax consumption; the tax on saved wages, with the subsequent exemption for such savings plus interest, can be viewed as an advance collection system.²⁰ Example 1 evidences this understanding, as *T* had equal results under the hybrid approach and the

17. Debt repayments also are deductible only against non-wage consumption in order to prevent taxpayers from avoiding the limitation. For instance, assume *T* wants to save all of his year 01 wages. *T* cannot avoid current tax on the wages by saving the \$100,000, because the savings deduction cannot offset wages. *T* could dodge this limit if interest repayments were deductible against wages. Assume *T* borrows \$1,000,000 on 1/1/01 at ten percent, agreeing to repay \$1,100,000 on 12/31/01. *T* invests the \$1,000,000 in a savings asset that grows in value to \$1,100,000 as of 12/31/01. *T* sells the savings asset to repay the loan. The leveraged investment converts the original savings deduction to a debt repayment since (i) net savings were reduced to zero (\$1,100,000 dissaving from the 12/31 sale of the savings asset less the sum of the original \$100,000 savings from the wages plus \$1,000,000 of additional savings from the loan proceeds) and (ii) a net debt repayment of \$100,000 was generated (\$1,100,000 debt repayment on 12/31 less \$1,000,000 loan proceeds on 1/1).

18. In theory, the hybrid (consumption) approach, like the cash flow (consumption) tax, allows deductions for the costs of generating wages but not for personal consumption expenditures. However, a similar inquiry arises under the income tax. See, for example, discussion in Subpart III.A defining income as the sum of consumption plus change in wealth. Therefore, the hybrid approach or the cash flow approach follows current law on (i) mixed work/consumption items like child-care expenses, commuting costs, and so forth and (ii) non-work related items such as charitable contributions. Without necessarily endorsing the current treatment of any such item, this assumption recognizes that these issues generally do not distinguish the hybrid approach, the income tax, or the cash flow tax. The propriety of the current treatment of such items is beyond the scope of this Article. A similar point can be made about investment-related expenses and other items receiving preferential treatment under current law, for example, life insurance. Current law provides cash flow treatment for a limited amount of qualified retirement savings and is continued under the hybrid approach. See *infra* note 102 and accompanying text.

19. That is, the cash flow tax defers the tax on saved wages until consumption. Part III provides an alternative way to understand this risk-free adjustment. As discussed therein, the income tax imposes an excess burden on the risk-free return to savings, relative to the consumption tax. A current tax on saved wages, typically viewed as an income tax feature, can be converted to a consumption tax equivalent through an exemption of the risk-free return on after-tax savings. However, see *infra* notes 164-71 and accompanying text for a discussion of the possible understatement of the risk-free rate.

20. In addition to this advance collection feature, the hybrid approach applies progressivity differently than the cash flow tax. See discussion at Subparts IV.A and IV.D.1.

cash flow tax. Further analysis of risky returns in Subpart IV.D below provides additional conceptual support.²¹

III. CONSENSUS IN FAVOR OF THE CONSUMPTION TAX

This Part discusses the consensus potential of a progressive consumption tax. Subpart III.A focuses on the practical reasons supporting this conclusion. Income taxation raises serious practical distortions due to its reporting of income and loss only when “realized” through a sale or exchange. In favorable contrast, both consumption tax alternatives—the cash flow tax and the hybrid approach—largely eliminate these distortions. Subpart III.B supplements this rejection of the income tax on practical grounds with two theoretical points. First, recent scholarship shows a relatively narrow difference in theory between individuals’ relative tax burdens under a consumption tax and an income tax. Subpart III.B also takes notice of the reasonable disagreement between serious tax scholars as to the merits of taxing income versus consumption.

A. *Income Tax’s Long-Standing Practical Problems*

In theory, an income tax base generally should include the sum of consumption plus change in wealth for the tax period, typically one year.²² Under such an accretion concept, items of gain or loss should be reported in the year of accrual. For the reasons developed below, any net increase in the value of a taxpayer’s assets during the year should be taxed, even if not yet converted to cash.²³

In practice, however, the income tax has never implemented such accretion or “mark-to-market” treatment.²⁴ Such failure is attributed primarily to the practical difficulties in valuing all assets each year. Additionally, liquidity concerns have been prominent.²⁵ Instead, income generally is included

21. See, e.g., Example 7 in Subpart IV.D.

22. Most tax scholars agree that this is the theoretically correct income tax base. E.g., DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 15-19 (1986). This is often referred to as the “Haig-Simons” tax base. ROBERT M. HAIG, *THE CONCEPT OF INCOME—ECONOMIC AND LEGAL ASPECTS, IN THE FEDERAL INCOME TAX* 1, 7 (Robert M. Haig ed. 1921); HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938); see also *infra* note 23 (explaining why the Haig-Simons formulation is, in theory, the preferred income tax base).

23. The discussion below provides several perspectives for understanding why a viable income tax system requires the accretion concept. At the more basic level, an income tax that includes gain only upon sale raises a host of intractable problems. For example, see the discussion throughout Subpart III.A. At a deeper level, as discussed in Subpart III.B, an income tax imposes an excess burden on the risk-free component of the return to savings. However, such a risk-free burden is imposed inequitably unless all gains are taxed in the year of accrual. See *infra* note 205.

24. The current Internal Revenue Code (I.R.C.) utilizes mark-to-market treatment, but only in very limited circumstances. See I.R.C. § 475 (2002) (securities dealers); *id.* § 1256 (futures contracts). A more universal accretion regime has proven elusive despite the efforts of numerous scholars. Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism and the Virtue of Attainable Virtues*, 19 *CARDOZO L. REV.* 861 (1997).

25. See *TREASURY DEP’T, BLUEPRINTS FOR BASIC TAX REFORM* 81 (1977) [hereinafter

under current law only when “realized” through a market transaction, for example, a sale or exchange. Notwithstanding compelling reasons to reject an accretion income tax,²⁶ the realization requirement raises several serious problems. Realization allows certain taxpayers to defer their taxes, generally without any interest charge.²⁷ Under time value of money principles, such taxpayers reduce their tax burdens relative to others.²⁸

Example 2 below evidences one particular concern. Taxpayers who defer realization until consumption effectively receive consumption tax treatment. This is problematic because, *inter alia*, not all taxpayers have equal opportunities to defer realization until consumption.²⁹ Thus, shifting to a consumption tax would level the playing field for those less able to defer realization until consumption.

Furthermore, Example 3 below demonstrates a more dramatic problem. The realization requirement also allows some taxpayers to delay paying taxes until after consumption. This results when a taxpayer holds investments with offsetting gain(s) and loss(es). There is no net economic loss to the extent gain on the appreciated investment(s) offsets the loss investment(s). Nonetheless, such taxpayer can generate a current tax loss by selectively selling only the loss investment (and reinvesting the proceeds). This allows consumption without current tax where the tax loss is deductible against the income receipts funding consumption.³⁰

The following examples illustrate these problems. To highlight the areas of exposure, these examples assume in the first instance the lack of any

BLUEPRINTS]. Liquidity concerns arise since taxpayers would have to pay tax even though they have not yet converted their appreciated asset(s) to cash.

26. In addition to the stated valuation and liquidity concerns, taxpayer compliance may be undermined. The average taxpayer might have difficulty in understanding and accepting a tax on “paper gains.” Zelinsky, *supra* note 24, at 893-901. *But see* David Shakow, *Taxation without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986) (concluding that the obstacles to accrual taxation largely are surmountable).

27. While current law occasionally imposes an interest charge, a more universal interest charge is hampered by the same key practical problem underlying the realization requirement. Charging interest for the deferral period requires knowledge of when the gain accrued; determining the timing of gain accrual requires annual valuation. For a more detailed discussion, see Mitchell L. Engler, *Partial Basis Indexation: An Implicit Response to Tax Deferral*, 53 TAX L. REV. 177, 180-82 (2000).

28. Under time value of money principles, deferring a \$100 tax liability reduces the current cost below \$100 if the government does not charge interest on the deferred tax liability. Where interest is not imposed, an amount less than \$100 can be set aside today to satisfy the future \$100 liability (since the lesser amount can be invested and earn interest).

29. Thus, those fortunate enough to defer realization until consumption have relatively lower burdens than those who realize income before consumption. *See infra* note 32 and accompanying text for a discussion of possible deferral opportunities on earned income. On the other hand, if all taxpayers could defer tax until consumption with proper tax planning, choosing an income tax over a consumption tax would be merely a trap for the unwary. The undertaking of transactions solely to avoid tax also raises efficiency issues.

30. As shown in Example 3, this defers the tax without necessarily eliminating it. The taxpayer continues to hold assets with unrealized gain (*i.e.*, an imbedded tax liability). A sale of such appreciated assets would trigger the deferred tax. Nonetheless, the taxpayer has reduced his tax liability through the interest-free deferral beyond consumption. In addition, see *infra* note 118 and accompanying text for a discussion of the possibility that the tax liability would be eliminated by virtue of the taxpayer’s insolvency.

government responses. The impacts of protective provisions are addressed after Example 4.

Example 2: Realization Income Tax as a Consumption Tax—*T* performs services in year 01 for his wholly owned business. The services increase the value of the business by \$100,000 as of 12/31/01 (i.e., matching *T*'s labor income in Example 1). Rather than drawing a salary, *T* retains such \$100,000 value in the business, hoping to receive a positive return on the new capital value during year 02. The value of the business increases by \$10,000 in year 02 (matching the ten percent return on the treasury note investment in Example 1). *T* realizes all value by selling the business for \$110,000 on 12/31/02. *T* consumes all after-tax proceeds on 12/31/02.

Under the realization income tax, *T* owes no tax in year 01 because he has not realized his labor income.³¹ This allows continued investment of the full \$100,000 value in the business. *T* realizes \$110,000 of income in year 02 upon the sale of the business. *T* pays \$55,000 tax in 02, leaving \$55,000 for consumption. Recall the results of Example 1 where *T* similarly performed \$100,000 of services in year 01 and received a ten percent investment return for year 02. *T*'s after-tax consumption was \$55,000 under the consumption tax, but only \$52,500 under the income tax. In Example 2, *T*'s results under the realization income tax therefore match the consumption tax.³²

Example 3—Consumption without Current Tax: assume the same facts as Example 2 except *T* also holds two offsetting investments. Investment #1 is worth \$110,000 more than its purchase price; investment #2 is worth \$110,000 less than its original cost. *T* sells investment #2 on 12/31/02, immediately reinvesting the proceeds.

Despite selling his business to fund consumption in year 02, *T* owes no tax that year since the \$110,000 realized loss on investment #2 offsets the \$110,000 business sale gain.³³ *T* has \$110,000 of after-tax proceeds available for consumption in year 02. The tax has not been completely avoided since a sale of the appreciated investment #1 in the future would trigger tax

31. Assume the business itself did not realize any income by selling products or other transactions. Rather, the increase in value was reflected in the appreciation of business assets, including possibly goodwill.

32. This example illustrates deferral of only labor income since the investment return was realized in the year of accrual. A similar concern arises where investment return is not realized in the year of accrual (for example, the taxpayer holds appreciated investment assets at year-end).

In addition to this example's specific factual situation, a realization income tax provides taxpayers other opportunities to defer tax on their labor income until consumption. See *infra* note 105; see also *infra* note 42.

33. Under the realization requirement, the excess of purchase price over sales proceeds constitutes a tax loss.

on the investment gain. Nonetheless, the interest-free deferral of the \$55,000 tax liability until after consumption reduces its true cost.³⁴

Finally, the capital gains preference presents a related realization problem. Realization creates a lock-in scenario for taxpayers who would like to shift their savings from an appreciated asset to a new investment. There is a tax incentive to maintain the current investment: continued interest-free deferral of the tax on the gain. Prior commentary shows that such lock-in arguably supports a lower capital gains rate for investment assets under the income tax; i.e., a lower rate reduces the tax incentive to retain appreciated assets.³⁵ However, the lower capital gains rate under current law generates other serious distortions. The following example illustrates these concerns.

Example 4: assume the same facts as Example 2 except (i) a twenty-five percent capital gains rate applies to all investment returns, (ii) *T* sells his business for its \$100,000 value on 12/31/01 (to isolate the preference issue by removing any deferral benefit), and (iii) *T* reinvests the sales proceeds from the business in a ten percent treasury note like Example 1.

Despite realizing the full \$100,000 income in year 01, *T*'s after-tax consumption increases relative to the consumption tax. *T*'s after-tax funds on 12/31/01 are \$75,000 since the \$100,000 labor income is taxed at the twenty-five percent capital gains rate. The labor income was reported as investment gain since it was realized from the sale of the business. *T* purchases a \$75,000 treasury note, which pays \$82,500 on 12/31/02.³⁶ *T* owes \$1875 tax on the \$7500 of investment return, leaving \$80,625 of after-tax consumption.³⁷

A realization income tax could, and the current law does, attempt to protect against these realization shortcomings.³⁸ Such current protections

34. It is also possible that the taxpayer ultimately will not pay the \$55,000 tax liability. This could occur where the taxpayer does not have enough assets to repay the deferred tax when the appreciated asset is sold. The problem arises where the taxpayer's portfolio is funded with obligations owed to other parties. If so, outside lenders might have priority over the government on the sales proceeds. Thus, the government will collect only if *T* has other assets remaining in the year of sale. See *infra* note 118 and accompanying text. Independently, complete tax avoidance also is possible under current law due to the "basis step-up" rule at death (eliminating built-in investment gains at death). I.R.C. § 1014 (2002).

35. From a fairness perspective, earlier tax collections at a lower rate might be preferable to waiting for a possible later collection at a higher rate. See Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 321 (1993); Daniel N. Shaviro, Commentary, *Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 396, 417 (1993). See *infra* note 52 and accompanying text (offering another justification for the capital gains preference under the income tax and why consumption taxes generally remove such justifications).

36. \$75,000 x 1.1.

37. Tax = .25 x \$7500 = \$1875. \$82,500 investment proceeds less \$1875 tax = \$80,625. This assumes that the interest income qualifies for the lower capital gains rate. As discussed *infra* note 40 and accompanying text, interest does not qualify for the lower rate under current law. Even with the interest taxed at the regular rates, *T*'s position is still improved relative to the consumption tax. In addition, as discussed at Subpart IV.E, some taxpayers attempt, under current law, to convert interest returns to capital gains.

38. Consider also the income tax's long-standing failure to reduce nominal gains by the inflationary

include: (i) the government's ability to impute salary income to business owners in the absence of adequate compensation payments, (ii) a one-year holding requirement for the favorable capital gains rates,³⁹ (iii) the denial of the capital gains rate for interest income,⁴⁰ and (iv) limitations on the ability to use investment losses.⁴¹ Serious concerns nonetheless remain for several reasons.

First, given the inevitable gaps in coverage, the tax avoidance possibilities suggested above remain ready for exploitation (i.e., deferral of labor income and/or investment return, conversion of labor income and/or interest income to capital gains).⁴² In this regard, each example showed the income tax's shortcomings in isolation (for example, either deferral or the preferential rate, but not both together). Even assuming partial blockage of each strategy, taxpayers can link the remaining availability of the different strategies.⁴³ As a related distributional point, the wealthy tend to disproportion-

component. While marginal rate brackets are increased for inflation, this is conceptually distinct from the failure to reduce nominal gain for inflation. See Reed Shuldiner, *Indexing the Tax Code*, 48 TAX L. REV. 537, 542-45 (1993). Such over-taxation does not raise direct tax avoidance concerns. Nonetheless, this is another income tax weakness since the tax burden unfairly varies with the amount of inflation. See Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 39-43 (1996). In addition, such shortcoming might raise indirect tax avoidance concerns by allowing an argument by capital gains proponents that a lower rate is needed to offset the excess inclusion of the full nominal gain. See Cunningham & Schenk, *supra* note 35, at 337 ("[O]ne of the principal arguments used to support the preference is that capital gains are largely inflationary."). However, a lower capital gains rate is a poor offset to the taxation of inflationary gain. *Id.* at 338-41. Similarly, the excess inclusion of the full nominal gain arguably offsets tax deferral under the realization requirement. Taxation of nominal gain is also a poor offset to realization deferral. See Engler, *supra* note 27, at 198-99 n.115.

39. I.R.C. §§ 1(h)(1), 1222 (2002).

40. *Id.* § 1222 (requiring gain from sale or exchange); see also *id.* § 1271 (treating certain income from debt instruments—including payments on sale or exchange—as ordinary income, rather than long-term capital gain).

41. There are several limits on realized losses. First, realized capital losses generally are deductible only against capital gains plus \$3,000 of ordinary income each year. *Id.* § 1211(b). Second, I.R.C. § 1091 "wash sale" rules disallow losses on the sale of stock/securities where substantially identical stock/securities are purchased within thirty days of the loss sale date (backwards or forwards). I.R.C. § 1091 (2002). Third, I.R.C. § 1092 "straddle" rules defer realized losses to the extent the taxpayer holds "offsetting positions" with matching amount of unrealized gain. *Id.* § 1092. An "offsetting position" exists under § 1092(c)(2)(A) "if there is a substantial diminution of the taxpayer's risk of loss [on the asset sold for a loss]." *Id.* § 1092(c)(2)(A).

42. For instance, salary imputation requires enforcement resources by the Internal Revenue Service and is further hampered by the difficulty in ascertaining the true labor component in the absence of a market transaction. In this regard, note the difficulty even in theory, let alone practice, of separating the labor component from capital component in the development of a patent etc. See *infra* note 157 and accompanying text. In addition, sophisticated taxpayers might use leveraged acquisitions to convert labor income to investment return potentially (i) receiving preference rates and/or (ii) skirting limits on offsetting labor income with selectively realized losses. Mitchell L. Engler, *Partial Basis Indexation: Tax Arbitrage and Related Issues*, 55 TAX L. REV. 69, 93-104 (2001); Shuldiner, *supra* note 38, at 646. Taxpayers similarly might avoid the straddle rules by investing in comparable companies. See Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643, 665-68 (1995).

43. For instance, assume the same key underlying facts as the prior examples: (i) *T* earns a \$100,000 salary in year 01 and (ii) all (after-tax) earnings as of 12/31/01 generate a ten percent return for the one-year investment period. Also assume Example 5's twenty-five percent capital gains rate and that *T* realizes his ten percent investment return as capital gains rather than interest income. Finally, assume *T* can defer only half of his earned income from year 01 to 02 and that only true investment return qualifies for the twenty-five percent rate. *T* owes \$25,000 tax in year 01 (50% x \$50,000 wages), leaving \$75,000 for investment as of 12/31/01. The invested \$75,000 grows to \$82,500 (\$75,000 x 1.1) as of 12/31/02. *T*

ately benefit from these shortcomings.⁴⁴ Second, "non-abusive" transactions still can benefit from the lower tax burden.⁴⁵ Third, the protective provisions add significant complexity and require enforcement resources.⁴⁶ Finally, the protections often are too broad, unfairly overtaxing certain taxpayers.⁴⁷ In sum, the realization requirement has been called the Achilles heel of the income tax for excellent reasons.⁴⁸

In favorable contrast, the hybrid approach and the cash flow tax generally eliminate the realization-based problems.⁴⁹ First, consider Example 2 where *T* deferred his earned income from year 01 to year 02. Compare *T* to other taxpayers who similarly earn \$100,000 of labor income in year 01 and defer consumption for one year at the ten percent risk-free rate. Under the realization income tax, those capable of utilizing the deferral strategy have after-tax consumption of \$55,000 while those unable to defer realization consume only \$52,500. In favorable contrast, all such similarly situated taxpayers would have \$55,000 of consumption under the hybrid approach or the cash flow tax.⁵⁰

owes additional tax of (i) \$25,000 on the \$50,000 of deferred wages, and (ii) \$1,875 on the \$7,500 true investment return [25% x (\$82,500 - \$75,000)]. This leaves *T* with \$55,625 of consumption (and no further tax liability), more than the \$55,000 under either of the two consumption tax alternatives. *T* came out ahead of the consumption tax even though: (i) realization was deferred on only half the labor income and (ii) no labor income qualified for the capital gains rates. The results would be more dramatic if *T* received a higher risky investment return on invested capital.

More generally, aggressive taxpayers attempt to skirt the protective provisions. For instance, a successful "conversion" of ordinary income to capital gains through a conversion transaction provides two potential benefits: (i) taxation of the ordinary income at the lower capital gains rate and/or (ii) the ability to offset such ordinary income with realized capital losses (thereby avoiding the general prohibition on using capital losses against ordinary income). See *supra* note 42 and accompanying text.

44. See George R. Zodrow & Charles E. McLure, Jr., *Implementing Direct Consumption Taxes in Developing Countries*, 46 TAX L. REV. 405, 436 (1991) ("[I]ncome taxes in practice are commonly replete with tax preferences for capital income that are of little benefit to the average taxpayer, but enable the wealthy to lower their tax burdens dramatically.").

45. For example, gain on a long-term stock investment receives the dual benefit of deferral and the lower capital gains rate.

46. Shuldiner, *supra* note 38, at 646; Michael S. Knoll, *Financial Innovation, Tax Arbitrage, and Retrospective Taxation: The Problem with Passive Government Lending*, 52 TAX L. REV. 199, 201-02 (1997).

47. Consider, for example, the I.R.C. rule limiting investment losses to only \$3000 of earned income. I.R.C. § 1211(b) (2002). Consider a taxpayer who earns \$100,000 salary and sells his only investment for a \$100,000 loss. Although the taxpayer has true net income of \$0, he reports \$97,000 of net income due to the loss limitation rule. While the \$97,000 unused loss carries forward for use in subsequent years, the taxpayer is not fully compensated under time value of money principles since the loss is not adjusted for interest.

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

49. See Knoll, *supra* note 46, at 207 n.49, 220 n.84 (discussing the cash flow consumption tax). See *infra* note 118 and accompanying text (discussing a related, but more narrow problem under the consumption taxes); see also *infra* notes 104-05 and accompanying text (regarding imprecision due to progressive tax rates which cannot be completely eliminated under an income or consumption tax).

50. Please see calculations above for each approach in Example 1 and see Part IV for possible divergences between the two consumption tax approaches where progressive rates and/or risky returns apply. See Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53, 66-68 (2003) (offering an explanation of why the consumption taxes generally eliminate the time value of money significance of realization and how consumption taxes

Consider next Example 3 where *T* sold only his losing investment. This selective loss strategy increased *T*'s after-tax consumption to more than \$55,000 under the realization income tax. In favorable contrast again, such sale would not generate any tax loss under either the hybrid approach or the cash flow tax.⁵¹ Both taxes therefore eliminate this selective loss concern. Finally, recall the capital gains problems evidenced by Example 4. Recall how the lock-in problem under the realization income tax arguably supports the capital gains preference as a "second-best" response. The two consumption taxes eliminate the potential second-best arguments favoring a capital gains preference. In particular, selling appreciated assets for reinvestment generally would no longer generate any tax liability.⁵² Thus, the capital gains preference has no place under the hybrid approach or the cash flow tax. Accordingly, both forms of consumption taxation should remove the problems raised by Example 4.

B. Supplementary Theoretic Support for Replacing the Income Tax

The merits of taxing income versus consumption have been debated for a long time. The traditional concepts of the income and consumption taxes initially suggested a very significant difference between the two taxes, in theory. Traditionally, the income tax was distinguished from the consumption tax through its "double taxation of saving."⁵³ This label follows from Example 1 above where the saved wages were taxed initially upon receipt and a subsequent tax was imposed on the investment return as well. In contrast, the conventional cash flow consumption tax imposes only a single tax (upon consumption). The "double taxation of savings" label suggests that the income tax imposes an excess burden on all investment return. Assuming the desirability of taxing investment return, such a significant difference between the two taxes might sustain the income tax despite its serious implementation flaws discussed above. More recent scholarship demonstrates,

maintain a present value equivalency of tax burdens under certain assumptions).

51. Under both taxes, the sale of a loss asset would generate an increase to the tax base if the sales proceeds were used for consumption. There generally would not be any increase or decrease if the sales proceeds were reinvested; the inclusion of the sales proceeds would be offset by a new savings deduction. If anything, a sale for reinvestment could increase the base (reinvestment in a consumer durable). See *infra* note 111 and accompanying text.

52. Under both taxes the inclusion of the sales proceeds generally would be offset by new savings deductions. A limited exception might arise upon certain reinvestments in consumer durable. This does not alter the textual conclusion since, *inter alia*, either consumption tax version generally would eliminate the current time value of money benefit from deferral. See *infra* note 111 and accompanying text. In addition, continuation of the current exclusion for some gain on a home sale, see I.R.C. § 121 (2002), would limit situations where a sale/repurchase could trigger gain. Similarly, consumer durable gain more generally could be deferred if reinvested in another durable (through a basis carryover regime).

The inflationary justification also is neutered since the two consumption taxes exempt the entire risk-free return, and not just the inflationary component. See *supra* note 38 and accompanying text (discussing inflationary justification); *supra* note 19 and accompanying text (discussing risk-free exemption under the consumption taxes).

53. See, e.g., RICHARD GOODE, *THE INDIVIDUAL INCOME TAX 25-26* (1976) (discussing the fairness of the income tax's "double taxation of savings").

however, that a theoretic income tax imposes a much more limited excess burden on investment return. In particular, the income tax, in theory, generally imposes an excess tax burden only on the real risk-free rate of return.⁵⁴ The following example illustrates this point.

Example 5: assume the same facts as Example 1 except, under the cash flow tax, *T* invests \$50,000 of the salary in a risky stock (the other half remains invested in the treasury note). The stock doubles in value as of 12/31/02.

Under the cash flow tax, *T* would have \$155,000 of pretax proceeds as of 12/31/02: (i) \$100,000 stock proceeds and (ii) \$55,000 from the treasury note. This allows \$77,500 of after-tax consumption.⁵⁵ Assume *T* invests the full \$50,000 of after-tax wages under the income tax in the risky stock: i.e., matching his risk tolerance under the cash flow tax. *T* would have after-tax proceeds of \$75,000: \$100,000 pretax proceeds less tax on the \$50,000 gain.⁵⁶ Despite the "double taxation of savings," *T*'s reduced consumption of \$2,500 under the income tax equals the tax rate times only the risk-free return on the \$50,000 investment.⁵⁷ Historically, the real risk-free rate has been a very small component of investment return, with the short-term rate averaging around 0.5% over a recent sixty-year period.⁵⁸

The second theoretical point involves the merits of the income tax's theoretical burden on the risk-free return, assuming away the practical problems in accretion taxation.⁵⁹ While such analysis is beyond the scope of this Article, notice should be taken of the long-running debate. In particular, reasonable disagreement remains among serious scholars as to which base is preferable, in theory.⁶⁰ The serious efforts of numerous scholars over many

54. See Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1, 16 (1996) (summary and conclusions #3). This assumes that the theoretic income tax appropriately adjusts for inflation. As shown in the textual example, this also assumes that taxpayers make appropriate portfolio adjustments under the income tax. A further assumption in certain circumstances is that taxpayers can borrow at the risk-free rate; i.e., where portfolio adjustments require individualized borrowing. See *infra* notes 165-71 and accompanying text (discussing the comparable issue under the hybrid approach). A theoretic income tax therefore could impose an additional excess burden, relative to the cash flow consumption tax, on taxpayers with higher borrowing rates in certain circumstances. However, such potential excess tax burden has been criticized because it varies based on taxpayers' individual borrowing rates. See Cunningham, *supra* note 38, at 35-39. Furthermore, such burden can be maintained by forms of consumption taxation other than the cash flow tax, such as the hybrid approach. See *infra* note 205 and accompanying text.

55. $\$155,000 - (\$155,000 \times .5) = \$77,500$.

56. $\$25,000 \text{ tax} = 50\% \text{ tax rate} \times (\$100,000 \text{ stock value} - \$50,000 \text{ purchase price})$.

57. $\$77,500 - \$75,000 = \$2,500$. $\$2,500 = 50\% \text{ tax rate} \times 10\% \text{ risk-free rate} \times \$50,000$. See *infra* notes 144-49 and accompanying text (offering a deeper explanation of this result).

58. See Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax A Debate about Risk? Does it Matter?*, 47 TAX L. REV. 377, 387-90 (1992) (for a detailed analysis of the real risk-free rate).

59. See *supra* note 25 and accompanying text regarding the practical reasons supporting realization taxation.

60. Compare Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 1006-16 (1992) (rejecting attempts to justify a consumption tax on grounds that it preserves savers' relative

years have failed to generate a decisive winner between the income and consumption bases, even ignoring the income tax's serious practical problems.⁶¹

C. Summary

The foregoing theoretical and practical points establish a strong threshold case for the consumption tax. The income tax imposes a relatively narrow excess burden on investment return, even in theory, and reasonable doubts remain as to the desirability of such burden. Serious implementation problems further allow select taxpayers to (i) avoid the relatively light excess burden on investment return⁶² and (ii) reduce their taxes on other income (e.g., wages).⁶³

In sum, those favoring the income tax in theory should consider instead a consumption tax with progressive rates. Progressive rates satisfy the desire to impose proportionately higher tax burdens on the wealthy.⁶⁴ The progressive consumption tax also must avoid problems comparable to those highlighted under the income tax. Depending on its structure, a consumption tax therefore has the potential to satisfy, in practice, both theoretic consumption tax and income tax advocates.⁶⁵ With these goals in mind, Part IV demonstrates the advantages of the hybrid approach relative to the cash flow tax.

IV. BENEFITS OF THE HYBRID APPROACH OVER THE CASH FLOW TAX

A clear consensus for the progressive consumption tax has failed to emerge despite the strong threshold case delineated above. Prior commentators have raised serious concerns about the cash flow tax, which is the leading progressive consumption tax proposal.⁶⁶ These problems have decreased

pretax positions), with Eric Rakowski, *Can Wealth Taxes Be Justified*, 53 TAX L. REV. 263, 356-57 n.158 (2000) (critiquing Professor Fried's analysis).

61. See Bankman & Griffith, *supra* note 58, at 406 (noting that arguments by consumption tax proponents that the income tax's burden on interest is unfair and inefficient "have been ably, but for the most part, inconclusively, rebutted by defenders of the income tax").

62. See, e.g., Example 2 under which *T* matched the consumption tax results, thereby avoiding the tax burden on the risk-free return.

63. See, e.g., Example 3.

64. Income tax proponents often base their preference on the fact that (i) the income tax imposes an additional burden on investment return, and (ii) the wealthy tend to receive higher percentages of investment income. The income tax's practical problems instruct, however, that distributional goals would be better addressed through a progressive consumption tax. See Daniel N. Shaviro, *Rethinking Anti-Tax Shelter Rules: Protecting the Earned Income Tax Base*, 71 TAXES 859 (1993). Many favoring a consumption tax in theory also prefer progressive rates. See, e.g., Rakowski, *supra* note 60, at 354 (discussing why "liberal egalitarians" might favor a progressive consumption tax); see also *infra* note 99. Not everyone, of course, prefers progressive rates. See ROBERT HALL & ALVIN RABUSHKA, *THE FLAT TAX* (1985). Nonetheless, a progressive consumption tax might be a more acceptable compromise to flat tax proponents than the current progressive income tax.

65. As discussed in Subparts IV.A, D, and F.1, even those favoring a consumption tax in theory might reject certain forms of consumption taxation.

66. These concerns are discussed throughout this Part. Other proposals have linked a wage tax with a business-level consumption tax. See *infra* note 99 and accompanying text. The hybrid approach has

the attractiveness of a shift to the consumption tax. As shown herein, the hybrid approach significantly addresses the problems in cash flow taxation. Subpart IV.A first discusses how an undesirable impact on risk-free savings arises under the progressive cash flow tax. Subpart IV.B addresses tax avoidance and evasion issues related to the lack of tax collections on saved wages under the cash flow tax. Subpart IV.C considers the linked transition and revenue concerns that have hindered the cash flow tax. Subpart IV.D analyzes the treatment of risky returns under the different taxes. After Subpart IV.E addresses complexity issues, Subpart IV.F summarizes the consensus potential of the hybrid approach.

A. Progressivity Impact on Risk-Free Savings

A consumption tax consensus likely requires progressive rates to satisfy distributional concerns. Wealthy individuals would bear a greater percentage of the overall tax burden under a progressive consumption tax than a flat consumption tax.⁶⁷ This progressivity desire, however, conflicts with the most straightforward consumption tax model: a "sales" tax collected by businesses on sales for consumption.⁶⁸ Administrative concerns preclude tracking each individual's aggregate spending so that the tax could be collected at varying rates (based on each individual's overall spending).⁶⁹ In a significant advancement, the cash flow tax demonstrated how each individual's consumption could be calculated without tracking expenditure.⁷⁰ As discussed above, this is accomplished through two major modifications to the existing income tax base: (i) an unlimited deduction for savings (plus debt repayments) and (ii) the inclusion of all savings withdrawals (plus borrowed funds). Progressive rates then could be applied to the individual's resulting tax base.

several advantages over such linked wage and business tax approaches, including the ability to impose progressivity on all receipts (not just wages) and avoidance of difficult classification issues regarding which activities constitute businesses.

67. A full discussion of the underlying merits of progressivity is beyond the scope of this Article. As discussed *supra* in note 64 and the accompanying text, there is significant support for progressivity in the tax system.

68. For instance, a retail sales tax could be imposed only upon the ultimate sale for consumption. Alternatively, a value-added tax could be imposed at every level of production (typically with offsetting deductions or credits at the latter stages of production to minimize double taxation of the same value). Thus, in theory, the two forms differ in the timing of the tax collection.

69. KLEIN ET AL., *supra* note 2, at 383. Applying higher rates to luxury goods (and/or lower rates to staples) might achieve some progressivity. This is unsatisfactory, however, for several reasons. First, progressivity would turn on how money was spent rather than the amount of consumption. For example, the consumption of large amounts of "non-luxury" goods would avoid the progressivity. Second, troubling classification issues arise in determining luxury items. Third, economic inefficiencies arise as some consumers substitute "non-luxury" goods for "luxury" items. *Id.* Issues also arise regarding the treatment of services.

70. A 1974 article by Professor Andrews popularized the cash flow tax in the U.S. legal literature. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); see NICHOLAS KALDOR, *AN EXPENDITURE TAX* (1955) (containing an earlier discussion of the consumption or cash flow tax).

The progressive cash flow tax is not without its own problems. Consider first the treatment of savings under the progressive cash flow tax. As discussed more fully below in Subpart IV.D, a flat-rate consumption tax generally can be viewed as implicitly exempting investment return from tax.⁷¹ The consumption tax receives substantial support from this perceived neutrality on savings.⁷² A progressive cash flow tax can deviate significantly from this savings neutrality, thereby making the consumption tax less attractive.

First, saving wages could increase the tax burden even when invested at only the risk-free interest rate. Consider the following example.

Example 6: *T* receives a \$100,000 salary on each of 12/31/01 and 12/31/02. A fifty percent rate applies to amounts up to, and including, \$100,000; additional amounts are taxed at a sixty percent rate. *T* prefers to save all his year 01 wages for consumption in year 02, investing at the ten percent risk-free rate.⁷³

Under the cash flow tax, *T*'s tax base includes the \$210,000 of pretax funds available on 12/31/02: the \$100,000 of year 02 salary, the \$100,000 of saved wages from year 01, and the \$10,000 of interest income on the saved wages.⁷⁴ *T*'s tax bill in year 02 is \$116,000, leaving \$94,000 available for consumption.⁷⁵ Had *T* not saved, *T* could have consumed \$50,000 each year (after paying \$50,000 tax each year on the \$100,000 of wages). Therefore, saving reduced *T*'s overall consumption from \$100,000 (\$50,000 each year) to \$94,000. Under a neutral savings regime, however, *T*'s overall consumption would have increased by \$5000 because (i) *T* deferred \$50,000 of consumption for one year and (ii) *T* invested at the ten percent interest rate.⁷⁶ Savings neutrality was broken because the saved wages plus interest were

71. For instance, *T* had \$55,000 of after-tax consumption in Example 1. The same result would occur under a wage tax that explicitly exempted investment return. Under a fifty percent flat rate wage tax, *T* would have paid \$50,000 of tax on his \$100,000 of wages in year 01. Investing \$50,000 for one year would have generated \$55,000 investment proceeds one year later. No further tax would be imposed on the investment return under the wage tax. For a more detailed analysis of risky investment returns, see Subpart IV.D.

72. See, e.g., BRADFORD, *supra* note 22; see also Rakowski, *supra* note 60.

73. The assumption of no consumption in 01 was made for ease of exposition. Even where *T* consumes a portion of his salary, the more general conceptual point is that unequal spending from year to year can lead to a progressivity impact (where the consumption-year tax rate differs from the wage-year tax rate).

74. As shown in Example 1, *T* is not taxed in year 01 since the entire wages are saved.

75. Tax liability = $(\$100,000 \times 50\%) + (\$110,000 \times 60\%)$. $\$210,000 - \$116,000 = \$94,000$.

76. The \$50,000 deferred consumption multiplied by the ten percent investment rate. Under a savings-neutral wage tax with the same rates, *T* would pay \$50,000 tax in year 01. In year 02, *T* again would owe \$50,000 tax on his wages but the investment proceeds (including the gain) would be exempt. This would leave \$105,000 available for consumption (\$50,000 after-tax wages plus \$55,000 ($\$50,000 \times 1.1$) investment proceeds). The textual calculation assumes that interest rates did not rise in response to the income tax.

consumed in a heavy consumption year, thereby subjecting them to the higher sixty percent progressive rate.⁷⁷

Next, favorably contrast the results under the hybrid approach. Even though *T* saves all available after-tax wages, *T* pays \$50,000 tax on the \$100,000 wages in 01 because savings deductions cannot offset wages.⁷⁸ *T* invests the remaining \$50,000, which grows to \$55,000 as of 12/31/02.⁷⁹ The year 02 hybrid base includes: (i) the \$100,000 current-year salary (under the wage component) and (ii) the \$55,000 savings withdrawal for consumption (under the adjusted cash flow component).⁸⁰ However, *T* can deduct his \$55,000 basis offset account against the savings withdrawals. The original basis offset account was \$50,000 since *T* saved \$50,000 in year 01.⁸¹ The ten percent interest adjustment for one year increases the basis offset account to \$55,000.⁸² *T*'s tax base is reduced to only the \$100,000 of wages, thereby generating another \$50,000 tax liability.

T's after-tax consumption in year 02 under the hybrid approach therefore equals the savings neutral \$105,000: \$155,000 pre-tax proceeds less the \$50,000 tax liability on the current-year wages.⁸³ This resulted since the hybrid approach avoided the progressivity impact on the saved wages and the interest. Even though these amounts were used for consumption, the basis offset account effectively excluded them from the adjusted cash flow component of the hybrid approach for year 02. Savings neutrality was, therefore, maintained on risk-free returns; the more complicated risky returns are discussed below in Subpart IV.D.

Since *T*'s unequal spending raised the progressivity concern under the cash flow tax, the problem might appear negligible under the "life cycle" hypothesis. Under this hypothesis, savings tend to smooth out annual consumption levels.⁸⁴ Significant concerns remain nonetheless. First, some

77. *T* faced the higher sixty percent rate on \$110,000 of his tax base, generating an \$11,000 progressivity burden (*i.e.*, the extra ten percent rate \times \$110,000). The \$11,000 equals the sum of his actual reduced consumption by virtue of saving (\$6000) and the loss of the increased consumption that would arise under a savings neutral system (\$5000).

78. $50\% \times \$100,000$. As discussed *supra* at note 18 and accompanying text, other deductions allowed against wages under current law could offset the wages. For ease of exposition, such deductions are assumed to be zero. This example also assumes that *T* paid the \$50,000 wage tax in 01. See Subpart IV.E for possible complications where the 01 tax liability is not paid until 02.

79. $\$50,000 \times (1.1)$.

80. As discussed at Subpart II.C, consumption in excess of wages is included under this second component. \$155,000 cash flow consumption less \$100,000 wages equals \$55,000.

81. The hybrid approach prevented *T*'s \$50,000 new savings deduction from offsetting his wages. If *T* had other savings withdrawals in the current year, the \$50,000 alternatively could be used against such dissaving.

82. A one-year interest adjustment was correct since exactly one year elapsed between the 12/31/01 tax payment and the 12/31/02 savings withdrawal. See Subpart IV.E for more complicated scenarios where some events occur on dates other than December 31.

83. *T*'s consumption should increase from \$100,000 to \$105,000 where *T* saves \$50,000 for one year at a ten percent interest rate. See *supra* note 76 and accompanying text.

84. See Alberto Ando & Franco Modigliani, *The "Life Cycle" Hypothesis of Saving: Aggregate Implications and Tests*, 53 AM. ECON. REV. 55 (1963). Concerns might be further reduced if there were relatively few rate brackets covering large amounts. See Lawrence Zelenak, *The Selling of the Flat Tax: the Dubious Link between Rate and Base*, 2 CHAP. L. REV. 197, 222 (1999). Less broad-based brackets

spending inequality from year to year is likely and occasionally more significant inequalities can arise where savings are used for cars, down payments on homes, and so forth.⁸⁵

In addition, wealth transfers could make the progressivity concern particularly acute since significant savings can be transferred at death (rather than consumed at more regular levels). Some consumption tax proponents couple their advocacy with a wealth transfer tax.⁸⁶ Such linkage strongly appeals under a cash flow tax to preserve taxation of the transferor's earnings at the transferor's tax rate (since the transferor is not otherwise taxed on saved wages).⁸⁷ A comparable argument arises under the hybrid approach despite its taxation of saved wages; if wealth transfers were exempt, a significant tax incentive would arise to characterize wages as investment return.⁸⁸ Treating wealth transfers as consumption by the transferor keeps the cash flow and hybrid systems "closed."⁸⁹ The view that wealth transfers

might be desired, however.

85. The entire purchase price of a car or home would be taxed in the year of purchase notwithstanding the savings element on such consumer durables. See *infra* note 111 and accompanying text. The special treatment of home acquisition indebtedness (and possibly other consumer debt) would respond to additional "bunching" concerns on debt-financed acquisitions. See *infra* notes 112-13 and accompanying text.

86. See HENRY J. AARON & HARVEY GALPER, *A Tax on Consumption, Gifts and Bequests, in OPTIONS FOR TAX REFORM* (Joseph A. Pechman ed. 1984).

87. If a tax were imposed only upon the transferee's consumption, wealthy taxpayers could lower the tax burden on their heavy earnings by transferring assets to lower-bracket individuals (for example, other family members). Insuring ultimate inclusion also preserves the notion that the consumption tax burdens the taxpayer's endowments as reflected by receipts. See BLUEPRINTS, *supra* note 25, at 38-42 (offering a discussion of the endowment theory). As possible related support, the failure to tax wealth transfers under the cash flow tax might raise concern as to potentially dynastic wealth growing from generation to generation without any tax burden (under the cash flow tax). Compare James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825 (2001) (concluding that current wealth transfer taxes serve a useful role in curbing dynastic wealth). A cash flow tax without a wealth transfer tax would exacerbate such concerns even relative to an income tax without a wealth transfer tax. See discussion *infra* note 91.

88. As discussed below, one attractive feature of the hybrid approach is that the cash flow component protects against taxpayer attempts to "convert" wages to investment income. The cash flow component provides such protection since paying tax on saved wages reduces future tax liabilities through the basis offset account. If wealth transfers are not included in the transferor's tax base, the basis-offset account might become irrelevant to the extent a taxpayer transfers wealth. In fact, a strategy of avoiding wage characterization could backfire if lump-sum transfers were treated as consumption since they could be taxed at a higher marginal rate; *i.e.*, the hybrid approach results would then follow the cash flow tax results.

89. See David A. Weisbach, *Ironing out the Flat Tax*, 52 STAN. L. REV. 599 (2000) (discussing virtue of closed system in analysis of proposed flat tax). The consumption tax could take the form of a separate wealth transfer tax. As discussed above, however, seeing wealth transfers as a potential escape hatch from the underlying consumption tax supports an integrated approach. An integrated approach is especially compelling under the hybrid approach given the basis-offset account. See discussion *infra* note 88 and accompanying text. Consideration could be given to some limited exclusionary amount for wealth transfers. A limited exclusionary amount might be acceptable, especially given that tax avoidance would require the taxpayer to transfer wealth (rather than consume himself).

Even if the wealth transfer tax were integrated into the consumption tax (by treating wealth transfers as consumption), some gaps under the current wealth transfer system would remain. For instance, current techniques are used to reduce the reported value of transferred assets for transfer tax purposes. Such techniques similarly might reduce the reported consumption value on asset transfers under an integrated system. Similar issues would arise, however, even under a realization-income tax regime that treated wealth transfers as a realization event (contrary to current law). An analysis of valuation concerns in the

are a form of consumption provides additional support, although reasonable arguments to the contrary have been made.⁹⁰ (As an aside, while this discussion appropriately focuses on the transferor's treatment, the transferee arguably should be taxed as well.⁹¹)

In sum, assuming wealth transfers are treated as consumption, the progressivity concern becomes more pronounced under the cash flow tax. The cash flow tax could impose an undesirable higher burden on wealth transfers than the hybrid approach since it would include two additional amounts in the wealth transfer year: (i) previously saved wages and (ii) the portion of investment return equal to the risk-free rate. Thus, the cash flow tax could impose a significant progressivity burden on the gradual buildup of even modest amounts of wealth (and even in the absence of extraordinary investment returns).

Provisions averaging multiple years' tax base amounts might be considered under the cash flow tax as a response to such progressivity concerns.⁹²

wealth transfer context and potential responses is beyond the scope of this Article. See Laura Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP*, 86 TAX NOTES 1461 (2000) (offering a discussion of some recent valuation techniques and potential responses).

90. See Joseph M. Dodge, *Taxing Gratuitous Transfers Under a Consumption Tax*, 51 TAX L. REV. 529 (1996).

The equality of opportunity distributive justice theory provides related support; *i.e.*, taxation should reduce pretax unequal opportunities. Since progressivity is designed to smooth out unequal opportunities, the redistributive tax should apply even where the taxpayer decides to pass on excess resources (likely attributable to excess opportunities) to others. In other words, others with less equal opportunities do not even have such a choice.

Finally, even if one rejects the view that the transfers are a form of consumption, their treatment as such might be a reasonable compromise. One critique of the cash flow approach has been that it fails to take into account "availability of choice" by waiting to tax until consumption. See Fried, *supra* note 60, at 963 n.7. Taxing transfers might, therefore, be viewed as a compromise (*i.e.*, while the system declines to tax control over assets while retained, tax would be imposed upon ultimate exercise of control through direct consumption or transfer).

91. For instance, under the equality of opportunity theory, a wealth transferee receives an unequal excess opportunity. Similarly, under the view that a consumption tax burdens endowments, a recipient arguably should be taxed on wealth transfers too. By generally avoiding the income tax's potential "double" tax on saved wages (on wages and investment return), the consumption tax should weaken an objection that taxing both transferor and transferee imposes too many levels of tax. Transferees could be taxed only when the transferred funds were used for consumption. Multiple taxation of wealth transfers implicates some of the current wealth transfer tax difficulties such as (i) distinguishing support payments from wealth transfers and (ii) the appropriate treatment of generation-skipping transfers. See Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (1991). The merits of the hybrid approach, however, can be considered independent of the issue of multiple wealth transfer taxation. Assuming that the transferor reported the transferred property as consumption under the hybrid approach, double taxation could be avoided by, *inter alia*, increasing the transferee's basis offset account by the transferred property's value. See also *infra* note 186 (offering an alternative treatment of wealth transfers.) Thus, an analysis of the difficulties in subjecting wealth transfers to multiple taxation, and potential responses, is beyond the scope of this Article. (Note that multiple taxation can be imposed on wealth transfers under current law since, *inter alia*, the transferor might have paid income tax on the original invested funds).

92. As discussed *infra* notes 110-13 and accompanying text, some debt might be treated as "tax prepaid." This, by itself, would allow some self-help averaging under the cash flow tax, since consumption funded by tax prepaid debt would be taxed upon debt repayment and not actual consumption. This is an unsatisfactory response to the stated problem since tax prepaid debt treatment more generally allows tax deferral, thereby exacerbating the tax collection concerns discussed in Subpart IV.B. As discussed therein, the availability of tax prepaid debt treatment likely would be quite limited.

Another suggested approach would allow taxpayers to "prepay" the tax on investment returns when

Full-scale averaging provisions, however, would likely be contentious, complex, and imprecise.⁹³ Averaging provisions covering only several years would provide only a partial response for long-term savings.⁹⁴ The hybrid approach's built-in response compares favorably: all previously taxed wages plus the risk-free return would be exempt from the tax base, even if saved years ago.⁹⁵

Additional progressivity problems under the cash flow tax arise in the other direction as well. Savings from high-wage years, which level consumption, would decrease the tax burden.⁹⁶ While there might be some support for a savings incentive,⁹⁷ the cash flow tax again compromises the savings neutrality argument in favor of a consumption tax.⁹⁸ Someone receiving high wages over a short time could minimize the progressivity impact by significantly extending the consumption period. In particular, the imposi-

the investment is made by declining the usual investment deduction. In return, the investment proceeds on such investments would be excluded. Thus taxpayers would have a choice to pay the tax at the investment year rate. BLUEPRINTS, *supra* note 25, at 119-27. This approach has been criticized for allowing tax avoidance possibilities. Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1598-1610 (1979). In addition, it is unlikely to generate a consensus since it fails to collect tax in accordance with actual outcomes. *Cf. infra* note 157 and accompanying text (regarding wage tax shortcomings).

93. *Cf. MARVIN CHIRELSTEIN, FEDERAL INCOME TAXATION* 261-62 (9th ed. 2002) (former income averaging provisions "proved rather complex in operation" and "not clear that the eligibility requirements always succeeded in confining benefits [to the intended beneficiaries]"). Determining the period of time over which the taxpayer could average highlights some of these issues. A shorter period denies a full response to someone saving wages for an extended time period. A longer averaging period enhances administrative concerns. In addition, a longer period increases the chances that benefits would extend beyond the intended scope. *Cf. id.* ("[B]eneficiaries of income-averaging sometimes turned out to be taxpayers who had enjoyed a sudden but sustained increase in earnings."). Compare also Richard Schmalbeck, *Income Averaging after Twenty Years: a Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509 (arguing that equity arguments in favor of income averaging are insubstantial) with M. Carr Ferguson & Edwin T. Hood, *Income Averaging*, 24 TAX L. REV. 53, 92 (1968) (construing income averaging provisions to require balance equity appeal against administrative complexities).

94. For a proposal suggesting averaging over several years for the more general concern of heavy consumption within a year, see for example, Andrews, *supra* note 70, at 1157. See also Zelenak, *supra* note 84, at 222 (discussing more general income averaging for "a period of a few years"). But see WHAT SHOULD BE TAXED: INCOME OR CONSUMPTION 318-19 (Pechman ed. 1980) ("[G]ifts and bequests could be taxed under the [cash flow] tax itself only if some sort of averaging were provided."); Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 945 (1975) (stating that savers could face a tax burden due to additional receipts equal to the investment return, even assuming perfect lifetime averaging).

95. Some progressivity concerns might remain where the taxpayer has significant risky returns. The hybrid approach, however, significantly reduces such concerns relative to the cash flow tax. See discussion *infra* notes 160-63 and accompanying text.

96. Saved wages could face lower rates if shifted to a low consumption year. See Warren, *supra* note 94, at 945 n.53 for potential unfairness to someone preferring current consumption from high wages. The extra taxable investment receipts might reduce the potential savings benefit. See discussion *supra* note 94. Benefits would not accrue to the extent the shifting involved amounts in the middle of rate brackets. See Zelenak, *supra* note 84, at 222.

97. See Zelenak, *supra* note 84, at 222. There would be a tax incentive to save wages from high earning years for consumption in lower wage years.

98. See Warren, *supra* note 94, at 945 (offering that the strongest argument for consumption tax has been compromised due to loss of savings neutrality in both directions).

Imposing progressivity only on consumption also raises a related progressivity enforcement point. By removing progressivity on wages, the cash flow system places greater reliance on successfully blocking attempts by high-bracket consumers (for example, parents) to shift consumption to lower-bracket consumers (for example, children).

tion of progressivity on high wages themselves, even if saved, generates a fair degree of support.⁹⁹ Furthermore, this uncapped opportunity to avoid progressivity on high wages might trouble even those favoring a more limited savings incentive.¹⁰⁰

The hybrid approach's current tax on saved wages responds to this progressivity impact as well.¹⁰¹ Furthermore, in favorable contrast to the unlimited ability to minimize progressivity under the cash flow tax, the hybrid approach could provide a more carefully circumscribed allowance. For instance, like current law, a limited amount of wages saved for retirement could receive cash flow treatment (i.e., taxed only when withdrawn for consumption in retirement).¹⁰² Finally, also in favorable contrast to the cash flow tax, a legislative tax rate change generally would not impact saved wages or the risk-free return thereon under the hybrid approach.¹⁰³

In sum, the hybrid approach's progressivity neutrality on saved wages and the risk-free return is a positive tradeoff for a potential progressivity problem of its own. Taxing wages upon receipt under a progressive rate structure causes variance in tax burdens based on the timing of the wages. This highlights the unavoidable tradeoff between savings shifts and wage timing variance.¹⁰⁴ Unlike the cash flow tax, the hybrid approach favorably follows the current resolution: rejecting savings shifts in favor of wage-based shifts.¹⁰⁵

99. Progressivity on high wages might be justified under an equality of opportunity theory of distributive justice; i.e., taxation should reduce pretax unequal opportunities. As wages increase, especially to really high levels, it arguably becomes increasingly more likely that unequal birth endowments and/or sheer luck played a significant role (for example, an athlete or entertainer). See Rakowski, *supra* note 60. Such high wages might, of course, be attributable to efforts devoted over a significant time frame (developing invention, medical school, athlete/entertainer spending years honing skills etc.). See Zelenak, *supra* note 84, at 226-27 (noting possibility that persons with equal opportunities might have different wage earning patterns). For prior proposals suggesting a progressive wage tax (coupled with a flat rate business tax), see BRADFORD, *supra* note 22, at 329-34; David F. Bradford, *What Are Consumption Taxes and Who Pays Them*, 39 TAX NOTES 383, 384-85 (1988); and CHARLES MCLURE & GEORGE ZODROW, *A HYBRID APPROACH TO THE DIRECT TAXATION OF CONSUMPTION*, IN FRONTIERS OF TAX REFORM 70, 72 (Boskin ed., 1996). Additional supporters of progressivity on wages include those favoring a progressive income tax in theory. See Martin J. McMahon, Jr. and Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998).

100. Under current law, taxpayers who save in qualified retirement plans can avoid progressivity on wages in high wage years. This ability to avoid the current progressivity burden is limited. First, there are caps on the amount of wages qualifying for such tax deferral treatment. See *infra* note 102. In addition, there are limits on the use of the saved amounts (e.g., for retirement). A pure cash flow tax would remove such amount and uses limitations.

101. As discussed at Subpart I.I.C, the wages themselves would be taxed. Compare the wage tax's neutrality on savings decisions at Subpart IV.D.1.

102. Such limits could be based on the current law limits. See, e.g., § I.R.C. 219 (2003) (dollar limitations on deductible contributions to individual retirement accounts); *id.* § 415 (dollar limitations on contributions to qualified retirement plans).

103. Under the cash flow tax, rate increases could harm savers while tax rate decreases could benefit savers. For an attempt to justify such impact under the cash flow tax, see Andrews, *supra* note 70.

104. See *supra* note 99 and accompanying text (arguing that the case for progressivity on all wages is mixed).

105. See Engler & Knoll, *supra* note 50 (As a threshold matter this is a transitional advantage of the hybrid approach over the cash flow tax, since it avoids opening up the contentious progressivity tradeoff issue.). At the substantive level, someone favoring a consumption tax for its implicit savings exemption should be more accepting of the potential wage tax shortcomings. See Warren, *supra* note 94, at 945

B. Collection and Tax Avoidance Issues

The cash flow tax's failure to tax saved wages raises tax avoidance and evasion issues. Currently, an employer must report wages to the IRS and withhold taxes from an employee's paycheck. This provides tax evasion protection.¹⁰⁶ Wage withholding and information reporting would be inapplicable, or ineffective, under the cash flow tax to the extent of an employee's saved wages.¹⁰⁷ Shifting to the cash flow tax, therefore, would increase the pressure on tax collections from savings/investment withdrawals.¹⁰⁸ Even assuming the system could adapt to such increased pressure,

(noting that the progressivity impact under a progressive cash flow tax undercuts the strongest argument in favor of consumption taxation; in contrast, a graduated wage tax avoids this objection). In theory, similar issues arise under both the income tax and the wage tax. One might also favor high progressivity based on wages despite potential inequities in certain circumstances. See discussion *supra* note 99. Furthermore, the removal of progressivity on wages under the cash flow tax exacerbates concerns that taxpayers might minimize the progressivity impact by transferring assets to lower-bracket family members. Due to under valuation reporting issues, this could result even if wealth transfers were treated as consumption to the transferor. See discussion *supra* notes 86-87 and accompanying text. Finally, the hybrid approach has flexibility to resolve the tradeoff differently if a consensus ultimately forms in favor of accepting the savings shifts over the wage shifts. See discussion *infra* note 197.

Depending on one's view as to when wage variance raises fairness issues, tax avoidance concerns can arise regarding taxpayer attempts to defer wage receipts from the year of performance to lower rate years. As the same issue arises under current law, current doctrines like constructive receipt, economic benefit, and cash equivalence provide some protection. See CHIRELSTEIN, *supra* note 93, at § 11.01. In addition, there might be practical impediments to the wage deferral strategy. See discussion *infra* note 135. Taxing wages on the accrual method also could be considered.

106. Information reporting highlights the presence of taxable receipts. Wage withholding supplements the information reporting; thus, the system no longer relies solely on the payment of the correct tax by the employees themselves. See David Cay Johnston, *U.S. Warns to Businesses on Tax Protest*, N.Y. TIMES, June 7, 2001, at C1 (noting that no taxes collected when businesses stop withholding). While wage withholding is not foolproof; for instance, employees can overstate exemptions; it nonetheless provides another layer of protection.

107. While withholding technically could be required, such withholdings would be refundable given the lack of underlying tax liability. Similarly, the information reporting would no longer highlight for the IRS the correct tax inclusion time on saved wages. A slight tiering problem would arise in fully negating the withholding tax where the tax rate is expressed on a tax-inclusive basis. Assume *T* is paid \$1000 wages on 12/31/01 and a tax-inclusive rate of forty percent. The employer withholds \$400. *T* invests the remaining \$600 in 01, leaving a final 01 tax base of \$400. *T* receives back only \$240 of the \$400 withheld. (\$400 less \$160 tax liability on final 01 tax base.) Investing the \$240 refund generates a \$96 refund (.4 x \$240) in 02, and so on. Although *T* ultimately receives back the full \$400 withheld, there is a timing detriment (as \$160 is received in later years). *T* receives back the \$400 in 01 under an equivalent 66 2/3% tax exclusive rate (since taxes are deductible when withheld in 01). See Graetz, *supra* note 92, at 1582-84 (illustrating the converse point on under withholding).

108. See, e.g., WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE, *supra* note 94, at 316-17 (problems on monitoring, especially since withdrawn sales proceeds fully taxable under cash flow tax); Michael J. McIntyre, *Commentary: The Design of Tax Rules for the North American Free Trade Alliance*, 49 TAX L. REV. 769, n.14 (1994) (stating that "a good percentage of saved income would escape taxation entirely" partly due to tax evasion); Richard Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731, 734 (1996) (the necessary monitoring of financial transactions "will not be easy"). Withholding on savings withdrawals is unlikely to provide equivalent withholding protection due to, *inter alia*, the difficulty in determining the taxpayer's overall tax bracket on each savings withdrawal. See Graetz, *supra* note 92, at 1596 ("[W]ithholding on expenditure tax receipts other than wages does not seem practical."). In particular, a taxpayer might have low withdrawals from different accounts with different withholding agents. In contrast, wages tend to be received from a limited number of sources, typically providing sufficient progressivity information to the withholding agent. Withholding at a low rate would provide only partial protection. In addition, over withholding still could result where the taxpayer has transition basis deductions. Furthermore, full protection would require withholding on a broad range of

expatriation concerns would remain. In particular, U.S. taxpayers emigrating with savings might avoid all U.S. tax on saved wages.¹⁰⁹

Additional concerns might arise due to the likely special treatment of home acquisition indebtedness. Contrary to the cash flow rules for regular debt, (i) the proceeds from such "exempt" debt likely would be excluded from the tax base, while (ii) repayments of such exempt debt would be non-deductible.¹¹⁰ Such exempt treatment responds to the extreme progressivity "bunching" concerns on home purchases.

The bunching concern follows from the special issues presented by consumer durables. Under the cash flow tax, investments, but not current-consumption assets, should be deductible. Consumer durables, like a home or car, are purchased partly for both purposes. The theoretic ideal—current deduction for the asset's purchase price and annual inclusion of each year's consumption element—raises administrative difficulties. Therefore, for practical reasons, commentary on the cash flow tax typically suggests eliminating both the deduction and the annual inclusions. On a present value basis, the tax cost of the denied current deduction approximates the elimination of the subsequent inclusions.¹¹¹

transactions, such as real estate sales, and leasing arrangements. Similarly, effective information reporting would require reporting of all such financial transactions.

109. Concern arises since savings withdrawals would occur when the taxpayer was outside the United States taxing regime. The seriousness of this problem has been debated. *See* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE, *supra* note 94, at 323 (emigration "acknowledged to be extremely troublesome"); Reuven Avi-Yonah, *Comments on Grubert & Newlon*, 49 NAT'L TAX J. 259, 261 (1996) (downplaying significance); Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX J. 619, 640 (1995) (noting emigration and vacationing abroad problems); Harry Grubert & T. Scott Newlon, *Reply to Avi-Yonah*, 49 NAT'L TAX JOURNAL 267, 267 (1996) (noting the foreign consumption problem); McIntyre, *supra* note 108, at 769 n.14 (stating that "a good percentage of saved income would escape taxation entirely" partly due to expatriation). An expatriation tax would not be as effective as an initial wage tax. A comparable problem exists under current law when taxpayers expatriate holding appreciated assets. The cash flow tax exacerbates the problem since the entire value, not just gain, should be taxed. The current expatriation tax reportedly is virtually unenforceable. *See, e.g.,* Reuven S. Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329, 1338 (1996); Graetz, *supra* note 92, at 1648 (noting lack of easy response to expatriation issue).

110. For administrative reasons, relatively low levels of consumer indebtedness also might receive this special treatment. *See* Graetz, *supra* note 92, at 1618-20.

Treating consumer debt under the exempt debt regime also protects the government against a tax avoidance possibility where consumer goods are purchased on credit. Where consumer debt is treated under the normal cash flow rules, the purchaser's tax liability would be decreased where the interest component of the deferred payment was overstated (with a corresponding understatement of the purchase price of the good). A comparable problem arises under the current income tax, as well, since the seller of a capital asset has an incentive to understate the interest component of a deferred payment (so that some of the interest would qualify for capital gains rates and possibly deferral). *See* I.R.C. § 1274 (2003) (providing a partial response for covered transactions).

111. *See, e.g.,* BLUEPRINTS, *supra* note 25, at 121-22; Graetz, *supra* note 92, at 1614-15. In addition, some prior commentary has also suggested including in the tax base the receipt of sales proceeds/rent in excess of the original purchase price. Losses, however, would not be allowed. *See, e.g.,* Graetz, *supra* note 92, at 1616-18; Zodrow & McLure, *supra* note 44, at 468-69.

Nondeductible purchase price plus gain inclusion might raise concerns that such "double tax" restores the income tax's incentive to consume rather than save (*i.e.*, current consumption avoids the double tax). In response, however, the nondeductible/gain inclusion rule would apply to a much more narrow universe of assets under the hybrid approach. Furthermore, taxpayers are compensated for the nondeductible purchase price by the exclusion of the actual consumption element each year. The present

While this approach addresses the administrative concerns, the entire purchase price of a home would be taxed in the acquisition year if the mortgage amount were treated under the normal cash flow rules.¹¹² The exempt debt treatment responds to this concern by limiting the current year's inclusion to the down payment.¹¹³ Exempt debt, however, would allow current tax avoidance where the debt proceeds finance, in substance, the acquisition of deductible savings assets.¹¹⁴

Such concerns should be less threatening than the income tax shortcomings discussed in Subpart II.B for two reasons. First, a future tax liability with an equivalent present value generally would arise.¹¹⁵ Second, the narrow circumstances in which the consumption tax concerns arise favorably contrast with the more general avoidance possibilities under the income tax.¹¹⁶ Special tax avoidance rules (for example, loss of exempt debt treatment in abusive situations) would further reduce concerns.¹¹⁷ Nonetheless, the ability to defer paying taxes, until after consumption, exacerbates the collection concerns.¹¹⁸

value equivalency of the purchase price and subsequent consumption use generally eliminates the time value of money concerns that exist under the current structure. In addition, the income tax has its own imprecision on consumer durables. See Engler & Knoll, *supra* note 50, at 74-76 for a more detailed discussion of consumer durables, including why the imperfections under the consumption tax do not favor retention of the income tax.

112. Assume *T* purchases a \$500,000 home in 01 using (i) \$100,000 savings for the down payment and (ii) a \$400,000 loan. Treating the loan under the normal cash flow rules would increase *T*'s 2001 tax base by \$500,000 (\$100,000 dissaving plus \$400,000 loan proceeds included under cash flow approach). "Bunching" the home's lifetime of deferred consumption into a single year unjustly subjects *T* to greater progressivity (liquidity concerns also might arise as a portion of the borrowing would be needed to pay taxes). This rule would not eliminate bunching concerns attributable to the down payment.

113. On the above example, the \$400,000 loan proceeds would not be added to the 01 tax base. Instead, *T* would have additional inclusions as the mortgage (principal and interest) was repaid. See *infra* note 115 and accompanying text.

114. Assume *T* owns an appreciated house free and clear of debt. *T* sells the house, purchasing another house of equal value (for example, \$1,000,000). *T* borrows eighty percent of the purchase price of the new house (for example, \$800,000), thereby freeing up \$800,000 of sales proceeds from the first house. *T* invests the \$800,000; the resulting \$800,000 savings deduction allows tax-free consumption for the foreseeable future. For a comparable avoidance attempt under the USA tax, see 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, 597 (1995) (containing "Sell Your Fine Home" example). Forcing *T* to recognize gain on the sale of the home would block this scheme. It is likely, however, that some, or all, of the gain would be excluded from the tax base. As discussed *supra* at note 111, consumer durable gain generally would be included. Nonetheless, consistent with current law some gain on the sale of a home might be excluded regardless of whether a new home is purchased. See I.R.C. § 121 (2003). Alternatively, such gain might be excluded under a rollover rule to the extent *T* purchases a new home of equal or greater value. See the rollover rule in the proposed USA tax, discussed in Ginsburg, *supra*, at 597.

115. While the principal would be excluded on receipt, taxpayers would lose later deductions on the payment of both principal and interest for exempt debt. The taxpayer would have a net inclusion at such time since the funds used to repay such debt would be included in the base.

116. Also note that the current income tax's special tax treatment of home indebtedness raises tax avoidance possibilities as well. Current deductibility of home interest (subject to limits) allows tax avoidance possibilities when such debt funds the acquisition of capital assets. See Engler, *supra* note 42, at 93-94.

117. See discussion *supra* note 114. Separately, anti-avoidance rules would be needed to block attempts to report consumer durables as investment assets (to obtain a current deduction).

118. Additional concern might arise that *T* could "default" on the tax liability. Even if *T* repays the

The hybrid approach responds to these collection concerns. First, the hybrid approach responds to the general tax avoidance and evasion concerns by maintaining tax collections on saved wages at the wage date. Second, the prohibition against offsetting wages with new savings deductions also protects against the specific concern on exempt debt.¹¹⁹ Thus, residual tax collection concerns under the hybrid approach's adjusted cash flow component would be reduced relative to the cash flow tax. The hybrid approach would tax savings withdrawals for consumption only to the extent such amounts exceeded saved wages plus the risk-free rate of return.¹²⁰ In addition, the concerns under the hybrid approach would be more comparable to current law; i.e., investment gains generate tax liabilities under an income tax base.¹²¹

C. Transition/Revenue Concerns

The primary transition issue under the cash flow tax involves post-shift consumption funded from receipts saved and taxed under the prior income tax (wages, for example).¹²² Including withdrawals of such savings in the tax base, as under the normal cash flow rules, would result in an unfair double tax.¹²³ This potential double tax should be corrected.¹²⁴ Specifically ex-

third-party lender, *T* would need additional resources to pay tax on the funds used to repay the debt. Limiting the amount of exempt debt provides a significant response. (Treating debt under the regular cash flow rules eliminates this concern since no tax liability arises on receipts used to repay such deductible debt.) Also, a broader default concern exists under the realization income tax. As discussed in Subpart II.B, a taxpayer holding offsetting gain and loss investments could selectively sell only the losing investment, with such loss offsetting otherwise taxable consumption. While the sale of the gain investment would trigger a later tax liability, a third party lender could have a prior claim to the sales proceeds. See Knoll, *supra* note 46. Thus, the default possibility exists under the income tax whenever sales proceeds are needed to repay third party debt. In contrast, the potential arises only on exempt debt under the cash flow tax. Also recall how *T* benefited under the income tax even absent the extreme insolvency scenario contemplated here with the interest-free deferral benefit. Separately, *T* might default on the underlying third party debt. While taxing debt forgiveness would preserve the government's tax claim, *T* might lack the resources to pay such tax. See Graetz, *supra* note 92, at 1609. This is also present under the income tax, however, and limiting exempt debt should lessen the issue relative to the income tax.

119. An alternative understanding of the additional protection recognizes that the concern regards tax collections on savings withdrawals. The hybrid approach relies relatively less on collections from savings withdrawals due to its strengthened wage tax (and corresponding basis offset account).

120. Cf. WHAT SHOULD BE TAXED, INCOME OR EXPENDITURE, *supra* note 94, at 316 (discussing the concern that cash flow tax raises greater collection concerns than the income tax since the entire proceeds would be taxable under the cash flow tax). Note that the full proceeds would not be taxable under the cash flow tax to the extent the taxpayer had usable transition deductions.

121. Additional concern might arise under the hybrid approach that taxpayers could avoid the wage tax protection by "converting" wages to investment income (and then offsetting the converted investment income through the phantom savings deductions). This does not favor the income tax over the hybrid approach, however, since a conversion transaction under current law similarly removes the wage tax protection. See discussion *supra* note 42. Thus, the wage tax protection under the hybrid approach is comparable to the current law protection; i.e., both have an extra level of protection vis-à-vis the cash flow tax. Similarly, under the hybrid approach, the incentive to shift wages from a high salary to a low salary year is present under current law. See discussion *supra* note 105.

122. See Engler & Knoll, *supra* note 50, for a more in-depth analysis of how the hybrid approach greatly simplifies the transition to a consumption tax.

123. Assume the cash flow tax replaces the income tax in year 02 and a flat forty percent rate. *T* pays

empting consumption funded from already-taxed savings raises tracing difficulties.¹²⁵ To avoid such administrative problems, taxpayers could be allowed "transition" deductions, usable against all consumption, equal to the aggregate tax basis of savings assets held at transition.¹²⁶ This approach raises revenue concerns, however, since a taxpayer would pay no tax until the exhaustion of all transition and new savings deductions.¹²⁷ The possible solution of issuing explicit government debt in the intervening years¹²⁸ raises political concerns.¹²⁹

\$400 income tax on \$1,000 wages received on 12/31/01. *T* saves the remaining \$600, withdrawing it for consumption on 1/01/02. Since savings withdrawals increase the new base, *T* pays additional tax of \$240 ($\$600 \times 40\%$) in year 02, for total taxes of \$640 on \$1000 wages.

124. There is a general consensus for transition relief from this problem, which is attributable to the government's shift in the timing for inclusion of saved wages. See DANIEL SHAVIRO, WHEN RULES CHANGE, 183-87 (2000); Avishai Shachar, *The Importance of Considering Liabilities in Tax Transitions*, 98 HARV. L. REV. 1842 (1985). For a thoughtful analysis providing the alternate view, see Joseph Bankman, *The Engler-Knoll Consumption Tax Proposal: What Transition Rule Does Fairness (or Politics) Require*, 56 SMU L. REV. 83 (2003). Other transition issues include the continuation of preferences like the current exclusion of state and local bond interest (since the preference might have reduced the pretax interest rate). The merits of transition relief for such preferences, however, are far less certain than the textual double tax issue. See Louis Kaplow, *An Economic Analysis of Legal Transitions* 99 HARV. L. REV. 509, 607 (1986); Shachar, *supra*; Shaviro, *supra* at 181-82. *But see* Graetz, *supra* note 92, at 1649-53; *see also* Engler & Knoll, *supra* note 50, at 69-70 n.85 (noting how the hybrid approach has flexibility to provide special relief on these issues as well, if needed for a political consensus).

125. Specific tracking rules also might encourage taxpayers to fund consumption from assets in which they have a relatively high purchase price.

126. Tax basis on purchased assets equals the purchase price less the tax depreciation, if any. Unusable deductions could be carried forward to subsequent years, possibly with an interest increase. See *infra* note 131 for the appropriateness of an interest adjustment in a comparable context. Allowing transition deductions for all basis arguably is overbroad. For instance, under I.R.C. § 1014 (2003), recipients receive a basis equal to an asset's value at the time of a bequest even though no income taxes have been paid on any appreciation (although some estate tax may have been paid). Distinguishing "taxed" basis from "tax-free" basis raises complexity concerns.

127. See Alliance USA, *Unlimited Savings Allowance (USA) Tax System*, 66 TAX NOTES 1482 (1995) (noting "substantial revenue shortfall during the early years"); *see also* Graetz, *supra* note 92, at 1654 (wealthy could pay no tax indefinitely); George Mundstock, *Comment: What's on Second*, 51 U. MIAMI L. REV., 1079, 1081 (1997) (noting revenue loss if investments currently deductible); *accord* DAVID BRADFORD, CONSUMPTION TAX: SOME FUNDAMENTAL TRANSITION ISSUES, IN FRONTIERS OF TAX REFORM at 142 (Boskin ed. 1996). Additional concern might arise that taxpayers would resolve ambiguities about actual tax basis at the time of transition in their favor (*e.g.*, stock purchased years earlier). See Alliance USA, *supra*. While basis uncertainty is a problem under current law, the suggested cash flow transition approach would allow such overstated basis to offset all income. Compare favorably the hybrid approach.

128. If interest were provided on deferred transition deductions, *see* discussion *supra* note 131, the government's cost is comparable. *E.g.*, WHAT SHOULD BE TAXED: INCOME OR CONSUMPTION, *supra* note 94, at 310 (noting that government could alter its explicit borrowing).

129. See Louis Kaplow, *Recovery of Pre-Enactment Basis under a Consumption Tax: The USA Tax System*, 95 TAX NOTES 171-47 (Aug. 31, 1995) (increasing conventional government debt would not be politically feasible). Compare Daniel Altman, *Accounts Chock-Full or a Plan Half-Empty?*, N.Y. TIMES, Feb. 1, 2003, at C1 (stating that the Bush proposal allows conversions of traditional IRAs to tax-exempt accounts in order to "shift revenue from the future to now"). The wealthy also could avoid all tax for an extended time. See Shounak Sarkar & George R. Zodrow, *Transitional Issues in Moving to a Direct Consumption Tax*, 46 NAT'L TAX J. 359, 363 (1993) (in context of a business consumption tax, noting the problem of certain businesses paying no tax in the early years). A significant increase in explicit government debt also might raise non-tax concerns. Separately, allowing certain taxpayers to avoid all tax payments on all their consumption for an extended period raises the tax collection concerns discussed above.

A prior legislative proposal therefore allowed transition deductions to offset only consumption funded from savings assets.¹³⁰ This approach is theoretically sound since the transition deductions correspond to savings assets.¹³¹ Prior commentary showed, however, that sophisticated taxpayers could avoid such limit merely by deferring the receipt of wages by one year.¹³² In addition, overall revenue concerns might remain given the lack of tax collections on (i) post-transition saved wages (due to new savings deductions) and (ii) much post-transition consumption (due to transition deductions).¹³³

The wage component of the hybrid approach once again responds to these concerns. The hybrid approach more naturally would restrict the use of transition deductions to savings-funded consumption. For instance, transition deductions could be added to the regular basis offset account.¹³⁴ Furthermore, deferring the receipt of salary until the next year would not meaningfully circumvent this desired restriction. Such one-year deferral would

130. USA Tax Act of 1995, S. 722, 104th Cong. (1995) (sponsored by Sens. Nunn, Kerrey, and Domenici). The USA approach had an additional limitation in that transition assets needed to be sold to free up the transition basis. This limitation would not be meaningful in practice. See Ginsburg, *supra* note 114, at 596.

131. Thus, an alternative suggestion raises other concerns. Each year's usable transition deductions could be limited to a fixed percentage of the overall amount; unused amounts could be carried forward with interest. Kaplow, *supra* note 129. The interest addresses concerns that accelerating taxes (by deferring deductions) increases the taxpayer's cost under time value of money principles. Transition basis should be reduced by the taxpayer's liabilities (other than debt exempt from cash flow treatment. For possible exempt debt, see notes 110-13 and accompanying text). Tax still would not be paid, however, on either (i) saved wages, due to unlimited new savings deductions or (ii) significant consumption (due to the partial allowance of the transition deductions). While a low percentage allowance would minimize revenue losses, the likelihood of double taxation increases where significant transition savings are spent in early post-shift years. Taxpayers would benefit from the carry forward of unused transition deductions only if they generated enough subsequent consumption through new wages or extraordinary investment returns on their remaining savings. Compare a similar, but more limited possibility of unusable basis under the hybrid approach at *supra* notes 175-78 and accompanying text. The hybrid approach has several advantages over the other alternative including: (i) full allowance of transition basis against consumption funded from savings, (ii) tax collections on saved wages, and (iii) responsiveness to the other concerns raised under the cash flow tax.

132. Ginsburg, *supra* note 114, at 596. The strategy involves the following: taxpayers arrange to have their salary paid only in alternate odd-numbered years (deferring receipt of the even-year salary until the following odd year); savings assets are used to purchase consumption goods only in even years (but goods are consumed in even and odd years); transition deductions offset the consumption purchased from savings assets in the even years; salary paid in odd years replenishes the withdrawn savings assets; whereby the resulting new savings deductions avoid all tax on the salary. Additional tax-free consumption in the odd years could be achieved by (i) purchasing a consumer durable asset in an even year and (ii) selling it in the odd year, using the proceeds to fund consumption. For the exclusion of consumer durable proceeds when sold for the original purchase price, see *supra* note 111. In sum, taxpayers would avoid tax on (i) the salary (since it was "saved") and (ii) all consumption (since it was funded from "savings").

133. Revenue would not be collected from (i) saved wages or (ii) significant consumption funded from savings (due to transition deductions). The problem is that taxes generally are collected on the "front-end" as wages are paid under current law (even if they are saved). Under the cash flow tax, taxing savings withdrawals on the "back-end" compensates for the revenue loss from savers on the front-end. Revenue is not collected from either group, however, if the shift to the back-end cash flow tax contains appropriate transition relief for asset holders, the future dissaving population. This revenue loss is most pronounced in the early years of the interim transition period since tax collections from dissavers (once transition deductions are used up) eventually will offset the revenue loss from savers.

134. Recall that the basis offset account is usable only against non-wage consumption.

merely defer the tax payment until the following year, in favorable contrast to the long-term deferral concern expressed under the cash flow tax.¹³⁵ The hybrid approach also generates revenue on saved wages.¹³⁶ The stronger wage tax base facilitates appropriate transition relief (i.e., free deductibility of all transition basis against consumption funded from savings).¹³⁷

135. A comparable strategy under the hybrid approach would require a more difficult, prolonged deferral of salary. Under such prolonged deferral strategy, the taxpayer would fund consumption from savings withdrawals, using transition deductions to avoid tax. Interest on the deferred salary would provide an investment return. This indefinite salary deferral, however, is less likely to be acceptable to taxpayers from a non-tax perspective than the one-year deferral strategy under the cash flow tax. First, taxpayers would have to bear their employer's credit risk for an extended period of time. (Under current law, taxpayers generally can avoid current tax on deferred salary only if the employer's promise to pay is unfunded and unsecured.) Second, converting their assets to deferred rights against their employer might limit their investment opportunities on such long-term "savings assets." In contrast, the one-year deferral strategy under the cash flow tax requires a deferral of one year or less (until January 1 of the next year). In any event, if thought problematic, a rule could limit the deferral of "earned but unpaid" wages (even if an unfunded, unsecured promise to pay). See discussion *supra* note 105 (regarding potential accrual system on wages). A similar rule for the one-year deferral year problem under the cash flow tax would need a precise allocation of salary to the correct year in order to be effective. In contrast, such precision is not necessary under the hybrid approach (where the concern is to prevent unlimited deferral). (Precise income allocation, however, might be desirable for reasons of rate progressivity. See discussion *supra* note 105.)

136. This responds to the overall revenue loss concern under the cash flow tax during transition (due to the lack of collections from savers and some consumers). See discussion *supra* note 133 and accompanying text.

A separate revenue point concerns the corporate tax. The corporate-level tax arguably lacks theoretic justification once shareholders are taxed on consumption under the cash flow tax or the hybrid approach. See Graetz, *supra* note 92, at 1634-42 (raising this point in the context of the cash flow tax). Shifting to a consumption tax at the individual level therefore might raise revenue concerns if such move required the elimination of the corporate tax. In response, however, similar theoretic objections have been raised regarding the corporate tax under the current "income" tax structure. See, e.g., *Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992). A possible argument that the corporate tax substitutes for the failure to tax shareholders currently on their share of corporate income fails to withstand close scrutiny. The current corporate and income tax regime has a weak correlation to a current tax on each shareholder (on their share of corporate income). In addition to the different rates faced by different shareholders, consider, for instance, a corporation that pays out most of its earnings as dividends. This presents the classic double taxation scenario as the corporate-level tax is imposed on top of a current shareholder tax on the dividends.) Thus, corporate tax revenues do not favor the retention of the income tax over a consumption tax. That is, a theoretically questionable corporate tax could be maintained in conjunction with either an individual-level income or consumption tax.

137. Compare the criticism of the USA bill's compromise due to revenue concerns. See Kaplow, *supra* note 129; Alvin C. Warren, Jr., *The Proposal for an "Unlimited Savings Allowance."* 68 TAX NOTES 1103 (1995). Recall also the concern that taxpayers might overstate allowable deductions. Concern is reduced when the deductions cannot shelter new wages.

Denying transition relief might impose an efficient one-time tax on existing savings. The transition double tax arguably is efficient since taxpayers holding previously taxed savings at transition generally cannot change their behavior to avoid such excess tax (taxpayers with knowledge of an impending consumption tax could avoid the tax, but only by using their savings to consume before the effective date). In fact, it has been argued that this potential double tax provides most of the efficiency gains from a shift to a consumption tax. See ALAN AUERBACH, *Tax Reform, Capital Allocation, Efficiency, and Growth*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 31 (Henry J. Aaron & William G. Gale eds., 1996).

Notwithstanding the loss of an efficient one-time wealth tax, many proponents of a consumption tax favor transition relief for existing basis. E.g., FUNDAMENTAL TRANSITION ISSUES, *supra* note 127, at 144-47; see also Sarkar & Zodrow, *supra* note 129, at 363 (while efficiency suggests revenue benefits to denying transition relief, lack of transition relief has cost of offsetting expectations regarding future tax policy); see *supra* note 124.

D. Risky Returns

This Subpart contrasts the treatment of risky returns under the hybrid approach and the cash flow tax. As discussed above, the consumption tax receives significant support from its implicit exemption of investment return. Therefore, this risky return analysis also compares the hybrid approach to a stand-alone wage tax, under which earned wages face current tax with an explicit exemption for all investment return. Subpart IV.D.1 analyzes the progressivity impact on risky returns. As shown therein, the hybrid approach imposes a desirable moderate progressivity burden on risky returns, whereas the cash flow and wage taxes take polar positions. Subpart IV.D.2 then considers several other potential risky return burdens that are independent of progressive rates.

1. Progressive Rate Issues

Subpart IV.A analyzed the cash flow tax's progressivity burden on saved wages and the risk-free return.¹³⁸ A progressive cash flow tax similarly could burden risky returns. This is especially possible since the cash flow base includes the original investment amount, the risk-free return, and the risky premium when savings are withdrawn for consumption.¹³⁹ At the other end of the spectrum, the wage tax's direct exemption of all investment return fails to impose any progressivity burden on risky returns, even where the risky returns materially enhance a taxpayer's lifestyle. The hybrid approach moderates by imposing a progressivity burden on risky premiums, but not on the other components. The following examples illustrate these principles.

Example 7 assumes a flat tax rate to focus on the underlying structures of the three different taxes regarding risky returns. Example 8 then applies progressive rates to a risky return scenario.

Example 7: T receives a \$100,000 cash salary on 12/31/01. T invests all (after-tax) wages in a risky stock that doubles in value as of 12/31/02. T consumes all (after-tax) proceeds on 12/31/02. The tax rate is a flat fifty percent.

Consider first the wage tax. *T* owes \$50,000 tax in year 01 on the wages.¹⁴⁰ *T* invests the remaining \$50,000 of (after-tax) wages in the stock.

138. This might arise because (i) the cash flow tax has extra tax base inclusions equal to the risk-free return on saved wages or (ii) saved wages can be consumed (including through wealth transfers) in relatively heavier consumption years. The saved wage amount is included earlier under the hybrid approach than the cash flow approach. This potential also could work in the other direction *supra* if wages are earned in a high wage-earning year and are consumed in a lower year. See discussion *supra* notes 96-101 and accompanying text.

139. Risky returns generally should increase the likelihood of the progressivity burden given the inclusion of extra amounts in the tax base. See Warren, *supra* note 94, at 945 n.53.

140. $0.5 \times \$100,000$.

The stock is sold one year later for \$100,000. No further tax is owed given the direct exemption of all investment return. *T*'s after-tax consumption is \$100,000.

Consider, next, the results under the cash flow tax. *T* owes no tax in year 01 since *T* saves everything (i.e., he consumes nothing). *T* invests the \$100,000 of wages in the stock, selling the investment for \$200,000 at the end of year 02.¹⁴¹ The \$200,000 proceeds are fully taxable since they will be consumed (not reinvested). *T* pays \$100,000 tax, leaving \$100,000 for consumption.¹⁴² The equal results under the wage and consumption tax illustrate the cash flow tax's implicit exemption of investment return in certain circumstances.¹⁴³

Finally, compare the hybrid approach. *T* owes \$50,000 tax on the wages in year 01 even though he is saving. If *T* limited his stock investment to the remaining \$50,000 of after-tax wages, *T* would have significantly less proceeds available for consumption than the \$100,000 under the cash flow and wage taxes. This would occur since (i) the stock investment would be sold for \$100,000, while (ii) the stock return in excess of the ten percent risk-free rate (i.e., \$45,000 of the \$50,000 gain) would be taxed under the adjusted cash flow component of the hybrid approach.¹⁴⁴

A conceptual understanding of the cash flow tax's implicit risky return exemption highlights, however, that such significant decrease can be avoided under the hybrid approach.¹⁴⁵ In contrast to the wage tax, the fifty percent cash flow tax required *T* to share half the stock gain with the government. *T* negated this formal tax collection, however, by doubling the risky stock investment from \$50,000 (under the wage tax) to \$100,000 under the cash flow tax. While the consumption tax reduced *T*'s after-tax profit share to fifty percent of the pretax gain (100% - 50% tax rate), doubling the investment generated twice as much pretax gain.¹⁴⁶ *T* similarly can

141. This assumes that *T*'s investment of \$100,000, rather than \$50,000, does not affect the pricing of the investment. The increased demand for risky assets relative to the wage tax, however, arguably would increase the purchase price of risky assets. The extent of such pricing change is uncertain, however, since investors not subject to the U.S. taxing regime (for example, foreigners, tax exempts) would not adjust their portfolios in response to the U.S. tax. Terrence R. Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 WAKE FOREST L. REV. (forthcoming 2003). In addition, some U.S. taxpayers will not increase their risky investments (relative to the wage tax). See discussion *infra* note 147.

142. Tax = \$200,000 x 0.5 = \$100,000. Consumption = \$200,000 - \$100,000 tax.

143. Equal results will not always occur. The most significant difference occurs under progressive rates. See discussion *infra* concerning Example 8; see also discussion *infra* note 147, for other reasons why the implicit exemption might fail.

144. The risk-free return on the \$50,000 investment would be only \$5000 (\$50,000 x 10%). Technically, the \$100,000 stock proceeds would be included in the base; the deductible basis offset account would be only \$55,000 (\$50,000 x 1.1).

145. This insight follows from the recent literature explaining why the income tax's excess theoretic burden, relative to the cash flow consumption tax, generally is imposed only on the risk-free rate of return. See Bankman & Griffith, *supra* note 58; Cunningham, *supra* note 38; Warren, *supra* note 54; see also discussion *supra* concerning Example 5. The hybrid approach analysis differs from the income tax analysis, however, in that the hybrid approach provides an exemption for the risk-free rate of return (through the interest adjustment to the basis offset account). As discussed above, this exemption makes the hybrid approach a consumption tax equivalent.

146. While a fifty percent tax rate was used for ease of exposition, the analysis remains true for other

negate the tax collection under the fifty percent hybrid tax by doubling his stock investment to \$100,000.¹⁴⁷

While *T* has only \$50,000 of after-tax wages under the hybrid approach, *T* nonetheless can increase his risky investment to \$100,000 by borrowing or using other assets. In the first instance, assume *T* makes this portfolio adjustment by borrowing \$50,000 at the ten percent risk-free rate. (Subpart IV.D.2 below discusses the possibility that *T*'s borrowing rate would exceed the risk-free rate.) Like the cash flow tax, *T* sells the stock for \$200,000. *T* owes the lender \$55,000, including the \$5,000 interest. *T* owes the government \$45,000 under the adjusted cash flow component of the hybrid tax: the fifty percent tax rate multiplied by the excess of (i) the \$200,000 stock proceeds over (ii) total deductions of \$110,000 (\$55,000 debt repayment plus the \$55,000 basis offset account).¹⁴⁸ This leaves *T* with the same \$100,000 of after-tax consumption as under the wage and cash flow taxes.¹⁴⁹

The following example reintroduces progressive rates into the analysis. This example demonstrates how the three taxes can reach very different results under a progressive rate system.

Example 8: *T* receives a \$100,000 salary on each of 12/31/01 and 12/31/02. *T* invests all after-tax wages from 01 for one year in a very risky stock that quadruples in value as of one year later. The tax rate is fifty percent for amounts up to, and including, \$100,000; additional amounts are taxed at a sixty percent rate. *T* consumes all available funds on 12/31/02.

Under the stand-alone wage tax, *T* pays \$50,000 tax in year 01 on the \$100,000 of wages, leaving \$50,000 for investment in the risky stock. *T*

tax rates. More generally, in order to achieve the wage tax results, *T* should increase his risky stock investment under the cash flow tax by a multiplier equal to $1/(1 - \text{tax rate})$. *E.g.*, a fifty percent tax rate requires doubling the investment amount since $1/(1 - .5) = 2.0$.

147. Some taxpayers might fail to increase their portfolios in response to the tax, perhaps failing to understand the ramifications of the government's co-investment. Such taxpayers do not necessarily face an excess tax burden under the consumption taxes relative to the wage tax, however. For the same amount of investment, the taxpayer has a lower risk of loss since investment losses on risky assets reduce the tax payments under the consumption taxes, but not the wage tax. In effect, the government provides implicit insurance against the risk of loss. A similar point can be made about the income tax. See Chorvat, *supra* note 141; see also, Fried, *supra* note 60, at 988-89. This assumes that the loss is usable under the hybrid approach, the cash flow tax, and the income tax. The cash flow tax provides the greatest assurance in this regard since any loss will reduce the proceeds available for consumption, thereby reducing the tax bill. Compare the discussion of how the taxpayer might have unusable tax losses under the hybrid and/or income taxes at notes 172-79 and 205. In this sense, the cash flow tax has a comparative advantage since it allows for greater portfolio adjustments. On the other hand, greater portfolio adjustments might increase the purchase price of risky assets, imposing an implicit tax. See discussion *supra* note 141. Furthermore, even a partial ability to use losses reduces the risk on risky investments.

148. Debt repayments generally are deductible under the cash flow component. See discussion *supra* note 10. The basis offset account equals the \$50,000 saved wages plus the ten percent risk-free return thereon for one year. $\$50,000 \times 1.1 = \$55,000$. Tax = $0.5 \times [\$200,000 - (\$55,000 + \$55,000)] = 0.5 \times \$90,000 = \$45,000$.

149. $\$200,000$ stock proceeds - $(\$55,000$ debt repayment + $\$45,000$ taxes) = $\$100,000$.

owes no tax when the stock is sold for \$200,000 (\$50,000 x 4). *T* pays \$50,000 tax on the year 02 wages, generating additional after-tax funds of \$50,000. *T* therefore has \$250,000 available for consumption in year 02.

Under the cash flow tax, *T* purchases \$100,000 of stock on 12/31/01 since no tax was owed at that time. *T* has \$500,000 of pretax funds on 12/31/02: (i) \$100,000 of new wages plus (ii) \$400,000 (\$100,000 x 4) of stock sale proceeds. *T* owes \$290,000 tax under the progressive rate structure,¹⁵⁰ leaving only \$210,000 for consumption.

Under the hybrid approach, *T* owes \$50,000 tax in year 01 on the wages. Similar to Example 7, *T* should increase his risky investment to \$100,000. Therefore, assume again that *T* borrows \$50,000 at the ten percent risk-free rate. At the end of year 02, *T* has pretax funds of \$445,000: the same \$500,000 calculated under the cash flow tax less the \$55,000 debt repayment. *T* owes tax of \$224,000 of tax under the progressive rate structure, leaving \$221,000 for consumption.¹⁵¹

To summarize the results, the wage tax left *T* with the most consumption (\$250,000). There was no progressivity burden since the wage tax excluded the entire investment return from its base. In sharp contrast, the cash flow tax left *T* with the least consumption (\$210,000). The higher progressive rate applied to the risky return, the saved wages, and the risk-free return.¹⁵² The hybrid approach left *T* with a moderate consumption amount (\$221,000); only the risky return was subject to the progressive rate.¹⁵³

As discussed above, the consumption tax derives significant support from its perceived investment return exemption. The wage tax therefore might appear to have greater (consumption tax) consensus potential than either the cash flow or hybrid approaches. The wage tax, however, goes too far in its direct exemption of all investment return. Even those favoring a consumption tax in its own right, and not as a replacement for the flawed income tax, often do not rely solely on the implicit savings exemption. Separately, by ultimately collecting tax on all resources when consumed, a consumption tax arguably satisfies an "ability to pay" criteria.¹⁵⁴ A related articulation focuses on the correlation between tax collections and the actual standard of living under a consumption tax. By ignoring all actual investment return, a wage tax can deviate significantly from these desires. Pro-

150. $(0.5 \times \$100,000) + (0.6 \times \$400,000)$.

151. Tax base = \$390,000. { \$100,000 wages + [\$400,000 - (\$55,000 basis offset account + \$55,000 debt repayment)] }. Tax = $(.5 \times \$100,000) + (.6 \times \$290,000) = \$224,000$.

152. The higher rate, by 10% (60% - 50%), applied to the \$100,000 saved wages plus the entire \$300,000 gain. $10\% \times \$400,000 = \$40,000$ progressive burden. (There was additional consumption of \$40,000 under the wage tax relative to the cash flow tax: \$250,000 - \$210,000.)

153. The higher rate, by ten percent, applied only to the stock gain in excess of the risk-free rate (\$10,000 of the \$300,000 stock gain correlates to the risk-free rate; \$290,000 was the risky premium). $\$290,000 \times 10\% = \$29,000$. (There was additional consumption of \$29,000 under the wage tax relative to the cash flow tax: \$250,000 - \$221,000.)

154. Ability to pay has been criticized for its theoretical imprecision; *i.e.*, ability to pay is not self-defining. See, *e.g.*, Daniel N. Shaviro, *Commentary: Inequality, Wealth, and Endowment*, 53 TAX L. REV. 397, 399 (2000). Nonetheless, ability to pay continues to frame the debate and seems to require, at a minimum, that tax be collected on available resources at some particular time.

gressive rates enhance the objection. As demonstrated by Example 8, consumption of extraordinary investment returns on modest wages would avoid all progressivity (consider also a lottery winner).¹⁵⁵ Thus, even some favoring a consumption tax in theory desire progressivity on risky returns.¹⁵⁶

A wage tax would have an even more difficult time satisfying those supporting the consumption tax only as a replacement for the flawed income tax. Shifting the tax collection timing from realization to consumption is a relatively minor change for an income tax advocate, one more easily accepted in order to avoid the realization problems. In contrast, shifting to a system which completely ignores actual investment outcomes is a much more dramatic change.¹⁵⁷

At the other end of the spectrum, the cash flow tax imposed a progressivity burden not only on the risky premium, but also the saved wages and the risk-free return. However, deferring consumption of saved wages from a light consumption year to a heavy consumption year does not increase one's overall standard of living. A similar argument can be made to the extent the taxpayer's investment return is limited to the normal risk-free rate of return.¹⁵⁸ Thus, the cash flow tax imposed an excessive progressivity burden even taking into account the standard of living desire. In favorable contrast, the hybrid approach moderately imposed a progressivity burden only on the risky premium. The hybrid approach's consensus promise is evidenced by its simultaneous (i) imposition of a progressivity burden when risky returns materially enhance the living standard, in favorable contrast to the wage tax,¹⁵⁹ and (ii) avoidance of the cash flow tax's undesirable progressivity burden on the deferred consumption of saved wages and risk-free returns.¹⁶⁰

155. A consumption tax would collect significant tax where lottery winnings funded heavy consumption. In contrast, the wage tax would collect tax only on the lighter wages.

156. See, e.g., Rakowski, *supra* note 60, at 354 (discussing support for progressivity on "risky investment income"); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 954-55 (1975).

157. See, e.g., Graetz, *supra* note 92, at 1600-01. The consumption tax's potential implicit exemption of investment return might suggest the difference is merely in appearance. As shown herein, however, such implicit exemption can fail under a progressive rate structure. The after-tax results under a wage and consumption tax also might differ for reasons distinct from progressive rates. In particular, the consumption taxes do not implicitly exempt inframarginal returns. Taxpayers cannot undo the explicit tax collection by increasing inframarginal investments since they are limited by above-market opportunities (after adjustment for risk). As a related practical matter, the difficulty in distinguishing inframarginal opportunities from earned income highlights a more general classification problem under the wage tax. Any labor income not properly classified as such under the wage tax avoids all tax, placing tremendous pressure on separating the labor and capital components. Consider receipts from technological inventions like Microsoft DOS, mineral deposits such as a successful oil venture, increased rental value of land, or a successful advertising campaign. BRADFORD, *supra* note 127, at 130; Bradford, *supra* note 99, at 387; Weisbach, *supra* note 89, at 608 (noting problem, especially on patents); see also discussion *supra* note 147 (failure of taxpayers to adjust their portfolios); discussion *supra* note 141 (potential pricing changes).

158. One might question drawing the line at precisely the risk-free rate of return, rather than the risk-free rate plus a small percentage. Nonetheless, it provides a rough rule of thumb to separate out those returns that materially alter one's standard of living. See Rakowski, *supra* note 60, at 354.

159. While this was a truncated two-year example, the point applies as well when a longer-term extraordinary return materially increases the living standard over an extended period.

160. Thus, not only does the hybrid approach collect tax on the significant investment return, the

Finally, the hybrid approach has further responsiveness to any residual concerns of potential excess progressivity. As demonstrated above, risky returns can bear a progressivity burden under both the cash flow and hybrid approaches. Therefore, a bunching problem could arise under the hybrid approach as well as the cash flow tax if heavy risky returns were disproportionately consumed in a single year.

Such concerns should be less pronounced under the hybrid approach than the cash flow tax for several reasons. First, as evidenced by Example 8, the hybrid approach reduces the bunching problem through its exclusion of the original investment amount and the risk-free return. In addition, the hybrid approach's flexibility provides a second source of protection. Taxpayers could be provided an election to decline the use of available basis offset account balances in any year. Such unused amounts would carry forward indefinitely, with interest, as per the usual rules. This election would allow taxpayers to save their basis offset accounts for unusually heavy consumption year(s) funded by risky returns; in return, they would voluntarily pay taxes in lower-rate years on consumption funded from savings.¹⁶¹ Finally, consideration could be given to a relatively short-term averaging provision applicable in the year of death, looking back three to four years. As discussed above, a short-term averaging provision by itself inadequately responds to the deeper bunching problem under the cash flow tax.¹⁶² Nonetheless, a relatively modest averaging provision might work well in conjunction with the hybrid approach's other, self-contained, protections.¹⁶³

2. Non-Progressive Burdens under the Hybrid Approach

The hybrid approach might impose an excess burden on risky returns relative to the cash flow tax for two reasons. The first relates to the assumption above that *T* could increase his risky investments by borrowing at the

burden also cannot be eliminated through portfolio adjustments when the standard of living increases (similar to the cash flow tax). Such inclusion (with potential progressivity on actual consumption levels) placates ability-to-pay objections to the wage tax (which fails to collect any tax at all on significant investment returns). This recognizes the desire to have actual standards of living impact the progressivity burden. On the other hand, the hybrid approach's exclusion of saved wages plus the risk-free return helps to protect against undesirable progressivity burdens attributable to unequal spending from year to year.

161. This would provide taxpayers a structured way to obtain averaging. See discussion *supra* notes 92-94 and accompanying text (for the difficulties of averaging provisions). If such election were not provided, sophisticated taxpayers might attempt to achieve a de facto election by manipulating the character of their income (*i.e.*, converting investment return to wages would allow them to carry forward the exclusionary amount). Any risk that the additional carry forward could not be utilized in the future would be knowingly borne by the taxpayer. See also *supra* notes 175-76 and accompanying text (for a more general discussion regarding the possibility of an unused basis offset account).

162. Recall the potential excess burden on wages saved numerous years ago. See discussion *supra* notes 86-95 and accompanying text. As discussed therein, a more responsive long-term averaging provision is more contentious as it raises deeper administrative and over breadth concerns.

163. Successful resolution of the contentious averaging issue is a lesser requirement for the hybrid approach than the cash flow tax, given the hybrid approach's self-contained responses to the bunching problem. See discussion *supra* note 95.

risk-free rate. Assuming initially a flat-rate structure, an excess burden would be imposed on *T* under the hybrid approach where *T*'s portfolio adjustment required borrowing at a rate above the risk-free rate. This results conceptually since *T* receives compensation on the corresponding basis offset account at only the risk-free rate.¹⁶⁴ No such burden arises under the cash flow tax since *T* can make the necessary portfolio adjustment by investing the full pretax wages.

The following factors, however, should minimize this excess tax concern under the hybrid approach.¹⁶⁵ First, the risk-free rate provides the precise adjustment to the extent the taxpayer would have purchased some risk-free assets under the cash flow (or wage) tax. In such cases, taxpayers need not borrow to increase their risky investments under the hybrid approach. Instead, taxpayers can use the cash that would have funded risk-free assets under the cash flow tax.¹⁶⁶ Second, taxpayers might be able to offset the explicit tax collection by purchasing riskier assets, rather than purchasing an increased amount of the same risky investment.¹⁶⁷ Borrowing would not be necessary for such strategy. Third, explicit individualized borrowing for investment provides collateral that should reduce the actual borrowing rate.¹⁶⁸ Separately, the basis offset account can be conceptualized as a loan

164. That is, compared to the cash flow tax, *T* pays tax earlier but receives interest at the risk-free rate. If the earlier tax collection forces *T* to borrow under the hybrid approach (to match the risky investment amount under the cash flow tax), the two systems will deviate unless *T*'s borrowing rate on his loan matches the interest paid on the offsetting basis offset account balance. Recall Example 7 that assumed a flat fifty percent tax rate. *T*'s \$100,000 consumption under the cash flow tax matched the wage tax results (with its direct exemption of investment return). This resulted since *T* invested the full \$100,000 of pretax wages in the risky stock. The hybrid approach matches the cash flow tax assuming *T* can borrow at the ten percent risk-free rate (as per Example 7). If *T*'s borrowing rate exceeded ten percent, however, *T* would have less than \$100,000 consumption since *T*'s after-tax interest expense would increase. For instance, if *T* borrowed at a twenty percent rate, *T* would have only \$97,500 consumption. *T* would owe (i) \$60,000 to the lender (\$50,000 x 1.2) and (ii) \$42,500 to the government {50% x [\$200,000 stock proceeds - (\$60,000 to lender + \$55,000 basis offset account)]}. \$200,000 stock proceeds - (\$60,000 + \$42,500) = \$97,500.

165. See also Engler & Knoll, *supra* note 50, at 72-73 n.93 for the suggestion that the cash flow tax, rather than the hybrid approach, has the more significant interest rate imprecision. In particular, a consumption tax can be viewed as an implicit accrual tax on all wealth with an implicit exemption for the risk-free return. Under this conceptualization, the cash flow tax improperly allows taxpayers to borrow, implicitly, at the understated risk-free rate in a greater number of circumstances. Relative to the cash flow tax, the hybrid approach appropriately denies the below-market loan to taxpayers on saved wages.

166. Consider again Example 7, but now assume under the wage tax that *T* would invest only \$25,000 in the risky stock. The remaining \$25,000 after-tax wages would have been invested in risk-free treasury notes. Under the hybrid and cash flow taxes, *T* needs to increase his risky investments to \$50,000 (doubling the \$25,000 risky investment he would have made under the wage tax). *T* no longer would need to borrow under the hybrid approach to make the portfolio investment. Instead, he could invest the full \$50,000 of after-tax wages in the stock (effectively reducing his risk-free investments to zero). Also see the comparable analysis of the income tax at Example 5.

167. See, e.g., Cunningham, *supra* note 38, at 44 (taxpayers can adjust portfolio in many ways, including changing proportion of risky assets, borrowing, or simply finding riskier investments); see also Chorvat, *supra* note 141. In addition, publicly traded options might provide some implicit borrowing opportunities at approximately the risk-free rate. See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 605-09 (5th ed. 1996).

168. See Engler, *supra* note 27, at 195. But see Cunningham, *supra* note 38, at 37 n.72 (stating that margin loans to wealthy bear interest at rates ranging from .75% to 4% above the federal funds rate).

from the taxpayer to the government.¹⁶⁹ Such conceptualization arguably supports use of the government's borrowing rate, the risk-free rate, even if the taxpayer incurs higher borrowing costs in making its investments.¹⁷⁰ Finally, the interest adjustment to the basis offset account could be increased to the risk-free rate plus a small percentage (in the range of one to three percent).¹⁷¹

As evidenced by the following example, the hybrid approach also could impose an excess burden relative to the cash flow tax due to losses.

Example 9: *T* earns a \$100,000 salary on 12/31/01. *T* invests all (after-tax) wages in a risky stock, which loses twenty percent of its value over the one-year investment period. *T* consumes all available proceeds on 12/31/02. The tax rate is a flat fifty percent.

Under the cash flow tax, *T* invests \$100,000 in the stock, selling one year later for \$80,000. The \$80,000 proceeds are taxable, leaving \$40,000 of consumption.¹⁷² Contrast the hybrid approach. First, recall that *T* increased the original stock investment to \$100,000 by borrowing \$50,000 (at the ten percent risk-free rate) since *T*'s after tax wages were only \$50,000 under the hybrid approach. *T* would not owe any additional tax on the stock sale for \$80,000; both the \$55,000 debt repayment and the \$55,000 basis offset account are deductible against the stock proceeds.¹⁷³ After using \$55,000 of the stock proceeds to repay the lender, *T* has only \$25,000 cash available for consumption, \$15,000 less than under the cash flow tax.

169. Recall the notion of the hybrid approach as an advance collection system vis-à-vis the cash flow tax. As such, tax is paid in advance under the hybrid approach with the interest adjustment on the basis-offset account compensating for the advance payment.

170. See Michael Knoll, *A Primer on Prejudgment Interest*, 75 TEX. L. REV. 293, 308-11 (1996) (theorizing that even though the lending arrangement is involuntary, prejudgment interest in litigation context should be assessed at the borrowing rate of the defendant—the implicit borrower). Some issues arise in using the government's risk-free rate in the hybrid approach context since (i) a portion of the basis recovery account might expire unused (see *infra* notes 175-76 and accompanying text), (ii) the basis might not be used for many years, (iii) tax law changes might deprive taxpayers recovery of the basis offset account, and (iv) tax rates might change. The following responses minimize these imperfections. The hybrid approach minimizes the first issue by netting all of the taxpayer's investments, plus unusable amounts could be reimbursed. See *infra* notes 175-79 and accompanying text. Further minimization occurs if a wealth transfer tax is integrated into the hybrid approach, since the basis offset account could be used at death to reduce the wealth transfer base. See discussion *supra* note 88 and accompanying text. A blended risk-free rate (equally weighting short-term, mid-term, and long-term risk-free rates) would address the second concern. Fair transition allowance for existing tax basis in the move to a consumption tax responds to the third issue by providing greater comfort in relying on tax benefits going forward. See Sarkar & Zodrow, *supra* note 129, at 363 (lack of transition relief has cost of offsetting expectations regarding future tax policy).

171. Only a slight bump should be considered given the arguments above favoring the risk-free rate. Compare the provision of interest to taxpayers on refunds at the government's short-term risk-free rate plus three percent. I.R.C. § 6621(a)(1) (2003). Utilizing individualized borrowing rates raises administrative issues (for example, determining which debt was incurred in response to the hybrid approach's tax on saved wages).

172. This is the same result as under the wage tax. Under the wage tax, *T* invests only \$50,000 in the stock. The twenty percent decline leaves \$40,000.

173. Both calculations are \$50,000 x 1.1.

However, *T*'s remaining basis-offset account of \$30,000 should minimize concerns over this shortfall.¹⁷⁴ The remaining account balance allows *T* to avoid \$15,000 of tax on \$30,000 of other consumption. Even if *T* does not have other current consumption funded from savings, the unused basis offset account carries forward. The interest adjustment protects against time value of money dilution.¹⁷⁵ Thus, the loss scenario primarily is problematic only where *T*'s portfolio over time provides an overall rate of return less than the risk-free rate.¹⁷⁶ If so, *T*'s savings available for consumption would be less than the basis offset account carry forward, thereby negating the account's full value.¹⁷⁷ The historic tendency of risky portfolios to provide returns in excess of the risk-free rate (over sufficient time frames), however, should reduce this concern.¹⁷⁸ Finally, compensating taxpayers for unusable basis offset account balances could provide additional comfort.¹⁷⁹

In sum, the hybrid approach could impose an excess burden relative to the cash flow tax for two reasons under a flat rate structure. As discussed above, however, a variety of factors should minimize such concerns. In addition, Subpart IV.F summarizes how the advantages of the hybrid approach relative to the cash flow tax outweigh these concerns.¹⁸⁰

174. The tax base is calculated as the excess of (i) the \$80,000 stock proceeds less (ii) the sum of (iii) the \$55,000 debt repayment plus the \$55,000 basis offset account. The deductions therefore exceed the inclusion by \$30,000, creating a deduction carry forward of \$30,000. Alternatively, the \$55,000 debt repayment reduces the taxable stock proceeds to \$25,000 (\$80,000 - \$55,000). Only \$25,000 of the \$55,000 basis offset account is needed to offset that remaining amount, thereby leaving an unused basis offset account of \$30,000.

175. See *supra* note 28 and accompanying text (discussing the principle of the time value of money).

176. But see discussion *supra* notes 164-71 and accompanying text (regarding possible understatement of the interest adjustment where the taxpayer incurs borrowing costs).

177. The basis-offset account only has value to the extent it can be deducted against savings withdrawals for consumption. Taxpayers also could receive less than full value if the basis offset account were utilized in a tax year where the rate was lower than the rate imposed on the saved wages in the wage year. Providing an election to taxpayers to defer use of their basis offset account would help to minimize such concerns. See discussion *supra* note 161 and accompanying text.

178. Risk-free assets by definition provide a return equal to the risk-free rate. Risky assets have an expected return in excess of the risk-free rate due to the premium for bearing risk. BREALEY & MYERS, *supra* note 167, at ch. 8. Thus, this possibility of unused basis should be a lesser concern under the hybrid approach than a similar concern under a suggested cash flow transition approach that would block the use of transition deductions against savings withdrawals. In that context, unusable basis could arise even where the taxpayer earned a portfolio return equal to, or greater than, the risk-free rate. See discussion *supra* note 131.

179. For instance, the government could compensate the estates of taxpayers who die with unused basis offset accounts. Waiting until death has some appeal since death conclusively establishes how much, if any, of the basis offset account turns out to be unusable. While an earlier payment also has appeal (to get cash directly into the taxpayer's hands), it raises an administrative issue as to when taxpayers should be allowed to convert their basis offset accounts to cash. Another complexity concerns the amount of compensation to be provided for unused basis offset account balances. The theoretically correct response arguably would look to the tax rate that applied to the original saved wage amount. Administrative concerns counsel in favor of a standard rate structure. Again, taxpayers would be compensated for the time value of money through the interest adjustment to the basis offset account.

180. In addition, as discussed *supra* in notes 110-14, the likely "tax prepaid" treatment of certain consumer debt would allow some limited tax minimization strategies under the cash flow tax. Thus, taxpayer burdens under the cash flow tax also could vary in accordance with individualized borrowing rates. See also discussion *infra* notes 204-05 and accompanying text (regarding how the income tax has similar excess tax possibilities).

E. Complexity Issues

This Subpart compares the complexity of the different taxes. The hybrid approach's dual application (to both wages and saving withdrawals) initially might appear significantly more complex than the single-application cash flow tax.¹⁸¹ For instance, the basis offset account, with the interest adjustment, coordinates the hybrid approach's two components. A similar mechanism would be needed under the cash flow tax, however, to address savings held at transition, albeit for a more limited purpose.¹⁸² Furthermore, tax collection on savings withdrawals has relatively greater significance under the cash flow tax, necessitating additional enforcement efforts.¹⁸³ The cash flow tax also would generate additional complexity to the extent it adopted extensive averaging provisions.¹⁸⁴

Consider also the areas of reduced complexity under the hybrid approach relative to the current income tax.¹⁸⁵ Under current law, saved wages generally are taxed on receipt even if saved. Since investment income is calculated separately for each asset, taxpayers must track their basis in each asset. In contrast, the hybrid approach would have a single basis account for all investments.¹⁸⁶ The tax return itself would serve a valuable record-keeping function by tracking all unrecovered basis for all investment assets in a single aggregated account.¹⁸⁷ As a related point, partial asset disposi-

181. A stand-alone wage tax is relatively attractive on administrative grounds. As discussed *supra* in note 157 and accompanying text, however, the wage tax is unacceptable for other reasons. In addition, the wage tax would require additional policing efforts on wage characterization given the greater pressure on the wage/investment distinction.

182. See discussion *supra* Part IV.C. While the provision would have a more limited scope, complexities related to the determination of the interest rate adjustment would be comparable.

183. See discussion *supra* notes 119-21 and accompanying text.

184. See discussion *supra* notes 92-94 and accompanying text.

185. The hybrid approach might add complexity for taxpayers who save small amounts solely through simple savings arrangements, such as interest-bearing bank accounts. It is these taxpayers, however, who currently face relatively greater burdens on their investment income since such interest income does not receive either the deferral or preferential rate benefits. Most of the simplifications relative to current law stem from the cash flow treatment of investments. See, e.g., Andrews, *supra* note 70, at 1152-53; Graetz, *supra* note 92, at 1610.

186. As discussed below, separate basis record keeping might be necessary for consumer durables/homes. This does not distinguish the cash flow tax from the hybrid approach. As discussed at notes 111-12 and accompanying text, the treatment of consumer durables should be similar under the two forms of consumption taxation.

More generally, the need for separate basis calculations might appear prominent if wealth transfers were not treated as consumption. If that were the case, the transferor's basis offset account might appear artificially high absent a reduction equal to the specific basis of the transferred property. As discussed *supra* in notes 86-90, independent reasons support the inclusion of wealth transfers as consumption to the transferor. Even if wealth transfers were not treated as consumption, the need for widespread specific basis record keeping could be avoided by providing that a transferor's basis offset account would be decreased by the value of any transferred property. More narrow rules could be considered to address potential under valuation situations, for example, high-basis assets likely to be transferred at understated values. The hybrid approach need not eliminate all valuation concerns; the cash flow tax and current law also present valuation issues on wealth transfers. See, e.g., *supra* note 89; I.R.C. § 1015 (2003).

187. Under current law, taxpayers might have uncertainty as to their actual basis in each separate investment asset where the asset was acquired long ago. Additional uncertainties could arise where the asset was acquired in separate transactions over time and/or where a portion of the asset was sold at different times.

tions raise complexity issues under the income tax; how much of the taxpayer's total purchase price should be allowed to offset the partial sales proceeds.¹⁸⁸

The hybrid approach's cash flow treatment of investments also eliminates other complexities under the realization-based income tax. Under current law, sophisticated taxpayers attempt to (i) convert ordinary income into lower-rate capital gains and/or (ii) avoid the realization tax by transferring the economic burdens/benefits of ownership without an actual sale.¹⁸⁹ This creates increasingly complicated situations, as current law must police the artificial ordinary/capital and realization distinctions.¹⁹⁰ Additional issues arise under the realization income tax regarding the propriety of taxing realized gain where the proceeds consist of either comparable property or the buyer's note. Current deferral provisions for qualifying installment sales and "like-kind" exchanges present additional complexities.¹⁹¹

A final point concerns in-year calculations. Application of the hybrid approach's interest adjustment to investments/withdrawals occurring within a tax year raises complexity issues. In theory, interest should run from the tax payment date on saved wages until the savings withdrawal date, thereby raising administrative issues. However, comparable in-year complexities arise under both the cash flow tax and income tax. For instance, year-end savings followed by a withdrawal early the following year raises an interest-free deferral possibility under the cash flow tax, absent specific tracking of the saving and/or withdrawal dates.¹⁹² Furthermore, as discussed below,

188. For instance, under current law, taxpayers selling only a portion of shares held in a corporation or mutual fund company can claim to have sold the specific shares purchased at the highest price. This reduces the reported gain by increasing the portion of the overall basis allowed as an offset. Critics argue the provision is too generous. Compare the Clinton administration's more complicated provision allowing basis recovery equal to the average cost basis in all shares. White House Statutory Language; Title IX, Revenue Reconciliation Act of 1996, § 9511, Subtitle E: Corporate Reforms and Other Revenue Provisions, 96 TNT 56-6, Mar. 20, 1996. Cash flow taxation of investments eliminates this arbitrary distinction. Partial sales proceeds are included only to the extent they are consumed rather than reinvested.

189. For a straightforward attempt to transfer the economic burdens and benefits without an actual sale, consider the short against the box. A taxpayer holding appreciated stock (e.g., 100 shares), borrows 100 other shares in the same company and sells "short" the borrowed shares (while retaining his own actual shares). Technically the taxpayer retains ownership in his actual shares although he eliminates the economic benefits and burdens of ownership (since any gain (loss) on his own "long" stock position is perfectly offset by loss (gain) on the short stock position). The short against the box strategy was eventually shut down by I.R.C. § 1259 (2002). Nonetheless, it illustrates how some taxpayers inevitably find the gaps in the tax law.

190. See I.R.C. § 1258 (treating certain gains on the sale of capital assets as ordinary income); *id.* § 1259 (forcing gain recognition in the absence of actual sale in certain cases); see also *supra* note 46.

191. I.R.C. § 453 (installment sales); *id.* § 1031 (like-kind exchanges). There are additional "non-recognition" provisions. E.g., I.R.C. § 354 (stock exchanges which qualify as a "reorganization"). In the other direction, current law occasionally requires the reporting of income even before actual sale. E.g., the "original issue discount" rules at I.R.C. § 1271. These divergent tax rules add complexity; *i.e.*, the rules must be applied to relevant transactions and taxpayers analyze possible restructurings to avoid the rules.

192. For instance, deferring consumption from the last day of year 01 to the first day of year 02 defers the tax liability from year 01 to year 02 absent specific tracing rules. (The benefit of any such deferral turns on the workings of the estimated payment regime, which also depends on the degree of complexity it undertakes in tracking the specific timing of transactions within a year.) Another in-year

accounting conventions could address the in-year complexity issues under the hybrid approach.

The hybrid approach also eliminates an area of in-year complexity under the income tax. Because a decline in asset value constitutes an expense, investments in wasting assets require an annual depreciation allowance under an income tax. In-year difficulties arise under the income tax since, in theory, depreciation allowances should begin upon the placement of property in service.¹⁹³ Given the immediate deduction for the entire purchase price, the hybrid approach, like the cash flow tax, eliminates the need for depreciation. Separately, the current income tax treatment of this comparable in-year difficulty suggests one way to handle the in-year interest calculations under the hybrid approach. General accounting conventions could balance administrative concerns and precision, with an override provided for abusive cases. For instance, one such convention under the hybrid approach treats all savings withdrawals as made in the middle of the tax year, absent significantly disproportionate early-year withdrawals.¹⁹⁴

problem arises under the cash flow tax if wage withholding is maintained. While savers are entitled to refunds of any such withheld taxes, over taxation results, absent interest payments for the time lapse between the withholding and refund dates. See discussion *supra* note 107. Another problem arises under the cash flow tax if tax rates are expressed on a tax-inclusive basis (*i.e.*, no deduction for taxes paid). In this instance, taxpayers who defer paying taxes on year 01 consumption to year 02 reduce the tax cost (deferring the tax payment allows an extra deductible investment in year 01). While a tax-exclusive rate responds to such concern, this raises a potential offsetting optics concern since the tax-exclusive rate appears as a significantly higher stated rate. Graetz, *supra* note 92, at 1583. With some additional complexity, an alternative approach might treat unpaid taxes at year-end as savings withdrawals.

Similarly, both the cash flow tax and the hybrid approach need to protect against tax avoidance possibilities involving below-market loans between related parties. A below-market loan from father to child appears to raise a unique problem under the hybrid approach since, absent a protective provision, phantom deductions would accrue to the lender while the loan is outstanding. A similar issue also arises under the cash flow tax, since the transaction may generate a current "investment" deduction. Further, below-market loans raise issues under the income tax. For the current law response, see I.R.C. § 7872 (2002) (which can be used under the consumption tax systems, with appropriate modifications).

193. I.R.C. § 168(d)(1)-(2) (2002) finesses this complexity by deeming depreciable property, other than realty, as purchased in the middle of the year. This effectively allows six months of depreciation allowances for the initial year, regardless of the specific day within the year that the property is placed in service. This six-month allowance is overridden where substantial purchases of such depreciable property occur in the last three months of the taxable year. *Id.* § 168(d)(3). The depreciation rules also finesse complexities in determining actual declines in property by making assumptions about useful lives and value decreases. See *id.* § 168(b),(c). For additional in-year complexities under current law, see the current estimated tax payment rules at I.R.C. § 6654 (2002) (under which tax payments for a given year can be made as late as April 15 of the following year).

194. Compare the current depreciation rules discussed *supra* note 193. Under a mid-year convention, savings withdrawals are deemed made on June 30. As such, in determining basis offset account balances available against current year savings withdrawals, the balance carry forward preliminarily receives a six-month adjustment. Any remaining balance (after reduction for the current year's use) then receives the remaining six-month adjustment. A mid-point rule for taxes paid during the current year deems taxes paid in August/September (since taxes might not be paid until April 15 of the following year, assuming retention of the current timing rules). If so, new account balances receive only three to four months of interest adjustment in the year of creation. While a mid-point approach generally minimizes imprecision, potential manipulations (like disproportionate withdrawals early in the year) suggest consideration of stricter rules. Possibilities include: (i) specific disallowance provisions (such as reducing the in-year interest adjustment where significantly disproportionate withdrawals occur early in the year), or (ii) more general in-year interest disallowance (such as no interest adjustment on carry forward amounts used during year against saving withdrawals, and/or no in-year interest on new account balances). Assuming a

In sum, the hybrid approach adds some complexity in certain areas relative to either the cash flow or income tax. Given the offsetting areas of complexity reduction under the hybrid approach, the overall complexity case is far less certain. The remaining excess complexity, if any, should be balanced against the hybrid approach's other comparative advantages, which are summarized in the next Subpart.

F. Summary of the Hybrid Approach's Appeal

This Subpart summarizes the consensus potential of the hybrid approach. Subpart IV.F.1 discusses why the hybrid approach should appeal to those favoring, at least in theory, a consumption tax. Subpart IV.F.2 explains why the hybrid approach also should appeal to theoretic income tax proponents.

1. Appeal to Theoretic Consumption Tax Advocates

Subparts IV.A and D highlighted one reason why a progressive cash flow consumption tax might have difficulty in satisfying even those who favor, in theory, a consumption tax. The desired consumption tax system must heed the occasionally conflicting desires to collect tax (i) independent of saving decisions and (ii) in accordance with the standard of living. The hybrid approach strikes a more desirable balance than the cash flow tax between the inevitable conflicts of these two competing consumption tax desires. In favorable contrast to the cash flow tax, the hybrid approach incorporates savings neutrality when the living standard is not at issue; i.e., the hybrid approach avoids imposing a progressivity burden on the deferred consumption of saved wages and the risk-free return thereon. On the other hand, the hybrid approach imposes a progressivity burden on savings when the living standard becomes relevant; for example, where significant risky returns fund a materially enhanced lifestyle.¹⁹⁵ Related thereto, bunching

tax-inclusive rate, with no deduction for taxes paid, specific concern arises regarding taxpayers who defer payment of current-year taxes to the following year. Such deferral could free up assets for additional investments, thereby overstating the year-end basis offset account on which interest accrues the following year. In response, any current-year taxes not paid by year end could be deemed made from savings withdrawals on January 1 of the new year or December 31 of the prior year. The January 1 approach limits any excess interest accruals to the partial in-year adjustment, if any, for the prior year. The December 31 approach should eliminate any excess interest adjustment, albeit with some additional complexity (i.e., deeming savings withdrawals in the prior year requires an offsetting current year deduction). Separately, care is needed where offsetting withdrawals and savings occur on different days of the same year.

195. Thus, the hybrid approach imposes a progressivity burden on both high wages and high investment returns. Some consumption tax proponents vacillate between progressivity on wages versus investment return. *E.g.*, Rakowski, *supra* note 60; compare Bradford, *supra* note 99, at 384-85 (analyzing the "X-tax" which imposes progressivity only on wages), with DAVID F. BRADFORD ET AL., BLUEPRINTS FOR BASIC TAX REFORM 122-23 (2d ed. 1984) (analyzing cash flow tax under which progressivity generally applies at the time of consumption).

concerns from risky returns are significantly narrower under the hybrid approach than the cash flow tax.¹⁹⁶

Potential consumption tax proponents also might object to a form of consumption taxation, which raises serious implementation issues relative to the current structure. By maintaining tax collections on saved wages, the hybrid approach also responds to the transition, revenue, and tax avoidance/evasion concerns under the cash flow tax.¹⁹⁷

In sum, consumption tax proponents should favor the hybrid approach over the cash flow tax due to these combined benefits, which outweigh the hybrid approach's additional complexities, if any, and two possible areas of excess tax.¹⁹⁸

2. Appeal to Theoretic Income Tax Proponents

As discussed in Part III, those favoring an income tax should consider consumption taxation due to realization-based practical problems under the income tax. Ultimate acceptance of consumption taxation by this group is, however, contingent on comparable progressivity and the lack of offsetting practical concerns. The hybrid approach satisfies these criteria as well.

The primary theoretic difference between the income tax and the consumption tax is the income tax's excess burden on the risk-free investment return. In practice, however, the income tax unfairly taxes this relatively minor component of investment return. Realization-based gaps enable certain taxpayers to avoid completely, or minimize, the tax on risk-free re-

196. This occurs when high risky returns are consumed over a short time frame. The bunching concerns narrow under the hybrid approach since saved wages and the risk-free return thereon are excluded from the adjusted cash flow base. Giving taxpayers control over the timing of such exclusionary deductions would further blunt any remaining bunching concerns under the hybrid approach. See discussion *supra* notes 161-63 and accompanying text.

197. A modified hybrid approach could more closely follow the cash flow tax on the progressivity issue by giving a "tax paid credit" carry forward for taxes paid on saved wages (in lieu of the basis offset account carry forward). This would appeal if the consumption tax consensus preferred the cash flow tax on the progressivity issue yet wanted to incorporate the hybrid approach's responsiveness to the cash flow tax's other impediments. Under this modified hybrid approach, a preliminary tax liability is calculated by applying the tax rates to the hybrid tax base without any basis offset account deduction. Taxpayers reduce the preliminary tax by the (unused) tax paid credit carry forward, which equals taxes previously paid on saved wages, increased by an interest factor. Note that if the tax rate is expressed on a tax inclusive basis, the tax paid credit amount must be added to the tax base.

198. As discussed above in Subpart IV.D.2, this potential excess tax under the hybrid approach relative to the cash flow tax arises where the risk-free rate: (i) exceeds the taxpayer's overall portfolio return or (ii) is less than the interest rate incurred in making a portfolio adjustment. As discussed therein, a variety of factors should narrow such excess tax concerns. In addition, the cash flow tax's undesirable progressivity impact, as described above, presents a more general structural problem. Finally, in any specific risky return case, the cash flow tax's excess progressivity burden could match or exceed any potential excess burden under the hybrid approach. For instance, consider again the example in note 164 showing the hybrid approach's excess burden where *T* borrowed at twice the risk-free rate under a flat fifty percent rate. Assume now that a higher sixty percent rate applies to amounts above \$100,000. *T*'s consumption under the hybrid approach remains \$97,500 because *T*'s tax base in both years remains at \$100,000 or less. Under the cash flow tax, however, *T* faces the progressive rate when the asset is sold for \$200,000. *T*'s tax bill goes from \$100,000 ($.5 \times \$200,000$) to \$110,000 [$(.5 \times \$100,000) + (.6 \times \$100,000)$]. Accordingly, *T*'s after-tax consumption decreases to \$90,000. *T* therefore consumes more under the hybrid approach notwithstanding the excess borrowing costs.

turns.¹⁹⁹ Furthermore, these realization-based loopholes allow select taxpayers to reduce the tax burden on other income.²⁰⁰ Therefore, even if one favors, in theory, a tax on the risk-free return, the hybrid approach should be attractive. The hybrid approach removes what is, in practice, an inequitable tax on risk-free returns. It also largely eliminates the spillover problems affecting the remaining tax base.²⁰¹

The hybrid approach accomplishes this without sacrificing the income tax's direct progressivity burden on high wage earners who spread consumption over a number of years. In addition, the hybrid approach imposes progressivity on enhanced lifestyles funded by significant investment returns.

Finally, the hybrid approach's potential imperfections highlighted above should not weaken its attractiveness to theoretic income tax proponents. The income tax has comparable, if not greater, flaws in each such area. For instance, home acquisition indebtedness might present some tax deferral possibilities under the hybrid approach.²⁰² In favorable contrast to the deferral strategies under current law, however, market-rate interest is charged for such deferral under the hybrid approach. In addition, while taxpayers ulti-

199. The realization income tax imposes the excess burden on risk-free returns only on those who realize income before consumption. See discussion *supra* note 62 and accompanying text. In addition, under current law, the attempted burden unfairly varies with the inflation rate. See Cunningham, *supra* note 38, at 39-43.

200. The direct realization problems include the interest-free deferral on unrealized gains and the selective disposition of only loss assets. See Subpart III.A. Indirect realization problems flow from the reduced capital gains rate, primarily justified as a response to the lock-in issue under the realization requirement. The lower capital gains rate not only reduces the burden on all qualifying investment returns, but also encourages "conversions" of ordinary rate income (such as labor and interest income) to capital gains. See *supra* notes 42, 189-90 and accompanying text.

201. The hybrid approach eliminates (i) selective loss realization since losses are not deductible (see *supra* note 51 and accompanying text) and (ii) the leading justifications for the lower capital gains rate under the income tax (see *supra* note 52 and accompanying text). While the hybrid approach taxes wages when realized, the interest adjustment to the basis-offset account generally removes the timing significance of such realization. Some discontinuity will remain to the extent the risk-free rate is understated. See *supra* notes 164-71 and accompanying text. Taxpayers planning to avoid the adjusted cash flow component (for example, by expatriating) would benefit from avoiding wage realization. Nonetheless, as discussed at *supra* note 121, the wage component provides extra protection. Separately, although progressive rates provide an incentive to avoid high-wage years, an equivalent concern arises under the income tax. See *supra* note 105.

Also contrast the suggested "income tax" approach of taxing investments only when aggregate withdrawals exceed aggregate saved wages (*i.e.*, a basis offset account without interest). See Andrews, *supra* note 70. This approach fails to address the (i) current tax on inflationary gains, and (ii) the realization distortion on saved wages. Increasing the saved wage account by inflation, rather than the higher risk-free rate, provides a more limited response to the wage realization issue than the hybrid approach. As a related point, the hybrid approach has several advantages over asset-by-asset basis indexation. First, basis indexation is more complex, as the basis on each separate asset must be separately adjusted for inflation under a realization income tax. Second, it is likely that basis indexation would exclude debt (for both the creditor and debtor) due to complexity concerns and political realities. Such "partial" indexation allows tax arbitrage on debt-financed investments. See Engler, *supra* note 42, at 72-106. Third, the realization significance for invested capital is reduced, but not eliminated as under the hybrid approach. Finally, it provides a lesser response than the hybrid approach to the wage realization issue (the hybrid approach consistently provides the risk-free rate of return). Cf. Engler, *supra* note 27, at 186-90 (under certain assumptions, partial indexation adjusts at the short-term risk-free rate).

202. See discussion *supra* notes 110-14 and accompanying text. As discussed therein, provisions may limit this potential even in the first instance.

mately may default on such deferred liability under the hybrid approach, the realization income tax presents similar default possibilities in a broader range of circumstances.²⁰³ Also, consider the two ways in which the hybrid approach might impose an excess burden on risky returns relative to the cash flow tax. By taxing saved wages, the income tax, like the hybrid approach, imposes an excess burden where (i) portfolio adjustments require borrowing at higher individual rates²⁰⁴ and/or (ii) wages are invested in loss assets.²⁰⁵

In sum, the hybrid approach would significantly improve various problem areas of current law, without the offsetting new concerns presented by the cash flow tax.

V. CONCLUSION

Dissatisfaction with the current income tax system is increasing among academics and government officials. Shifting to the most logical replacement, a consumption tax, raises several prominent questions. First, can a consumption tax be designed with the progressivity necessary to satisfy the desire for a redistributive tax system? Second, would the resulting progressive consumption tax appropriately balance the conflicting desires of consumption tax proponents to collect tax (i) without regard to savings decisions and (ii) based on standards of living? Third, would the resulting progressive consumption tax satisfy those favoring the income tax in theory but frustrated by its long-standing practical problems? Finally, as a related matter, can the foregoing attributes be achieved without raising deep transition concerns or other intractable issues?

The hybrid approach satisfactorily responds to all such inquiries. First, the hybrid approach would achieve meaningful redistribution through its dual progressivity burden on high wages and heavy consumption funded by significant investment returns.²⁰⁶ Second, the hybrid approach would successfully moderate between the savings neutrality and living standard desires, favoring each when most compelling. Third, the hybrid approach should appeal even if one favors, in theory, the income tax's potential ex-

203. See discussion *supra* note 118.

204. Recall Example 2, discussed *supra* in Subpart II.A.

205. The loss scenario differs somewhat for the hybrid and income taxes. As discussed above, the issue under the hybrid approach arises where the portfolio return is less than the risk-free rate. In contrast, the issue arises under the income tax only for losses. On the other hand, the hybrid approach lessens the concern by providing an interest adjustment—through the basis offset account—on unused losses that carry forward.

On balance, these potential burdens are generally considered undesirable, even by those commentators favoring an income tax in theory; they unfairly burden taxpayers with higher borrowing rates and/or an inability to use tax losses. *E.g.*, Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 429 (2000) (discussing inability to use losses); Cunningham, *supra* note 38, at 35-39 (discussing excess borrowing rates). In any event, regardless of whether one ultimately favors these burdens, they generally do not distinguish the income and hybrid taxes.

206. This duality can appeal to someone favoring either a consumption tax or an income tax in theory. See discussion *supra* Subparts IV.F.1 and F.2.

cess burden on the risk-free return. In practice, loopholes arising from this attempted tax of the risk-free return allow well-advised taxpayers to avoid tax not just on the risk-free return, but on other, more significant items as well. The hybrid approach would relinquish the risk-free tax, which has proven inequitable in practice, while strengthening the remaining, more significant tax base. Finally, the hybrid approach's wage tax component addresses the transition, revenue, and tax avoidance concerns that impede the cash flow tax, the alternative progressive consumption tax.

In sum, the hybrid approach addresses both the deep structural flaws of the current system as well as the most prominent cash flow tax concerns. As shown above, the new hybrid approach combines significant substantive benefits, consensus-forming potential, and relative transition ease. This new hybrid structure, therefore, has real potential to break the current deadlock between the status quo income tax and the conventional consumption tax.