

Untangling Tax Reform: Simple Taxes, Complex Choices

ALICE G. ABREU*

I. INTRODUCTION

If taxes had existed in the Garden of Eden, the serpent would not have needed an apple; the promise of a simpler tax system alone would have seduced Eve. The promise of a simpler tax system now threatens to seduce the American people, and has become a dominant theme of both congressional and presidential politics in the 1990's.¹ In its current

* Charles Klein Professor of Law and Government, Temple University School of Law. I am indebted to David F. Bradford, whose book, *UNTANGLING THE INCOME TAX* (1986), inspired the title of this Article and whose work has helped me untangle much that is tangled in the world of taxes. I am grateful for the care and thoughtfulness with which Rob Bartow, Rick Greenstein, Nancy Knauer, and Marty McMahon read and commented on prior drafts, and for the incomparable research assistance of A. Christina Derry and Ivy Barton-Wagner, Temple '97, as well as for the unflagging dependability of John Necci, Assistant Library Director of the Temple Law School Library. A Summer Research Stipend from Temple University School of Law provided financial support for this project, but all of the views expressed here, and any errors, are mine alone.

1. See, e.g., Steven A. Bank, *Origins of a Flat Tax*, 73 DENVER L. REV. 329 (1996); Bill Bradley, *It's Government by Tax Break Again; Clinton and Dole Should be Talking About Fairness and Loopholes, Not Cuts and Credits*, THE WASH. POST, Sept. 29, 1996, at C1 (stating that simplicity and equity in a tax system are possible, but not from the flat tax, which benefits only the wealthy); David Gergen, *The Flat-tax Diversion*, U.S. NEWS & WORLD REPORT, Feb. 5, 1996, at 80 (criticizing politicians' emphasis on promoting flat tax as a cure-all); Howard Gleckman & Mike McNamee, *The Flat Tax May Be Back. Right, Bob?*, BUSINESS WEEK, June 10, 1996, at 34 (discussing potential effects of Bob Dole's flat tax plan); Robert S. McIntyre, *Flat on our Backs (flat tax proposals)*, THE NATION, Feb. 12, 1996, at 5 (identifying simplification as seductive,

incarnation, the promise of a simpler tax system has taken the form of various proposals for a “flat” tax.² Perhaps because flatness is dull, we assume it to be simple.³

The flatness of the proposed flat tax derives from its rate structure and is intended to provide a contrast to the progressive rate structure that has been the hallmark of the federal income tax since its inception. A tax system with a single positive rate appears simpler than one that is graduated, with multiple rate brackets. Appearances can be deceiving, however, and in this case they are dangerously so. The appearance of simplicity projected by a tax system that boasts a completely or relatively flat rate structure is deceiving because an analysis of the rate structure alone tells us only one of the things we need to know to evaluate a tax system: the rate of taxation. While the rate of taxation is an important feature of any tax system, a complete analysis must consider not only the rate itself but also the base to which that rate applies. It is meaningless to say that the rate of tax is, say, twenty percent, without also saying what it is twenty percent of.⁴ If the devil is in the details, then the tax base is the devil in any tax system, for the complexity of a tax system is generally proportional to the difficulty of determining its base. Under the current income tax system, it is arriving at taxable income that is difficult, not multiplying taxable income by the applicable rate.⁵

but deceptive, hook to most Americans); Alison Mitchell, *Attack and Parry: Taxes Set Political Pace*, THE N.Y. TIMES, May 11, 1996, at 9 (reporting that “Dole advisor said that the across-the-board tax reduction ‘would be politically attractive because it’s the kind of thing that can attract attention and seize the imagination’” of voters); Katharine Q. Seelye, *Shifting Campaign Strategy to Tax Cutting, Dole Meets with Forbes*, THE N.Y. TIMES, May 23, 1996, at B11 (explaining Bob Dole’s plan for a “single-rate income tax”); Mark Sherman, *Candidates’ Mantra: Simpler Tax Code*, ATLANTA J. & CONST., Feb. 2, 1996, at B3 (discussing presidential candidates’ use of flat tax slogans).

2. See Bank, *supra* note 1, at 329-32; Ernest S. Christian, *The Tax Restructuring Phenomenon: Analytical Principles and Political Equations*, 48 NAT’L TAX J. 373 (1995); David Sachs, *Variations on a Theme by Dick Arney—A Framework for Real Tax Simplification*, 66 TAX NOTES 863 (1995).

3. The word “flat” is defined not only as horizontally level and lacking in inequalities of surface, but also as uninteresting, dull, tedious, stale, tasteless, or insipid (as in flat beer or food), pointless (as a joke that falls flat), commercially dull (as a flat market), without gloss, and not clear, sharp or ringing (as a flat voice). In music, a note lowered half a step in pitch is a flat, as is one that is below an intended pitch. THE AMERICAN COLLEGE DICTIONARY 460-61 (1955).

4. Happily, Professor Graetz has eloquently made this point to those who need to hear it most: the members of the Senate Finance Committee. *Current Flat Tax Proposals*, testimony of Michael J. Graetz presented at hearings before the Senate Finance Committee on May 18, 1995, *reprinted in* 67 TAX NOTES 1256, 1257 (1995) [hereinafter Graetz Testimony].

5. The social security tax system is simple not because it contains a single rate but because it has an easily definable base—wages from employment. Indeed, whatever

Analysis of the tax base also tells us much that is important in evaluating a tax system: It tells us who bears the burden of taxation and who has the power to avoid taxation or to shift its economic incidence. I have previously suggested that tax systems should be evaluated not only on the basis of what they take away from people, but also on the basis of what they give people. Depending on how they are designed, tax systems can give people varying degrees of power to avoid their imposition (“avoidance power”), or to shift the economic burden they impose (“burden power”).⁶ The current tax system provides significant amounts of both types of power and allocates that power primarily to the holders of material capital.⁷ Both the grant and allocation of avoidance power and burden power reflect values—in this case, the value of personal autonomy and the value of the ownership of material capital.

The adoption of a tax system that gives people the power to alter their tax liability by altering their behavior reflects the value of personal autonomy because such a system empowers people. People who are empowered feel a sense of personal autonomy because empowerment allows them to feel that they are in control of their lives. Assuming empowerment is good, empowering primarily those who own material capital reflects the high value placed on the ownership of material capital.⁸

Empowerment analysis can illuminate the current tax reform debate. Applying the concepts of avoidance power and burden power to the current tax reform debate offers a number of insights. First, it reveals that tax systems which produce equivalent economic effects can produce starkly different allocations of power. Those allocations of power ought to be considered as the policy debate continues. Second, it shows that the simpler the system, the less power it confers. Gains in simplicity should therefore be weighed against losses in power, and the values

complexity exists in that system is directly attributable to the difficulty of determining the base—that is, determining precisely when it is that someone is employed. It is the difficulty of making that determination that has led to the controversy over independent contractor status.

6. Alice G. Abreu, *Taxes, Power, and Personal Autonomy*, 33 SAN DIEGO L. REV. 1, 12 (1996).

7. *Id.* at 35-37, 71, 75.

8. Although empowerment is not always good for a variety of reasons, which I have discussed at length in Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, I have concluded that, in matters involving taxation, power is generally perceived as good by those who have it. *Id.* at 12, 50-54.

implicit in bestowing any remaining power on specific classes of people should be carefully scrutinized. Third and most important, this analysis shows that measures calculated to increase savings can empower different categories of people. Savings can be increased by measures that empower primarily the holders of material capital or by measures that do not provide additional power to the holders of material capital but instead make it easier for providers of labor to become holders of material capital. Before adopting or enhancing either type of measure, the resulting allocations of power ought to be considered.

Part II of this Article outlines the salient features of the two tax reform proposals that have received serious scholarly and political attention: the proposal introduced by United States Representative Arme y as the *Freedom and Fairness Restoration Act of 1995*, which I will refer to as the Arme y Flat Tax,⁹ and the proposal introduced by Senators Domenici, Nunn, and Kerrey as the *USA Tax Act of 1995*,¹⁰ which I will refer to as the Nunn-Domenici Tax.¹¹ Part III considers the degree

9. 141 CONG. REC. E146-01 (July 19, 1995) (statement of Rep. Arme y); *see also* Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong., 1st Sess. (1995) [hereinafter Arme y Flat Tax]. Senator Shelby (R-Ala) also introduced a companion bill in the Senate. 141 CONG. REC. S10320-04 (July 19, 1995) (statement of Sen. Shelby; *see also* Freedom and Fairness Restoration Act of 1995, S. 1050, 104th Cong., 1st Sess. (July 19, 1995). I have chosen to refer to Representative Arme y's proposal as the Arme y Flat Tax to distinguish it from other flat tax proposals that have been made either by scholars or by other politicians. *See infra* notes 12-13 and accompanying text, for a discussion of other flat tax proposals. For a good compendium of the bills introduced and the amount of serious political attention the idea of a flat tax has received, *see*, Bank, *supra* note 1, at 329-32; William L. Raby and Burgess J. W. Raby, *Will the Flat Tax Kill Tax Practice?* 71 TAX NOTES 1269 (1996); *Joint Comm. on Taxation*, 104th Cong., 1st Sess., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX (Joint Comm. Print 1995) 30-31, 38 [hereinafter *JCT Pamphlet*].

10. USA Tax Act of 1995, S. 722, 104th Cong., 1st Sess. (1995) [hereinafter Nunn-Domenici Tax]. Although the rate structure of the Nunn-Domenici Tax is flat as it applies to business income, it is not flat at all as it applies to the income of individuals. *See infra* note 58 for a description of the rate structure of the Nunn-Domenici Tax on individuals.

11. Much of the recent scholarship on tax reform also focuses on the Arme y Flat Tax and the Nunn-Domenici Tax. *See, e.g.*, WILLIAM W. OLIVER, WHY WE SHOULD ABOLISH THE INCOME TAX—A GUIDE TO THE PRINCIPAL PROPOSALS 105-15 (1995); Christian, *supra* note 2; *JCT Pamphlet*, *supra* note 9, at 30-31, 38; Michael J. Calegari et al., *Flat Tax Ramifications for Self-Employed Taxpayers*, 72 TAX NOTES 641 (1996); N. Jerold Cohen and Robert Hall, *The Flat Tax: Is it an Idea Whose Time has come?*, 82 A.B.A. J. 82 (1996); Heidi Glenn, *Flat Tax Would Sting Low-Income Families, Study Finds*, 72 TAX NOTES 275 (1996); Amy Hamilton, *Treasury Official Discusses How Federal Reform Could Impact States*, 70 TAX NOTES 805 (1996); John S. Nolan, *The Merit of an Income Tax Versus a Consumption Tax*, 71 TAX NOTES 805 (1996); Fred Stokeld, *AICPA Releases Study Urging Caution In Moving Toward Consumption Tax*, 70 TAX NOTES 141 (1996); Martin A. Sullivan, *The Ultimate Flat Tax And Other Daring Ideas*, 72 TAX NOTES 1057 (1996); Martin A. Sullivan, *Housing and the Flat Tax: Visible Pain, Subtle Benefits*, 70 TAX NOTES 340 (1996); Eric Toder, *Comments on*

of avoidance power conferred by each proposal, and Part IV considers the degree of burden power conferred by each proposal. Part V concludes with some observations regarding the values implicated by the distribution of power each proposal would produce. Readers already familiar with the details of the two proposals may want to skip Part II.

II. THE TAX REFORM PROPOSALS

A. *The Arme y Flat Tax*

The Arme y Flat Tax descends from the seminal work of two Hoover Institution Fellows, Robert E. Hall and Alvin Rabushka, who popularized the concept of a flat tax in 1981 and then published a book entitled *The Flat Tax* in 1985.¹² The Hall and Rabushka flat tax has been the centerpiece of several political campaigns, including the 1996 presidential primary campaigns of Malcolm S. Forbes Jr. and Senator Arlen Specter, and the 1992 senatorial campaign of Bruce Herschensohn.¹³

Proposals for Fundamental Tax Reform, 66 TAX NOTES 2003 (1995). I have decided to refer to the USA Tax Act of 1995 as the Nunn-Domenici Tax primarily because that is how it is referred to most often. The central ideas of the Arme y Flat Tax and the Nunn-Domenici Tax were also prominent features of the Kemp Report. National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential—A Pro-growth, Pro-family Tax System for the 21st Century*, 70 TAX NOTES 413 (1996). Neither the Arme y Flat Tax nor the Nunn-Domenici Tax purport to replace the Internal Revenue Code of 1986 (the "Code"). Instead, both purport to amend it. See, e.g., Arme y Flat Tax, *supra* note 9, § 101; see also Nunn-Domenici Tax, *supra* note 10, § 201(a).

12. ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (1985). See also, James M. Bickley, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, 72 TAX NOTES 97, 98 (1996); *JCT Pamphlet*, *supra* note 9, at 31 n.39. A second edition of Hall and Rabushka's book, updated to reflect the endorsement of the initial concept by various legislators, including Representative Arme y, was published 10 years later, in 1995. ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995) [hereinafter *THE FLAT TAX*]. The second edition was also updated to reflect the enactment of the Tax Reform Act of 1986 and includes a new chapter of questions and answers. All references to *THE FLAT TAX* in this Article are to the second edition.

13. *THE FLAT TAX*, *supra* note 12. The 104th Congress has seen the introduction of at least seven bills that would enact some version of the flat tax. See, James M. Bickley, *Flat Tax*, *supra* note 12, at 98. See, e.g., Community Renewal and Economic Opportunity Act, S. 1533, 104th Cong. (1996) (Sen. McCain); Flat Tax Act of 1995, S. 1038, 104th Cong. (1995) (Sen. Helms); S. 488, 104th Cong. (1995) (Sen. Specter); Creative Revenues Act of 1995, H.R. 2526, 104th Cong. (1995) (Rep. Owens); National VOICE on a Flat Tax and Cap on Tax Increases Act of 1995, H.R. 2116, 104th Cong. (1995) (Rep. Hoekstra); H.R. 1780, 104th Cong. (1995) (Rep. Souder); Crane Tithe Tax

Although *The Flat Tax* includes a model statute, I have chosen to focus on the Arney Flat Tax rather than on Hall and Rabushka's model statute because, of the two, only the Arney Flat Tax stands any chance of actually becoming law, at least until someone introduces Hall and Rabushka's model statute as proposed legislation in Congress.¹⁴

The contrast between the current federal income tax system and the Arney Flat Tax is stark. The systems differ not only because they attempt to tax different things but because the differences in their design cause them to provide different amounts of information to the taxpaying public as well as starkly different opportunities for the exercise of taxpayer choice.

Act of 1995, H.R. 214, 104th Cong. (1995) (Rep. Crane). The 103rd Congress also witnessed the introduction of various flat tax proposals. See, e.g., Flat Tax Act of 1993, S. 193, 103d Cong. (1993) (Sen. Helms); Flat Tax Act of 1993, S. 188, 103d Cong. (1993) (Sen. Helms); Freedom and Fairness Restoration Act of 1994, H.R. 4585, 103d Cong. (1994) (Rep. Arney); Crane Tithe Act of 1993, H.R. 1190, 103d Cong. (1993) (Rep. Crane). Out of all of these proposals, only the Arney proposal has received sustained and serious attention, and I have therefore chosen to focus my discussion on it. I will not discuss the flat tax so stridently advocated by Malcolm "Steve" Forbes during his bid for the Republican Presidential Nomination because it never existed as a serious legislative proposal. For an explanation and discussion of the proposal, see *An Interview With Steve Forbes*, 72 TAX NOTES 165 (1996). Subsequent to his defeat in his quest for the nomination, Forbes joined forces with Representative Arney and continued to argue publicly for a flat tax. See Louis Lyons, *GOP Set to Make Tax Reform Central Campaign Issue*, 72 TAX NOTES 277 (1996).

14. That is highly unlikely because Hall and Rabushka's model statute is just not administrable. Hall and Rabushka's model statute contains a mere eight sections that set forth the structure of the tax in minimalist terms perfectly suited to their purpose. That minimalist statute could never produce a workable tax system, however. For example, the provision on exempt organizations provides, *in its entirety*, as follows:

Organizations exempt from the business tax are[.]

- (1) State and local governments, and their subsidiary units[.]
- (2) Educational, religious, charitable, philanthropic, cultural, and community service organizations that do not return income to individual and corporate owners.

THE FLAT TAX, *supra* note 12, at 145. Even so staunch a supporter of the flat tax as Mr. Arney recognized the impossibility of administering a system with so little definition, and the Arney Flat Tax not only retains all of the provisions of the Internal Revenue Code that are necessary to determine whether "an organization is exempt from tax," but adds an entire, substantially complicated, provision that imposes an additional tax on non-cash compensation provided to employees of exempt organizations. Arney Flat Tax, *supra* note 9, § 106(b)(2)(B)(ii); see *id.* § 102(b) (adding section 4977 to the present Code). The purpose of the provision is apparently to ensure that fringe benefits, which would not be included in the income of employees under the general definition of income in the proposal (see *infra* note 22), but would generally be subject to tax at the business level because they are not deductible to employers (see *infra* text accompanying note 53), are taxed at the business level. Proposed section 4977 would thus equalize the tax treatment of non-cash compensation as between exempt and non-exempt entities by ensuring that such compensation is taxable at the entity level in both cases.

Designers of tax systems who seek to achieve particular policy objectives have at least two fundamental options. One option is to design the system so that it starts with a broad base, which is then narrowed through the mechanism of exclusions or deductions to achieve the desired policy objective. The other option is to achieve the desired policy objectives by beginning with a base defined so narrowly that few exclusions and deductions are necessary to arrive at taxable income.

Designers of the current federal income tax system chose the first option. Section 61 of the Internal Revenue Code, which defines gross income, is broad indeed.¹⁵ Even lawyers who hated the course in federal income taxation are likely to remember the broad and unhelpful definition of income provided in the statute. Section 61 defines income as "all income from whatever source derived,"¹⁶ leaving to judicial and administrative construction the task of defining precisely what income is. Judicial intervention has not served to narrow the definition, and the Supreme Court, which initially defined income as "the gain from capital, from labor, or from both combined,"¹⁷ later expanded that definition to include all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."¹⁸ The broad base created by the expansiveness of the judicial definition of income is narrowed only through statutory exclusions and deductions which set the contours of the tax base.

Designers of the Arme y Flat Tax have chosen the second option. The Arme y Flat Tax defines income very narrowly, particularly for individuals, but also for businesses. The narrow definition of income results in the need for few deductions and exclusions. It is the absence of multitudinous deductions that most contributes to the illusion of simplicity. Pages upon pages of forms are not necessary since a taxpayer will not have any items which might be subtracted before

15. I.R.C. § 61 (West 1996).

16. *Id.*

17. *Eisner v. Macomber*, 252 U.S. 189, 207 (1919) (citing *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1917)).

18. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1954).

arriving at the figure to be taxed.¹⁹ Since not much enters the base in the first place, not much needs to be taken out.²⁰

The ArmeY Flat Tax would place a tax of 17% on the taxable income of every individual and on the business taxable income of “every person engaged in a business activity.”²¹ It represents a radical departure from the current federal income tax system not only because it provides for only one rate of tax but also because its definition of taxable income bears as much resemblance to the Code’s definition of that term as a canoe bears to an ocean liner.

Under the ArmeY Flat Tax, taxable income for individual taxpayers consists essentially of cash wages received for services performed in the United States minus a standard deduction.²² That’s it. It seems simple. It’s a canoe.

19. Hall and Rabushka have noted that in 1994, the Service published about 480 forms, 280 publications explaining the forms and the tax system, and sent out about eight billion pages of forms and instructions a year, which, placed end to end, would stretch 694,000 miles. THE FLAT TAX, *supra* note 12, at 5. They note that such mileage is enough to go around the earth twenty-eight times and accounts for the destruction of 293,760 trees, thus also allowing them to make an environmental claim for the virtues of the flat tax they propose. *Id.* That mileage is also enough to go to the moon and back, (the centers of the earth and moon are 238,857 miles apart), which would also allow them to claim that the tax system that generates it ought to go the way of the NASA program of travel to the moon.

20. The ArmeY Flat Tax might also be thought to be simpler than the current system because it appears to eliminate the need to distinguish between ordinary income and capital gain, a distinction often faulted for much of the complexity of the current system. As I discuss in more detail in Part V, *infra*, any such elimination is illusory. By distinguishing between “gross active income,” which is taxable, and other types of income derived by business, which are not, the ArmeY Flat Tax preserves the need to distinguish between the fruits of ordinary business activity (ordinary income under the current system) and returns on investment (capital gains under the current system). Conceptually, taxing one kind of income and not taxing another kind of income is no simpler than taxing one kind of income at one rate and another kind of income at another rate. Not taxing income is itself a rate, albeit a zero rate.

21. ArmeY Flat Tax, *supra* note 9, §§ 101(a), 102(a). The ArmeY Flat Tax calls for a rate of 20% during the first year it is effective, dropping to a rate of 17% thereafter. *Id.*

22. ArmeY Flat Tax, *supra* note 9, § 101(b) (amending I.R.C. § 63). The proposal also includes two items that can be regarded as substitutes for cash wages: retirement distributions and unemployment compensation. *Id.* The ArmeY Flat Tax defines retirement distributions as distributions from a plan described in section 401(a) of the Code, an annuity plan described in section 403(a) of the Code, an annuity contract described in section 403(b) of the Code, an individual retirement account described in section 408(a) of the Code, and individual retirement annuity described in section 408(b) of the Code, an eligible defined compensation plan as defined in section 457 of the Code, a governmental plan defined in section 414(d) of the Code, a trust described in section 501(c)(18) of the Code, and, in a sentence that proves that even in the world of tax reform, *plus ça change, plus c’est la même chose*, “any plan, contract, account, annuity, or trust which, at any time, has been determined by the Secretary to be such a plan, contract, account, annuity or trust.” *Id.*

The definition of business taxable income is only somewhat more complicated. The Arney Flat Tax defines business taxable income as gross active income reduced by certain deductions.²³ Gross active income is defined as gross receipts from: (1) the sale or exchange of property or services within the United States in connection with a business activity and (2) the export of property or services from the United States in connection with a business activity.²⁴ The available deductions are limited to the cost of business inputs, wages paid in cash for services performed within the United States, and retirement contributions.²⁵ The cost of business inputs consists of the amount paid for property sold or used in connection with a business activity, the amount paid for services (other than the services of employees), and excise or similar taxes imposed on the purchase of property or services.²⁶ This definition is a canoe, too.

The Arney Flat Tax differs from the current system not only in its design but also in what it subjects to taxation. Although the proposal uses the term "income," and the tax it imposes is on taxable income, the Arney Flat Tax is, in the estimation of many, including Hall and Rabushka, not principally an income tax at all. It is principally a consumption tax.²⁷ The Arney Flat Tax would impose a consumption tax not because of what it taxes, but because of what it does not tax.²⁸

23. Arney Flat Tax, *supra* note 9, § 102(a) (amending I.R.C. § 11(c)).

24. *Id.* (amending I.R.C. § 11(c)(2)).

25. *Id.* (amending I.R.C. § 11(d)(1)).

26. *Id.* (amending I.R.C. § 11(d)(2)(A)).

27. Robert E. Hall & Alvin Rabushka, *The Flat Tax: A Simple, Progressive Consumption Tax*, in *FRONTIERS OF TAX REFORM* 27, 28 (Michael J. Boskin ed., 1996) [hereinafter *FRONTIERS IN TAX REFORM*]; John J. Motley III, *Consumption Taxes—No Cure for What Ails Us*, 71 *TAX NOTES* 1235 (1996); J. D. Foster, *Fixing the Flat Tax*, 70 *TAX NOTES* 1695 (1996); Gene Steuerle, *The Simple Arithmetic of Flat Taxes*, 70 *TAX NOTES* 1041 (1996); Karen C. Burke, *VATs and Flat Taxes Reconsidered*, 70 *TAX NOTES* 899 (1996); *JCT Pamphlet*, *supra* note 9; MARTIN A. SULLIVAN, *CHANGING AMERICA'S TAX SYSTEM: A GUIDE TO THE DEBATE* (1996); Eric Toder, *Comments on Proposals for Fundamental Tax Reform*, 66 *TAX NOTES* 2003 (1995); Graetz Testimony, *supra* note 4.

28. Whether such a tax would be constitutionally permissible given that it is likely to be judged a direct tax (at least it is so judged by economists, see Charles E. McLure Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption*, in *FRONTIERS OF TAX REFORM*, *supra* note 27, at 70-71, 86-88), is an open question, complete exploration of which is beyond the scope of this Article. Preliminary thoughts suggest that both the Arney Flat Tax and the Nunn-Domenici Tax should pass constitutional muster even if adjudged to be direct taxes, for the same reason the current

The signal difference between income and consumption taxes, at least in the current tax reform debate, is that while income taxes tax the return

tax system appears to pass constitutional muster: They are really hybrid taxes that have consumption tax features but that do not tax more than income.

That the current system is a hybrid (principally because of its failure to tax savings invested through employer-sponsored pension plans) is well known. *See, e.g.*, DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 7, 28 (1986); DAVID F. BRADFORD, *UNEASY COMPROMISE—PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX* 1-3 (Henry Aaron et al. eds., 1988) [hereinafter BRADFORD]. That consumption taxes include both borrowed funds and the proceeds of gifts and inheritances in their base is also well known by anyone who has paid for a car with either borrowed or inherited funds and discovered that the source of the funds had no effect on the retail sales tax due. *See id.* at 19-21, 60. Because neither the Arney Flat Tax nor the Nunn-Domenici Tax treats borrowed funds or the proceeds of gifts and inheritances as income, they lack a significant characteristic of consumption taxes. This difference should also allow them to pass constitutional muster because it permits the argument that even if they are like consumption taxes in what they do not tax, they are like income taxes in what they do tax. The constitutional argument in their favor would be that even if the Arney Flat Tax and the Nunn-Domenici Tax omit from the base the same kinds of items that would be omitted from the base of a consumption tax, they still pass constitutional muster because what they do tax fits the definition of income.

This constitutional argument is premised on the proposition that as long as a tax system does not actually tax more than income, the system is constitutionally permissible; since neither of the proposed tax systems would necessarily tax more than income, the conclusion that both are constitutionally permissible would follow inexorably from that premise. The proposition that a system is constitutionally permissible as long as it taxes no more than income is consistent with the notion that the Sixteenth Amendment sets the outer boundaries of the constitutional power to tax but does not command that the full extent of the power be utilized. *Cf.* *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112-13 (1916) (asserting that “the provisions of the Sixteenth Amendment conferred no new power of taxation, but simply prohibited the previous complete and plenary power of income taxation possessed by Congress . . .”); *Brushaber v. Union Pacific R.R.*, 240 U.S. 1, 17-18 (1916) (noting that power to tax income was provided by Constitution prior to Sixteenth Amendment).

Nevertheless, because it would include borrowed amounts in the tax base in some cases, the Nunn-Domenici Tax presents some potentially thorny constitutional questions. *See infra* note 46. Although the Nunn-Domenici Tax would only include borrowed funds in the tax base in situations where that is necessary to prevent abuse, the inclusion of such amounts in the base might nevertheless be constitutionally significant. In addition, the Nunn-Domenici Tax includes wages in an employer’s tax base and in so doing might tax something closer to gross receipts than to income, at least in some cases. Even if low rates could serve as a proxy for an accurate measure of income in some cases, it is far from clear that the rates proposed in the Nunn-Domenici Tax would be low enough to accomplish that. In addition, since the business portion of the Nunn-Domenici Tax would apply to business conducted in both corporate and non-corporate form, even if the corporate portion could pass constitutional muster under the rationale that allowed the 1909 corporate income tax to survive a constitutional attack in *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911) (that is, that the tax is an indirect excise tax on the privilege of doing business in corporate form and therefore need not be apportioned), interesting constitutional questions would remain with respect to the non-corporate portion. Further exploration of those questions must await another day.

on material capital, consumption taxes do not.²⁹ By taxing only wages at the individual level, and only the income from the active conduct of a trade or business at the business level, the Arney Flat Tax exempts from taxation the return on material capital and thus closely approximates the economic effect of a consumption tax.³⁰

B. *The Nunn-Domenici Tax*

Although the Nunn-Domenici Tax is designed to look much like the current federal income tax, the Nunn-Domenici Tax would also enact a consumption tax.³¹ Like the current income tax, the Nunn-Domenici Tax begins with a broad definition of income. The Nunn-Domenici Tax defines gross income as "all income from whatever source derived by a taxpayer during the taxable year,"³² Compared to the canoe the

29. BRADFORD, *UNEASY COMPROMISE*, *supra* note 28, at 60. *THE FLAT TAX*, *supra* note 12, at 28; Graetz Testimony, *supra* note 4, at 1257-58. The term "consumption tax" when used in contradistinction to "income tax" may actually be a misnomer to the extent that it implies taxation of something not otherwise subject to tax. Income taxes can also tax consumption, and they do in the case of every taxpayer who consumes income. The federal income tax, for instance, taxes consumption by disallowing deductions for personal expenses and losses. Such expenses and losses represent consumption and by retaining them in the base, the system subjects them to taxation.

30. That the Arney proposal fails to create a pure consumption tax does not diminish the primacy of the consumption features of the tax. Conceptually, pure consumption taxation includes taxation of consumption that takes place with borrowed funds or gratuitously transferred amounts (gifts and bequests). Indeed, one of the most persuasive arguments for consumption taxation is that because total consumption (including consumption financed by borrowing, gifts, and bequests), provides a better measure of lifetime ability to pay than annual income, consumption taxes are more closely reflective of lifetime ability to pay than income taxes and may be less regressive than they appear when analyzed from an annual perspective. See DON FULLERTON & DIANE LIM ROGERS, *WHO BEARS THE LIFETIME TAX BURDEN* (1993); Gilbert E. Metcalf, *Life Cycle Versus Annual Perspectives on the Incidence of a Value Added Tax*, in 8 *TAX POLICY AND THE ECONOMY* 45, 49 (James M. Poterba ed., 1994); Don Fullerton & Diane L. Rogers, *Lifetime Effects of Fundamental Tax Reform*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 32 (Henry J. Aaron & William G. Gale eds., 1996) [hereinafter *FUNDAMENTAL TAX REFORM*]; see also *supra* note 28. Neither the original Hall/Rabushka design nor the Arney proposal would include borrowings or gifts and bequests in the tax base, and both thus differ significantly from a pure consumption tax. Indeed, both could therefore be said to be equivalent to a pure consumption tax only for individuals who consume an amount equal to their wages and for whom wages represent the only source of cash.

31. See *supra* notes 28-29 and accompanying text for a discussion of the differences between income and consumption taxes.

32. Nunn-Domenici Tax, *supra* note 10, § 3(a) (amending I.R.C. § 3).

Armed Flat Tax creates, the definition of income in the Nunn-Domenici Tax is an ocean liner in both size and complexity. For individuals, the Nunn-Domenici Tax narrows the base substantially in three major ways. First, the Nunn-Domenici Tax allows the deduction of an amount as a "family living allowance."³³ Second, the Nunn-Domenici Tax excludes from the tax base many of the same amounts excluded under the current system.³⁴ Third, the Nunn-Domenici Tax allows deductions comparable to the most popular deductions allowed under the current system,³⁵ and adds several important new deductions.³⁶

The most important new deduction added by the Nunn-Domenici Tax is the one that has given the tax its popular name and that serves to convert what looks like an income tax into something that comes much closer to a consumption tax: The unlimited savings allowance. The unlimited savings allowance is designed to permit a deduction for all amounts a taxpayer saves. By purporting to tax income but providing a deduction for all amounts saved, the Nunn-Domenici Tax succeeds in taxing only income that is not saved. Because income not saved is presumably consumed, the Nunn-Domenici Tax comes much closer to being a consumption tax than the current system.³⁷

33. Nunn-Domenici Tax § 201(a) (amending I.R.C. §§ 1(b), 7).

34. These include exclusions for gifts and inheritances, tax-exempt bond interest, damages received as compensation for personal injury, certain non-cash fringe benefits (such as meals and lodging or parking provided primarily for the convenience of the employer), and certain amounts attributable to the discharge of indebtedness. Nunn-Domenici Tax, § 201(a) (amending I.R.C. § 4).

35. The Nunn-Domenici Tax allows a "homeowner" deduction, a "philanthropic transfer" deduction, an alimony deduction and a personal and dependency deduction. Nunn-Domenici Tax, *supra* note 10, § 201 (amending I.R.C. § 1). The allowance of a personal and dependency deduction under the Nunn-Domenici Tax is substantially equivalent to the treatment of like amounts under the current system. Although the Code uses the term exemption with respect to the amounts allowed for the taxpayer, spouse, and dependents, section 151(a) provides that the exemption amounts shall be allowed as deductions. *See* I.R.C. § 151(a) (West 1996).

36. The Nunn-Domenici Tax adds an education deduction and a transition basis deduction. Nunn-Domenici Tax, *supra* note 10, § 201 (amending I.R.C. §§ 1(b)(1)(3)(B), 1(b)(1)(4)).

37. The Nunn-Domenici Tax has been described as consisting of a VAT at the business level and a cash-flow consumption tax at the individual level. *See* Jane G. Gravelle, *The Distributional Effects of Fundamental Tax Revisions*, 33 SAN DIEGO LAW REV. 1419 (1997). For insightful commentary on why current tax reform proposals, which would enact taxes that are perhaps closer to consumption taxes than to income taxes, are nevertheless drafted to look like income taxes, *see* Graetz Testimony, *supra* note 4, at 1260; Lawrence Zelenak, *Flat Tax vs. VAT: Progressivity and Family Allowances*, 69 TAX NOTES 1129, 1134 (1995). The cognitive phenomenon of "status quo bias," which suggests a preference for the familiar, is another reason for disguising consumption taxes as income taxes. *See* Deborah A. Geier, *Cognitive Theory and the Selling of the Flat Tax*, 71 TAX NOTES 241 (1996) (citing Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1871 (1994)).

The Nunn-Domenici Tax is therefore more like the Armeiy Flat Tax than like the current income tax in what it actually attempts to tax. Although the Nunn-Domenici Tax begins with a broad definition of income, which it reduces to a narrow tax base through the mechanism of deductions, as does the current income tax (rather than beginning with a narrow base, as does the Armeiy Flat Tax), that similarity is structural only. Like the base of the Armeiy Flat Tax, the base of the Nunn-Domenici Tax is radically different from that of the current system.

Unlike the individual portion of the Nunn-Domenici Tax, the business portion of the Nunn-Domenici Tax is both structurally similar to the Armeiy Flat Tax and quite different from the current income tax. The business portion of the Nunn-Domenici Tax imposes a flat 11% tax on the "gross profit of [a] business entity for the taxable year."³⁸ Like "gross active income" under the Armeiy Flat Tax, the term "gross profit" under the Nunn-Domenici Tax is narrowly defined to include only receipts from the sale or use of property or the performance of services in the United States, minus certain deductions.³⁹ The Nunn-Domenici Tax allows deductions for the costs of business purchases, loss carryovers, and the amount of a taxpayer's "transition basis," but it allows no deduction for the amount of wages paid to employees.⁴⁰

As under the Armeiy Flat Tax, under the Nunn-Domenici Tax businesses are taxed only on their income from business operations. Investment income is not included in the business tax base, but the costs of servicing investments are not deductible.

The business portions of the Armeiy Flat Tax and the Nunn-Domenici Tax are also similar in that both impose a tax directly on business activity regardless of the entity through which the business is conducted. Both taxes therefore differ from the current system in two significant respects. First, unlike the current system, neither the Nunn-Domenici Tax nor the Armeiy Flat Tax distinguishes between entities with respect

38. Nunn-Domenici Tax, *supra* note 10, § 301 (amending I.R.C. § 201(b)). The actual tax liability under the Nunn-Domenici Tax will be the excess of the business tax over the payroll tax credit, described *infra*. *Id.* (amending I.R.C. § 201(a)).

39. *Id.* (amending I.R.C. §§ 202-03).

40. Nunn-Domenici Tax, *supra* note 10, § 301 (amending I.R.C. § 204); *id.* § 301(a) (amending I.R.C. §§ 205(a)(3), (4)). For further discussion of the non-deductibility of wages under the Nunn-Domenici Tax, see *infra* notes 59-60 and accompanying text.

to taxation.⁴¹ Tax-motivated choice of entity questions would disappear under either tax. Second, unlike the current system, both the Nunn-Domenici Tax and the Arney Flat Tax attempt to integrate the business and individual income taxes. They achieve integration in varying degrees and through different mechanisms.

C. *Integration of Business and Individual Taxes*

1. *The Mechanisms: Yield Exemption and Consumed Income Taxes*

The Arney Flat Tax integrates the business and individual income taxes by simply not including returns on material capital in the tax base of either individuals or businesses.⁴² Business income is therefore taxed once when it is earned as "gross active income" by a business, but

41. In this respect, given the recent issuance of the check-the-box regulations in final form, the Nunn-Domenici Tax and the Arney Flat Tax differ from the current system only in the taxation of corporations and publicly-traded partnerships. Treas Reg. § 301.7701-3 (1997), issued on December 17, 1997. Under the check-the-box regulations, entities other than corporations, and publicly-traded partnerships (which are treated as corporations for tax purposes pursuant to I.R.C. § 7704), may elect to be treated either as corporations or as partnerships. Entities may therefore reap the most significant benefit of incorporation—limited liability—without necessarily suffering the detriments imposed by Section 11 and Subchapter C, just as they would be able to under either the Arney Flat Tax or the Nunn-Domenici Tax. For thoughtful commentary on the regulations as proposed, and as issued in final form, see W. Kirk Wallace, *Check-the-Box Regulations Released in Proposed Form*, 71 TAX NOTES 1401 (1996); Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 71 TAX NOTES 1679 (1996); David S. Miller, *The Tax Nothing*, 74 TAX NOTES 619 (1997); Lawrence M. Axelrod, *Are Consolidated Returns Obsolete?*, 97 TAX NOTES TODAY 3-78 (Jan. 6, 1997), available in LEXIS, Taxana Library, TNT File.

42. I use the term integration here as it has been used under the current system, to signify the fusion of the corporate and individual income tax systems into a system that taxes a particular type of income only once as it moves from original earner to final consumer. See, e.g., Alvin C. Warren, Jr., *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981); George K. Yin, *Colloquium on Corporate Integration: Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431 (1992); George K. Yin, *Achieving Corporate Integration Through Double Taxation*, 56 TAX NOTES 1365 (1992); Jasper Cummings, *Taxing Business Income Once: Where's the Beef? A Review and Critique of the Treasury Integration Study*, 54 TAX NOTES 1391 (1992); Jeffrey L. Kwall, *The Uncertain Case Against the Couble Taxation of Corporate Income*, 68 N. C. L. REV. 613 (1990); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965 (1988-89); Stanley S. Surrey, *Reflections on "integration" of Corporation and Individual Income Taxes*, 28 NAT'L TAX J. 335 (1975); Alvin C. Warren, Jr., ALI Federal Income Tax Project, Reporter's Study of Corporate Tax Integration (March 31, 1993); DEPARTMENT OF THE TREASURY, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992).

is excluded from the tax base for evermore. The Arme y Flat Tax is thus a variant of what economists refer to as a "yield exemption tax."⁴³

In its pure form, a yield exemption tax provides for cash-flow treatment of business-level, non-financial investment, but ignores loans and interest at both the individual and business levels.⁴⁴ A yield exemption tax is thus somewhat like a back-loaded IRA, where contributions are not deductible and are thus taxable at least once, when earned, just as business active income is taxed under the Arme y Flat Tax, but distributions are exempt from tax, just as all investment income is exempt under the Arme y Flat Tax.⁴⁵

By contrast to a yield exemption tax, which taxes income but exempts yield, a consumed income tax does not tax income that is saved, but it then taxes the full amount, income plus yield, when the amounts are withdrawn from savings for use in consumption. If a yield exemption tax is like a back-loaded IRA, a consumed income tax is like a front-loaded IRA, where amounts are deducted from the tax base when saved but then are subject to tax when consumed.

The individual portion of the Nunn-Domenici Tax is a form of consumed income tax.⁴⁶ The Nunn-Domenici Tax allows individuals

43. See, Charles E. McLure, Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption*, in *FRONTIERS OF TAX REFORM*, *supra* note 27, at 72-73.

44. *Id.* at 73.

45. Of course, a back-loaded IRA is not precisely the same as a yield exemption tax because amounts deposited in an IRA could very possibly have already been taxed more than once, not just because they might have been subject to payroll taxes, but because the amounts may have been taxable to the payor. Amounts received by a payee might have been taxable to the payor whenever they were not deductible to the payor. That might occur when one individual pays for services rendered by another individual who is an independent contractor. Thus, someone providing piano lessons in her home would be an independent contractor and have compensation income, but the cost of the lessons would not be deductible to most pupils or their parents.

46. The Nunn-Domenici Tax is not a pure consumed income tax because such a tax would include borrowings in the tax base, and the Nunn-Domenici Tax does not include borrowings in the tax base directly; section 4(a)(7) of the tax excludes "repayable amounts" from income. Nevertheless, the Nunn-Domenici Tax does include some borrowings in the tax base to the extent necessary to prevent the unlimited savings allowance from becoming a tax shelter by allowing taxpayers to deduct amounts borrowed and saved. It accomplishes this by reducing the deduction for amounts saved by the total amount of "non-exempt borrowing." Nunn-Domenici Tax, *supra* note 10, § 55. "Non-exempt borrowing" is defined as the amount of debt outstanding during the year, other than home mortgage debt on the taxpayer's principal residence, debt incurred to acquire consumer durables (up to \$25,000), charges for the acquisition of goods and

to deduct all amounts saved and then includes in income all amounts withdrawn from savings, presumably for use in consumption. It thus operates much like a front-loaded IRA, in which amounts contributed to the account are deductible, but withdrawals are taxable.⁴⁷ Because economists are confident that yield exemption taxes and consumed income taxes are generally equivalent in present value terms,⁴⁸ it would seem that the individual portions of the Armev Flat Tax (yield exemption) and the Nunn-Domenici Tax (consumed income) are probably equivalent in present value terms.⁴⁹

services to the extent paid within the billing cycle in which they are billed, and \$10,000 of other debt. By reducing the amount of the unlimited savings allowance deduction to the extent of non-exempt borrowing, the Nunn-Domenici Tax includes in income amounts that would have been included but for the borrowing, and thus indirectly taxes borrowing.

47. See I.R.C. § 219 (West 1996).

48. See, Charles E. McLure, Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption*, in FRONTIERS OF TAX REFORM, *supra* note 27, at 88. See also Appendix B, *Equivalence of a Broad-Based Consumption Tax and a Tax on Wages and Old Capital*, STAFF OF THE JOINT COMMITTEE ON TAXATION, METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 113, JCS-7-93, June 14, 1993.

49. Proposals to introduce a so-called "back loaded" Individual Retirement Account in the late 1980's and early 1990's provided many occasions for explanation of this general equivalence. See, e.g., Joint Committee on Taxation, *Description and Analysis of S. 612 (Savings and Investment Incentive Act of 1991)* (JCS 5-91) (May 14, 1991). More recently, Gene Steuerle has succinctly explained:

If tax rates are constant throughout time . . . pure *ex ante* and pure *ex post* taxes leave the taxpayer in exactly the same position when all is said and done. In mathematical terms, suppose I have some money (wages) that would be taxed at a rate "t." If that is the only tax that is imposed on me, for every dollar of wage, I will be left with $\$(1-t)$. If this grows at the rate of return "r" over some period of time, and r is not taxed, then I am left at the end with exactly $\$(1-t)(1+r)$. In this tax system, returns from new investment, which produce r, are taxed at a zero rate.

Suppose, instead, that no tax is imposed at the beginning provided I put this otherwise taxable money (wages) into an investment. For example, I will not be taxed initially on my wage if I am allowed to expense or write off that money when I purchase an investment with it. Suppose I start with \$1, and it produces a rate of return r that is also not taxed over the period that it is earned, but not withdrawn. Then at the end of this period I have $\$(1+r)$, and, if it is taxed when withdrawn as a pure *ex post* tax, I have exactly $\$(1+r)(1-t)$. As can be seen, the two expressions $\$(1-t)(1+r)$ and $\$(1+r)(1-t)$ are equivalent.

One can reach another type of equivalence above by actually letting r be taxed. In addition to the taxation of r, the government still has a choice as to whether to impose an up-front tax or one on ultimate withdrawal. In a one-period example, if one pays up front, the total amount of wealth left at the end of one period is equal to $(1-t)[1+r(1-t)]$. If one pays later on the entire withdrawal, the total amount left is equal to $[1+r(1-t)](1-t)$. Again, they are equal in value.

Gene Steuerle, *Zero Tax Rates on Returns To New Investment & Learning*, 72 TAX NOTES 1311 (1996). Nevertheless, Eric Engen and William Gale have argued

The business portions of the Arme y Flat Tax and the Nunn-Domenici Tax would impose yield exemption taxes. However, although the Arme y Flat Tax is a yield exemption tax in its entirety, the Nunn-Domenici Tax is actually a hybrid. It is a yield exemption tax in its business application but a consumed income tax in its individual application.⁵⁰

Thus, both the Arme y Flat Tax and the Nunn-Domenici Tax attempt to tax business income only once, although they differ in the way they attempt to accomplish that result and achieve it with different degrees of success. By attempting to integrate the business and individual taxes, both the Arme y Flat Tax and the Nunn-Domenici Tax depart significantly from the current system. Exploration of the ways in which they effect that departure is therefore appropriate.

2. *The Proposals: The Arme y Flat Tax*

The Arme y Flat Tax creates two tax systems, one for employee compensation and one for what it classifies as the active income of businesses.⁵¹ The Arme y Flat Tax taxes each of these types of receipts

persuasively that this general equivalence does not make wage taxes equal to consumption taxes because consumption taxes tax consumption from previously existing assets, whereas wage taxes do not, and consumption taxes tax excess returns to new capital, whereas wage taxes do not. Eric M. Engen & William G. Gale, *The Effects of Fundamental Tax Reform on Savings*, in FUNDAMENTAL TAX REFORM, *supra* note 30 at 83, 89-92.

50. Curiously, Charles McLure and George Zodrow have proposed a hybrid consumption tax with precisely the opposite design. See, McLure & Zodrow, *supra* note 43, at n.12.

51. The Arme y Flat Tax imposes a tax on "business activities." Arme y Flat Tax, *supra* note 9, § 11(a). That tax is imposed on "business taxable income," which is defined as "gross active income." *Id.* Gross active income is, in turn, defined as:

[G]ross receipts from

- (I) The sale or exchange of property or services in the United States by any person in connection with a business activity, and,
- (II) The export of property or services from the United States in connection with a business activity.

Id. The Arme y Flat Tax provides no further definition, although it does note that: "For purposes of this section, the amount treated as gross receipts from the exchange of property or services is the fair market value of the property or services received, plus any money received." *Id.* § 11(c)(2)(C). Careful readers will notice that some of the terms in the foregoing definition are closely analogous to terms that are relevant under the current tax system and that have been difficult to define under it. (Just two examples are "active business" under Code section 355 and "trade or business" under Code section

only once, and accomplishes this result through two related mechanisms.

First, the Arme y Flat Tax ensures taxation of employee compensation at least once. The Arme y Flat Tax does this by making cash wages deductible at the employer level but including such wages in the income of employees.⁵² The Arme y Flat Tax also taxes non-cash compensation (fringe benefits) only once. Although non-cash compensation is not includable in the income of employees, it is not deductible by employers and thus effectively bears a tax at the employer level.⁵³ By contrast to the current system, which exempts much non-cash compensation from taxation altogether through the mechanism of a deduction at the employer level coupled with an exclusion at the employee level, the Arme y Flat Tax ensures that the cost of fringe benefits is taxed once—at the employer level. The Arme y Flat Tax thus subjects to tax significant amounts of income from labor that the current system leaves untaxed.

Second, the Arme y Flat Tax ensures taxation of business active income once, by making such income taxable at the business level regardless of the legal form in which the business is conducted, but leaving returns on investments out of the tax base altogether. That narrow definition leaves all other types of income, which include the return on investment received by both businesses and individuals, as well as windfalls and possibly most damage recoveries, outside of the definition of income and therefore exempt from further taxation.⁵⁴ By separating the taxation of business income from the taxation of employee compensation, the Arme y Flat Tax makes very difficult the type of tax shelter activity that spawned the passive activity rules⁵⁵ and the at-risk rules⁵⁶ that have so complicated the current statute.⁵⁷

162.) For example, there is no reason to think terms like “business activity,” will be any easier to define under the Arme y Flat Tax than similar terms are under the current system. Indeed, the terms might be even more troublesome given that concluding that an amount falls outside the meaning of that term has the effect of exempting that amount from tax completely.

52. *Id.* §§ 63(a)(1)(A), 102(d)(1)(B).

53. *Id.* §§ 102(d)(1)(B), 102(d)(2)(A)(ii).

54. The definition of income under the Arme y Flat Tax differs for financial intermediaries, however. The Arme y Flat Tax provides that “in the case of the business activity of providing financial intermediation services, the taxable income from such activity shall be equal to the value of the intermediation services provided in such activity.” *Id.* § 11(e) (amending I.R.C. § 11(e)). With respect to damages, much would depend on whether the term “wages” is found to include wage substitutes or replacements.

55. I.R.C. § 469 (West 1996).

56. I.R.C. § 465 (West 1996).

57. By adopting a single rate for both employee compensation and business income but imposing a separate tax on business income and eliminating deductions at the individual level, the Arme y Flat Tax largely eliminates the need for rules that distinguish between business and non-business activities. *See, e.g.*, I.R.C. § 183 (West 1996). Since

3. *The Proposals: The Nunn-Domenici Tax*

The Nunn-Domenici Tax differs from the Arney Flat Tax both in its taxation of wage income and in its taxation of business income. Unlike the Arney Flat Tax, which taxes cash wages only once—at the individual level and at a flat rate—the Nunn-Domenici Tax will sometimes tax cash wages twice—once at the business level and again at the individual level—and will do so at different rates.⁵⁸ Under the Nunn-Domenici Tax, cash wages are not deductible at the business level, and amounts paid as cash wages are therefore subject to tax at that level, at least if the business has any taxable receipts.⁵⁹ Such amounts may be taxable again at the individual level because the Nunn-Domenici Tax includes them in the tax base as income and then removes them only if they are saved. Cash wages received by individuals who do not save them will thus be taxed twice—once at the business level and then again when presumptively consumed at the individual level.⁶⁰

business expenses (business purchases under the Arney Flat Tax) are only deductible from business income, unless an activity generates income, no amounts attributable to it will be deductible. Although the Arney Flat Tax does provide for the deduction of loss carryovers (*see* Arney Flat Tax, *supra* note 9, § 207) deduction of carryovers is only permissible against business income, so that by its structure, the Arney Flat Tax achieves the same result as sections 183 and 469 of the Code. Of course, businesses, particularly manufacturing businesses that make large capital outlays, will be able to shelter large amounts of income under the Arney Flat Tax, and individuals who would only be taxed on wages and business income would have an incentive to categorize all non-wage income as non-business.

58. The Nunn-Domenici Tax imposes a flat tax of 11% on the “gross profit of [a] business entity for the taxable year.” Nunn-Domenici Tax, *supra* note 10, § 201(b). As currently drafted, the rate schedule for individuals under the Nunn-Domenici Tax phases down over the lower brackets for a period of four years, but in the first year it would impose a tax that begins at 19% for married individuals filing a joint return who have taxable income of less than \$5,400, moves to 27% for taxable income between \$5,400 and \$24,000, and caps out at 40% for taxable income over \$24,000. *Id.* § 15(a)(1). When fully phased in, the tax on married people filing a joint return would be 8% on taxable income of less than \$5,400, 19% for taxable income between \$5,400 and \$24,000, but still 40% for taxable income over \$24,000. *Id.*

59. The Nunn-Domenici Tax specifically provides that compensation expenses of employees are not deductible to businesses. Nunn-Domenici Tax, *supra* note 10, § 301(a) (amending I.R.C. § 205(a)(3)-(4)). Compensation paid to independent contractors is deductible. *Id.* § 301(a) (amending I.R.C. 205(a)(2)(D)).

60. These amounts will be taxed at different rates; 11% at the business level and graduated rates that go up to 40% at the individual level. *See supra* note 58.

The taxation of non-cash wages, that is, fringe benefits, is somewhat more complicated. Some such amounts will be taxed twice under the Nunn-Domenici Tax while others will not be taxed at all. Under the Nunn-Domenici Tax some fringe benefits are excludable from the income of employees. Indeed, the list of excludable fringe benefits bears a striking resemblance to that in sections 132 and 119 of the current Code.⁶¹ If they are deemed to constitute additional, albeit non-taxable, compensation to the employee, those excludable fringe benefits will probably not be deductible at the business level.⁶² In that case, the cost of such benefits would be taxed once, at the business level.

If they are not deemed to constitute additional compensation (perhaps because they are not treated as income to the employee), the cost of providing such benefits might be deductible to the employer. In that case, by allowing a deduction at the business level and permitting an exclusion at the individual level, the Nunn-Domenici Tax would fail to tax the costs of such fringe benefits at all. In this regard, the Nunn-Domenici Tax would treat those fringe benefits in the same way that the current system treats them.⁶³

Nevertheless, not all fringe benefits would receive such generous treatment. The value of any fringe benefit that is included in an employee's income as compensation will not be deductible to the business that provides it; such amounts will therefore be subject to tax at both the business and individual levels. Like wages, then, the cost of fringe benefits included in an employee's income will be taxed twice under the Nunn-Domenici Tax unless the employee manages to save an offsetting amount.⁶⁴ Even then, taxation at the individual level will

61. See Nunn-Domenici Tax, *supra* note 10, § 4(a)(6)(B).

62. The text of the proposed statute is unclear on the treatment of excludable fringe benefits at the business level. Although the Nunn-Domenici Tax specifically provides that compensation expenses are outside the definition of "business purchases" that may be deducted from taxable receipts to arrive at the gross profit that is subject to taxation (see Subchapter B of the proposal), and further provides that fringe benefits included in an employee's income are also not deductible at the business level, it is silent on the treatment of the cost of fringe benefits that are excluded from the employee's income. Deductibility will probably turn on whether such expenses are seen as compensatory.

63. The Nunn-Domenici Tax defines the category of fringe benefits that receive this favorable treatment somewhat differently than does the current Code. For example, although Code section 132(f)(5)(C) allows an employee to exclude from income the value of parking provided by an employer even if the employee does not require that an employee use a vehicle on company business, the Nunn-Domenici Tax so limits the exclusion. See Nunn-Domenici Tax, *supra* note 10, § 4(a)(6)(B).

64. In some cases it will be easy for the employee to obtain a savings deduction, as in the case of retirement contributions, but in other cases, such as the cost of employer-provided parking or education that will be nearly impossible. See *id.* § 205(a)(4)(D). The provision of the benefit will always be effectively taxed to the

only be deferred, as the amounts will be subject to tax at the individual level when withdrawn from savings for use in consumption.

Non-wage income of individuals may also be taxed more than once under the Nunn-Domenici Tax. Although business income will only be taxed once at the business level because the business tax base includes only the amounts received from the conduct of business activity (and thus excludes returns on investment received at the business level), such income may be taxed again at the individual level. This will occur when an individual does not save business income received.

Double taxation of business income will be most conspicuous, and most like that which occurs under the current system, when business income is received by an individual as a return on investment and is then consumed, rather than saved.⁶⁵ Unlike the Arney Flat Tax, the Nunn-Domenici Tax only succeeds in integrating the business and individual income tax systems when individuals save the business income they receive, and the systems remain integrated only so long as the amounts remain saved. Business income will be taxed again at the individual level when and if consumed.⁶⁶ Perhaps it is this potential for double taxation of business profits that explains the low flat rate of tax on

employee in that it will always increase the employee's income base while not always providing for an offsetting deduction.

65. Indeed, since the business and individual portions of the Nunn-Domenici Tax are only integrated when taxpayers take particular actions, it may be misleading to refer to the tax as integrating business and individual taxation, at least in the sense that the term integration is used in other contexts, where unification of two systems does not depend on specific taxpayer action. For a discussion of integration of the income and employment tax systems under the Nunn-Domenici Tax, see Part D, *infra*.

66. Despite the general equivalence of yield exemption and consumed income treatment, (see McLure & Zodrow, *supra* note 43, at 88) taxation of business income saved but eventually consumed by individuals under the USA tax is not equivalent to the exemption provided by the Arney Flat Tax. For example, \$x earned by business A and distributed to individual Y as a dividend will not be taxed again to Y under the Arney Flat Tax regardless of what Y does with it. By contrast, \$x paid by business B to individual Z under the Nunn-Domenici Tax will be taxed again to Z if Z chooses to consume it rather than to save it. Perhaps what this suggests is that the Arney Flat Tax is a yield exemption tax only with respect to its treatment of wages at the individual level, for with respect to other income, the Arney Flat Tax not only exempts the yield but exempts the income as well. The taxes could be equivalent with respect to wages, for \$x wages paid by business A to individual Y will be taxed to Y under the Arney Flat Tax but any amounts yielded by the investment of \$x wages will not be taxed again to Y. By contrast, \$x wages paid by business B to individual Z under the Nunn-Domenici Tax will not be taxed to Z if saved, and both \$x and the amounts yielded by it will be taxed to Z when removed from savings for use in consumption.

business income (eleven percent) when compared to individual income, which is subject to rates than can be as high as forty percent.⁶⁷

D. *Integration of the Income and Employment Tax Systems*

Although the Nunn-Domenici Tax fails to achieve complete integration of the business and individual income tax systems, it does succeed in achieving another type of integration: integration of the income and employment tax systems. The Nunn-Domenici Tax integrates these tax systems by allowing a credit for the amount of social security (FICA) or SECA,⁶⁸ tax paid by both employers and employees.⁶⁹ For individuals, the Nunn-Domenici Tax allows a refundable credit for the amount of social security taxes paid as well as for half of the amount of SECA taxes paid.⁷⁰ For businesses, the Nunn-Domenici Tax allows a credit for the amount of social security taxes paid, and in the case of sole proprietors or partners in partnerships, one-half of SECA taxes paid.⁷¹

67. See *supra* note 58. This potential for double taxation occurs even if the business-level Nunn-Domenici Tax is viewed as a VAT, and it is assumed that price levels will adjust in response to the tax. See Gravelle, *supra* note 37. In that case individuals will bear the economic burden of the tax when they consume, effectively bearing the economic burden of the business and individual levels of the tax at the same time.

68. The SECA, or Self-Employment Contributions Act, tax is the analog to the social security tax for self-employed individuals. See I.R.C. §§ 1401-03 (West 1996). It is imposed by section 1401 of the Code on the self-employment income of individuals at rates that are now the same as the sum of the employee's and employer's share of the FICA tax. The effect of the SECA tax is to treat self-employed individuals as both employer and employee with respect to the payment of employment tax. Under current law, only a portion of the SECA tax is deductible by individuals. I.R.C. § 164(f) (West 1996).

69. Section 21(a) of the proposal provides a credit for the sum of "(1) the employee's share of the basic FICA tax, (2) the employee's share of the basic tier 1 railroad retirement tax, and (3) one-half of the basic SECA tax payable with respect to the taxpayer's compensation or earnings during the taxable year." SECA, § 21(a). Section 282(a) of the proposal provides a credit for the sum of "(1) the employer's share of the FICA tax imposed on wages of its employees during the taxable year, (2) the employer's share of the tier 1 railroad retirement tax for its employees during the taxable year, and (3) one-half of the allocable portion of the SECA tax (as described in subsection (b)(3))." SECA, § 282(a).

70. See *supra* note 69. Section 21(c) of the Nunn-Domenici Tax precludes any credit for amounts refunded to an individual because they were paid on amounts that exceed the wage base. Nunn-Domenici Tax, *supra* note 10, § 21(c). Section 6413(c)(1) of the Code now provides for a refund of such amounts and would presumably survive the amendment of the Code to be effected by the Nunn-Domenici Tax. I.R.C. § 6413(c)(1) (West 1996). Section 20(b) provides that certain credits, including the payroll tax credit are, refundable or may, at the taxpayer's election, be treated as a tax paid for the following year.

71. See *supra* note 69 for an explanation of the credit.

Although the business level payroll tax credit is not refundable, it can be carried over for up to fifteen years.⁷²

E. Summary: Comparison of the Salient Features of the Arme y Flat Tax and the Nunn-Domenici Tax

Despite the general equivalence of yield exemption and consumed income taxes,⁷³ examination of the specific provisions of the Arme y Flat Tax and the Nunn-Domenici Tax has revealed that the taxes are quite different from one another and would produce results that render them equivalent neither to each other nor to the current income tax. Indeed, each would make significant changes to the current system. The Arme y Flat Tax would integrate the individual and business taxes completely but would not change the relationship between the income and payroll tax systems. By contrast, the Nunn-Domenici Tax would integrate the business and individual taxes only partially but would integrate the income and payroll tax systems completely. In addition, while the Arme y Flat Tax would subject fringe benefits to tax at the business level, the Nunn-Domenici Tax would continue to exclude certain fringe benefits from the tax base while subjecting others to two levels of taxation. Each of these changes has important consequences for the ability of individuals to exercise choice with respect to the determination of the tax burden they are ultimately to bear.

III. AVOIDANCE POWER

The way in which a tax system is designed determines the extent to which individual behavioral choices affect the imposition of the tax.⁷⁴ A system of head taxes, for example, gives individuals scant opportunity to act in ways that affect the size of their tax bill. By contrast, a tax system rife with incentives for specific types of behavior gives individuals ample opportunities to act in ways that affect the size of their tax bill. The Internal Revenue Code currently imposes taxes that evoke both of these prototypes. Whereas the individual income tax allows taxpayers to affect the amount of their tax liability by making certain

72. Nunn-Domenici Tax, *supra* note 10, § 283.

73. *See supra* notes 48 and 66 and accompanying text.

74. The following discussion is taken from Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, at 13-17.

choices, such as the choice to buy a house rather than to rent, the social security tax provides few such choices.⁷⁵ In addition, the federal income tax system correlates the degree of choice it provides to a taxpayer's ownership of material capital.⁷⁶ The social security system also reserves for the holders of material capital the few choices it provides.⁷⁷ The grant of opportunities for the exercise of taxpayer choice, coupled with the preservation of those opportunities for the holders of material capital, reflects and reinforces particular values. Those values are personal autonomy and the ownership of material capital.

The grant of taxpayer choice reflects the value of personal autonomy because having choices empowers people. It allows them to control their destinies. Those who value personal autonomy should therefore want to know the extent to which a particular tax system design provides for the exercise of personal autonomy as well as the identity of those who receive the opportunity to exercise such autonomy. Both the Armev Flat Tax and the Nunn-Domenici Tax would change the opportunities for the exercise of personal autonomy provided by the tax system. They would therefore change the quantum of power bestowed by the tax system. Because the quantum of power it provides is an important feature of any tax system, examination of the ways in which the Armev Flat Tax and the Nunn-Domenici Tax would change that quantum is important to a study of the tax systems they would establish and may even serve as a guide to the likelihood that either will become law.

As Part II described in detail, although both the Armev Flat Tax and the Nunn-Domenici Tax narrow the tax base for individuals, each adopts a different strategy for doing so. The Armev Flat Tax narrows the base by narrowing the definition of income; the base starts out narrow and remains that way. By contrast, the Nunn-Domenici Tax starts with a broad base and then narrows it by providing deductions and credits. This difference in strategy creates a significant difference in the quantum of avoidance power the two systems provide.

75. I use the phrase "social security tax" to refer both to the tax imposed on employers and employees by Chapter 21 of the Code and to the tax imposed on self-employed individuals by Chapter 2 of the Code.

76. Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, at 36-37.

77. *Id.* at 39-45.

A. The ArmeY Flat Tax

1. The Individual Portion of the Tax

The ArmeY Flat Tax provides little avoidance power for individuals who derive most of their income from cash wages and who have little choice but to do so. All of the income received by such individuals would be included in the tax base under the ArmeY Flat Tax and would be taxed to the extent that it exceeds a threshold amount.⁷⁸ The only ways in which such an individual can avoid the imposition of the tax on income above that threshold amount are not to work, not to work for cash, or to leave the United States.⁷⁹ Leaving the United States is not

78. The only deduction the ArmeY Flat Tax provides is the standard deduction. ArmeY Flat Tax, *supra* note 9, §§ 63(b)(2)(A), (C) (amending I.R.C. § 63(a)(1)). The standard deduction consists of a basic standard deduction of \$21,400 for couples filing a joint return and \$10,700 for individuals, plus an additional standard deduction of \$5,000 for each dependent. *Id.* § 63 (b)(3) (amending I.R.C. § 63(b)). Under the ArmeY Flat Tax, then, the amount of cash wages, retirement distributions, and unemployment compensation received would be taxed at a flat rate to the extent that it exceeds the sum of the basic standard deduction and additional standard deduction.

79. Unlike the current system, the ArmeY Flat Tax would create a territorial system of taxation, so no tax would be due on amounts not earned in the United States. *See* ArmeY Flat Tax, *supra* note 9, § 101(b) (amending I.R.C. § 63(a)(1)(A)). *See also*, Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219 (1997); James R. Hines, Jr., *Fundamental Tax Reform in an International Setting*, in FUNDAMENTAL TAX REFORM, *supra* note 30, at 465, 473.

Because U.S. taxpayers could avoid the ArmeY Flat Tax through mere physical departure from the United States, (rather than renunciation of citizenship or residency), the ArmeY Flat Tax would provide slightly more avoidance power than that provided by the current tax system. The federal income tax not only taxes the worldwide income of citizens and residents, but also taxes some of the U.S. source income of former citizens and residents who renounce their citizenship, or relinquish their residency. I.R.C. §§ 877(a), (e), 7701(b)(10) (West Supp. 1996). Nevertheless, the increase in avoidance power provided by the ArmeY Flat Tax on this ground is slight for two reasons.

First, the social security tax, which accounts for a substantial portion of the tax burden of wage earners, is already largely territorial. The social security tax begins by defining employment as service performed within the United States. I.R.C. § 3121(b)(A)(i) (West 1989). While some service performed outside the United States is included in the definition (such as service aboard an American vessel (I.R.C. § 3121(b)(A)(ii) (West 1989)), or, under certain conditions, service performed for an affiliate of an American employer (I.R.C. § 3121(l) (West 1989)), the additions are few. The reach of the SECA tax is somewhat more broad than that of the social security tax, perhaps because the SECA tax is part of the income tax system, which is itself a worldwide system. *See*

a realistic option for most individuals who will be subject to the tax, and not working is not an option for individuals whose labor is their only source of income.⁸⁰ Although not working for cash, or not working exclusively for cash, might seem like an option for many individuals under the Arme y Flat Tax, the operation of the burden power granted to employers effectively removes the usefulness of that option.⁸¹

The most significant quantum of avoidance power the Arme y Flat Tax provides for wage earners is the power to avoid the imposition of the tax by converting wages into dividends or other distributions of capital. However, because wages are deductible at the business level under the Arme y Flat Tax, while dividends and capital distributions are not, only wage-earners who are also business owners will be able to exercise this power. Other wage-earners might try to avoid the imposition of the Arme y Flat Tax by either receiving wages in a different period or having someone else receive the wages, both of which are tried, and generally failed, techniques under the current income tax.⁸²

Because the Arme y Flat Tax is not truly flat, issues of timing and taxpayer identity will remain important under that tax, as they are under the current income tax, at least for taxpayers at the lower end of the income scale. Since the Arme y Flat Tax provides for a large standard

I.R.C. § 1402 (a)(ii).

Second, many of the wage earners, who provide the base for the individual portion of the Arme y Flat Tax, are unlikely to have a choice whether here or abroad. It is no accident that all of those who have reportedly expatriated to save taxes under the current system are holders of large amounts of capital, not wage earners. For an analysis of proposals to change the tax consequences of the renunciation of citizenship, including a description of the scope of the problem and the resulting allocation of power and choice, see Alice G. Abreu, *Taxing Exits*, 29 U.C. DAVIS L. REV. 1087 (1996). The HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 broadened the application of section 877 by providing for a presumption of tax avoidance in certain cases and expanding the definition of U.S. source income subject to tax. P. L. 104-91, 104th Cong., 2d Sess. (1996). See I.R.C. §§ 877 (a), (e), 7701 (b)(10) (West Supp. 1997).

80. Unless a tax is confiscatory, working and paying taxes will always be better than not working, at least up to the point where consuming leisure becomes more attractive. Under the Arme y Flat Tax the choice between working and consuming leisure is somewhat more difficult than under a progressively structured tax because the marginal cost of work, and therefore the marginal value of leisure, does not increase as income increases.

81. See *infra* text accompanying notes 104-07 for a discussion of this point.

82. The ability to accomplish such avoidance will depend on the extent to which the doctrines of constructive receipt and assignment of income, which address those techniques under the current system, become part of the Arme y Flat Tax. See *infra* text accompanying note 139 for a discussion of likelihood of importation of these doctrines. Of course, some possibility for income-shifting exists even after the application of those doctrines, but it is substantially more difficult to accomplish.

deduction,⁸³ it has the effect of providing for a zero bracket that is coextensive with the amount of that deduction. As long as a tax contains brackets, (zero percent and seventeen percent in the Armeiy Flat Tax), taxpayers will have the power to avoid its reach by changing either the timing of income or the identity of its recipient so as to cause it to fall into the zero bracket.⁸⁴ The Armeiy Flat Tax is therefore not bereft of avoidance power for wage earners. Nevertheless, because the Armeiy Flat Tax reserves most of the avoidance power it provides wage-earners for those wage-earners who are also business owners, it, like the current system, has the effect of reserving the lion's share of what avoidance power it does provide for the the owners of material capital.

2. *The Business Portion of the Tax*

The story for individuals who are not primarily wage earners is startlingly different, though analytically more complex. The narrowness of the definition of income would seem to provide such individuals with ample opportunity for the exercise of choice because individuals who have income from material capital can choose whether to receive income from wages as well as income from material capital and thus can choose whether to pay or to avoid the tax on wages.⁸⁵ Still, the analysis is complicated by the integration of the business and individual tax systems and the need to determine the consequences of that integration for the exercise of choice.

83. The deduction is \$21,400 in the case of a joint return. See Armeiy Flat Tax, *supra* note 10, § 101 (amending I.R.C. § 63(b)(2)(A)(i)).

84. See *infra* note 139 and accompanying text.

85. For individual holders of material capital, the Armeiy Flat Tax would seem to provide an abundance of avoidance power, for such individuals could avoid the individual portion of the tax simply by choosing not to work for wages, but to derive all of their income from material capital instead. Indeed, for such individuals, the Armeiy Flat Tax would provide greater avoidance power than the current income tax; choosing to realize income from material capital rather than from labor would not only reduce the rate of tax to which income is subject, as it does under the current system, but it would eliminate the individual tax on income from such capital altogether. Thus, business owners could choose to forego wages and receive dividends instead. Whether exercising such a choice could result in avoidance of the Armeiy Flat Tax as a whole depends on the interaction of the business and individual portions of the tax as I will explain, *infra*, and on the extent to which notions of substance over form would be applied as anti-avoidance mechanisms under that tax, as they are under the current tax system.

Curiously, integration actually reduces choice for the holders of material capital. Under the current system, holders of material capital have ample opportunity for the exercise of choice. The realization requirement means that they can choose whether or not to pay tax on gains by choosing whether or not to realize them.⁸⁶ This choice exists at both the business and individual levels. The Arme y Flat Tax removes this choice, and thus this opportunity to affect the size of the ultimate tax liability, by making realization irrelevant in many contexts.⁸⁷ Since returns on material capital are not subject to tax at either the business or individual levels under the Arme y Flat Tax, realization will be irrelevant in that context. While the removal of a choice that results in the removal of a tax might seem to yield a net positive for taxpayers, that result is far from clear, because the removal of the tax is not as complete as it might first appear.

Under the Arme y Flat Tax the amount of income taxed when earned by a business is potentially greater than the amount of income taxed to businesses under the current system. Although capital purchases will be expensed under the Arme y Flat Tax,⁸⁸ many other items that businesses now deduct in arriving at taxable income will be subject to tax under the Arme y Flat Tax. Two major such items are the cost of employee fringe benefits and the cost of material capital—interest.⁸⁹ For many businesses, particularly the service businesses that comprise an ever increasing segment of the American economy, this shift could result in the taxation of a larger amount of gross income than is subject to tax under current law.⁹⁰ Moreover, the change from a graduated to a flat

86. For many under the current system, realization, and the choice that attends it, also has the effect of a straightjacket which locks in gain in unrealized form.

87. Realization will remain relevant in certain business contexts. *See, e.g.*, *Cottage Sav. & Loan Ass'n v. Commissioner*, 499 U.S. 554 (1991).

88. Of course, immediate deduction of the cost of capital equipment purchases is technically a matter of timing only, since under current rules such cost is fully deductible over time, without reduction for salvage value. I.R.C. § 168 (West 1996); *see* *Simon v. Commissioner*, 68 F.3d 41 (2d Cir. 1995), *aff'g* 103 T.C. 247 (1994); *Liddle v. Commissioner*, 65 F.3d 329 (3d Cir. 1995), *aff'g* 103 T.C. 285 (1994). Nevertheless, timing matters and tax dollars saved on account of the time value of a deduction permitted sooner rather than later are just as valuable as tax dollars saved through an outright reduction in the applicable tax rate.

89. As David Bradford has lucidly explained, the inclusion of interest in the business tax base is consistent with its exclusion from the individual tax base. BRADFORD, *UNTANGLING THE INCOME TAX*, *supra* note 28, 119-29 (1986).

90. Since 1983, goods-producing jobs have remained almost constant, but service jobs have increased by 23 million and currently comprise 79% of the total labor market. *Employment by Major Industry—Actual and Projected*, BUREAU OF LABOR STATISTICS, OFFICE OF EMPLOYMENT PROJECTIONS (Nov. 1995) available on Employment by major industry division, actual, and projected (last modified Apr. 9, 1996) <<http://stats.bls.gov/emptab05.htm>>.

rate structure for businesses could also result in higher business taxes for those businesses that would be denied the benefit the graduated rates currently afford at the lower end of the income scale.

Under the Armeiy Flat Tax, then, businesses that use material capital to purchase items that are immediately deductible in full, even though they generate income for a considerable period of time in the future, will have the greatest quantum of avoidance power. The type of choice that individual holders of capital now have with respect to the realization of gain will be reserved to business managers under the Armeiy Flat Tax, for only they will be able to continue to act in ways that affect the tax liability of the business.⁹¹ The Armeiy Flat Tax is therefore low in avoidance power generally, and what avoidance power it does provide it reserves for holders of material capital who also manage businesses that use large amounts of such capital.

B. *The Nunn-Domenici Tax*

1. *The Individual Portion of the Tax*

By contrast to the Armeiy Flat Tax, which provides significant avoidance power only for business managers, the Nunn-Domenici Tax provides significant avoidance power and grants much of that power to individuals in their capacity as such. Not surprisingly, the Nunn-Domenici Tax is structured like the federal income tax. Although the individual portion of the Nunn-Domenici Tax has a much narrower base than the federal income tax, the Nunn-Domenici Tax, like the federal income tax, provides for a broad definition of income which it then

91. Despite the integration of the business and individual income taxes the Armeiy Flat Tax would achieve, this feature—the reservation of avoidance power to business managers—ought to make the tax particularly attractive to corporate America. Even if Professors Arlen and Weiss are correct that corporate managers actually like the corporate tax because it encourages the retention of earnings at the corporate level and the making of investments that have short term rewards, (Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L. J. 325 (1995)), corporate managers should support the Armeiy Flat Tax. Like the corporate income tax, the Armeiy Flat Tax reserves for corporate managers the opportunity for the exercise of choice. Indeed, an analysis of the corporate income tax through the lens of choice would show that if corporate managers like the corporate income tax (or at least do not dislike it with sufficient vehemence to spend significant amounts of time and money trying to change it), it is probably because the design of that tax reserves for them significant amounts of both avoidance power and burden power.

narrows through the provision of significant deductions. While the Nunn-Domenici Tax would lessen the impact of realization on many taxpayers, the Nunn-Domenici Tax, unlike the Armev Flat Tax, would not render the concept archaic.

Under the Nunn-Domenici Tax realization will continue to be relevant to the determination of income. Individuals will therefore have as much ability to choose to realize income, and thus to incur potential tax liability, under the Nunn-Domenici Tax as they do under the current income tax. In addition, as under the current income tax, under the Nunn-Domenici tax, individuals who choose to engage in activities that result in deductions will be able to reduce substantially, and perhaps even eliminate,⁹² their federal income tax burden.

The Nunn-Domenici Tax provides the highest quantum of avoidance power for those who can afford to invest, rather than consume, their income. In addition to deductions for a family living allowance and alimony and child support, which do not generally involve much exercise of tax-related choice,⁹³ the Nunn-Domenici Tax provides several other deductions that do. Most significant among these is the unlimited savings allowance deduction, which clearly allows for the exercise of taxpayer choice: All amounts saved as provided by the statute are deductible. However, the Nunn-Domenici Tax also provides for other deductions, all of which depend on the exercise of taxpayer choice and all of which involve activities that can be characterized as investments. Those investments are in homes, education, and charitable enterprises.⁹⁴ By providing many opportunities for the exercise of

92. Although the Nunn-Domenici Tax contains a provision designed to prevent individuals from using the unlimited savings allowance deduction as a tax shelter by investing, and therefore deducting, borrowed funds (*see* Nunn-Domenici Tax, *supra* note 10, § 52(a)(2) and *supra* note 46), individuals could still behave in ways that eliminate tax liability because the existence of exclusions from income in the Nunn-Domenici Tax base means that taxpayers could receive and consume exempt income while engaging in deductible activities with the remainder of their income, thus avoiding all tax liability under the Nunn-Domenici Tax.

93. The decision to structure alimony and child support so that payments are deductible to the payor and includable in the income of the payee, as provided by section 5 of the Nunn-Domenici Tax, does permit the exercise of taxpayer choice. However, in most cases, the decision to divorce is probably not tax-motivated. Couples like the Drukers are almost certainly rare. *Druker v. Commissioner*, 697 F.2d 46 (2d Cir. 1982), *cert. denied*, 461 U.S. 957 (1983). The Drukers challenged the constitutionality of the marriage penalty and, after their challenge failed in the lower courts, adopted a do-it-yourself solution to the problem by divorcing but continuing to live together. *Id.* at 50.

94. These are the so-called "USA Deductions": The homeowner deduction, the education deduction, and the philanthropic transfer deduction. Nunn-Domenici Tax, *supra* note 10, § 8. While reasonable people can differ on the question whether housing, education and philanthropy should be characterized as consumption or investment (for two examples of the view that philanthropy is consumption, see Jane B. Baron, *Gifts*,

taxpayer choice, the Nunn-Domenici Tax provides a high quantum of avoidance power.

Having determined that the individual portion of the Nunn-Domenici Tax is high in avoidance power, it is necessary to determine who receives that power. The answer to that is easy: It is those individuals who do not need to consume all of the amounts the Nunn-Domenici Tax classifies as income. In the case of individuals who derive the bulk of their income from wages, this means that the Nunn-Domenici Tax reserves avoidance power for individuals whose wages are high enough to allow them both to consume and to save. Like the current income tax, then, the Nunn-Domenici Tax gives with one hand while it threatens to take away with the other. What it threatens to take away is money, at rates that are not only progressive but that reach slightly higher, and arrive sooner, than those of the current income tax.⁹⁵ What the Nunn-Domenici Tax gives, however, is substantial power to avoid the taking. The recipients of that power are the very people who are most threatened: Individuals at the higher end of the taxable income scale. Because of the unprecedented opportunity for the exercise of choice that the unlimited savings allowance would provide, the avoidance power the Nunn-Domenici Tax confers on those individuals is also significantly greater than that which the current income tax system confers on owners of material capital.

Moreover, the Nunn-Domenici Tax distributes its avoidance power somewhat more broadly than does the current income tax. Under the Nunn-Domenici Tax, avoidance power is not reserved for the holders of material capital, but is also extended to the owners of human capital whose labor commands a sufficiently high price to allow them to save. Such individuals also receive a high degree of avoidance power under the Nunn-Domenici Tax because they will be able to reduce their tax liability by choosing to save rather than to consume.

Bargains, and Form, 64 IND. L.J. 155 (1989); Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1 (1994)), I think it is possible to classify such expenditures as investment because the return they provide is likely to be derived over the long term, rather than, as is usually the case with consumption, over the short term.

95. For married individuals filing a joint return the current income tax reaches its highest bracket, 39.6%, at \$250,000 of taxable income. I.R.C. § 1(a) (West 1996). The Nunn-Domenici Tax reaches its highest bracket, 40%, for such individuals at \$24,000 of taxable income. Nunn-Domenici Tax, *supra* note 10, § 15(a)(1).

The integration of the income tax and social security taxes that would result from enactment of the Nunn-Domenici Tax adds both to the avoidance power it gives individuals generally and to the avoidance power it gives holders of human capital in particular.⁹⁶ Because the payroll tax credit would reduce Nunn-Domenici Tax liability, it would free up those amounts for investment, thus giving even individuals who own only modest amounts of human capital a quantum of avoidance power that is nonexistent under the current system.

2. *The Business Portion of the Tax*

Under the Nunn-Domenici Tax, as under the Armev Flat Tax, realization will be relevant to the determination of business income, but will be largely irrelevant to the taxation of business returns on investment, as those returns will not be subject to tax. Nevertheless, the amount of business income subject to tax is potentially greater under the Nunn-Domenici Tax than under either the current income tax or the Armev Flat Tax. Although capital purchases and the cost of capital (interest) itself would be treated alike under the Nunn-Domenici Tax and the Armev Flat Tax, the cost of labor will be treated differently. Not only are fringe benefits not deductible under the Nunn-Domenici Tax, but wages are not deductible either. The business tax base of the Nunn-Domenici Tax is therefore potentially much larger than that of either the current system or the Armev Flat Tax, and would be particularly so for service businesses. The existence of such an enhanced business tax base would reserve avoidance power for those businesses which could make most use of deductible items—in this case, capital equipment. Thus, although the Nunn-Domenici Tax provides much avoidance power for businesses with respect to investment income, it provides little avoidance power with respect to business income, and what avoidance power it does provide for such income it reserves for capital intensive businesses, and in particular, for the managers of such businesses.

Because the Nunn-Domenici Tax does not completely integrate the corporate and individual income taxes, it would also reserve significant amounts of avoidance power for individuals in their individual capacities. Business income, taxed once, and in some cases only slightly, at the business level, might be subject to tax again at the individual level, but that tax could be avoided by the actions of particular individuals.⁹⁷

96. See *supra* notes 68-72 and accompanying text for a description of that integration.

97. Although business income would be taxed only once, at the business level, (*see* Nunn-Domenici Tax, *supra* note 10, § 4(a)(12)), the return on such income would be

By adding a deduction that is equally available to holders both of human and material capital, the Nunn-Domenici Tax provides more avoidance power overall and distributes that power more broadly than either the current income tax or the Arney Flat Tax. Nevertheless, the Nunn-Domenici Tax reserves that power for individuals who either own material capital or whose income from human capital (wages) is high enough to give them a meaningful choice between saving and consuming. The grant of such a choice is largely positive. Therefore, when the positive aspects of choice are considered, the Nunn-Domenici Tax, like the current income tax, appears less progressive overall than a simple analysis of its rate schedule might suggest.

IV. BURDEN POWER

I have used the term burden power to refer to the ability to shift the economic burden of a tax and I have urged that an explicit examination of the extent to which tax systems confer burden power, and a determination of whom they confer such power on, should be an important aspect of tax policy analysis.⁹⁸ Tax systems high in burden power impose taxes that are invisible and unknown to those who bear them. The economic burden of such taxes proceeds from the decision of specific individuals to shift that burden, and can therefore result in the dissimilar taxation of individuals similarly situated. While tax systems high in burden power might accurately reflect cognitive biases and prove politically easy to implement and maintain,⁹⁹ they deny personal autonomy to those who must ultimately bear their economic burden. The invisibility of such systems renders those subject to them powerless to react politically. In addition, the ability of individuals to act to shift the economic burden of taxes thus imposed results in the privatization of the decision to tax, which further erodes the ability of those subject to such taxes to react to them. Individuals who ultimately bear the economic burden of taxes high in burden power are denied the ability to take action in response to them because they know neither that they bear

taxed again at the individual level if not invested. Such return would constitute income to the individual receiving it and would be subject to tax unless eliminated from taxable income by an offsetting deduction. See *id.* §§ 1(b), 3(a).

98. See Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, at 23-39.

99. See Edward J. McCaffery, *Cognitive Theory and Tax*, 41 U.C.L.A. L. REV. 1861, 1864 (1994).

them nor who might have imposed them. Such tax systems should be eschewed by anyone who values personal autonomy.¹⁰⁰

A. *The Armeiy Flat Tax*

The nominal burden of the individual portion of the Armeiy Flat Tax is imposed on those who will almost certainly bear its economic burden.¹⁰¹ By contrast, the nominal burden of the business portion of the Armeiy Flat Tax is not imposed on those who will bear its economic burden. Since business activity as such is not a corporeal being, it cannot bear the economic burden of the Armeiy Flat Tax. The question, of course, is what a corporeal being does.

By integrating the business and individual tax systems, the Armeiy Flat Tax ensures that income is taxed only once. Thus, under the Armeiy Flat Tax cash wages will be subject to tax at the individual level and not at the business level,¹⁰² and employees will probably bear the economic burden of the tax imposed on them, just as they bear the economic

100. This argument is distinct from the argument about the desirable distribution of the economic burden. Both the Armeiy Flat Tax and the Nunn-Domenici Tax have been assessed as imposing economic burdens that are distributed regressively because they enact tax increases for lower income families and tax reductions for higher income families, Michael J. McIntyre & C. Eugene Steuerle, *Federal Tax Reform, A Family Perspective*, Doc. 96-19672, discussed in Heidi Glenn, *Flat Tax Would Sting Low-Income Families, Study Finds*, 72 TAX NOTES 275 (1996). It is possible that at least part of the reason for this result is the increased quantum of burden power these taxes provide. Gale, Houser and Scholz conclude that the Armeiy Flat Tax would "increase average effective rates by at most 2.2 percentage points for families in the bottom 40% of the income distribution, and by 1.3 percentage points or less for income groups above the fortieth and below the top one percent of the income distribution," and that families in the top 1 percent would receive tax cuts averaging \$37,900; a 7 percent reduction in average effective rates. William G. Gale, Scott Houser & John K. Scholz, *Distributional Effects of Fundamental Tax Reform*, in FUNDAMENTAL TAX REFORM, *supra* note 30, at 289-90. They also conclude that the Nunn-Domenici tax would "keep tax liabilities nearly constant in the bottom decile of the income distribution and lower taxes by 1.1 to 3.2 percentage points for families in the tenth to seventieth percentile of the income distribution. These tax reductions are financed by 3.4 to 5.9 percentage point tax increases in the top 5 percent of the income distribution." *Id.* at 301.

101. Although the incidence of the two tax reform proposals is difficult to determine, economists generally assume that taxes nominally imposed directly on individuals in their individual capacity are economically borne by them. *Id.* at 284; ALBERT ANDO ET AL., THE STRUCTURE AND REFORM OF THE U.S. TAX SYSTEM 32 (1985); Jane G. Gravelle, *The Distributional Effects of Fundamental Tax Revisions*, *supra* note 37; Jane G. Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden?*, 69 TAX NOTES 1517 (1995).

102. I use the term wages here generically, to include amounts that substitute for wages and are therefore subject to tax at the individual level under the Armeiy Flat Tax. See *supra* note 52.

burden of the current income tax on wages.¹⁰³ In addition, under the Arme y Flat Tax employees are likely to bear the economic burden of the tax on non-cash compensation.

Even though non-cash compensation would not be taxed at the employee level, such compensation would be taxed at the employer level.¹⁰⁴ Employers are likely to shift the economic burden of the tax on such non-cash compensation to employees, just as they shift the economic burden of the employer's portion of the social security tax under the current system.¹⁰⁵ This, in turn, will make it practically impossible for employees to avoid the Arme y Flat Tax by choosing to work for non-cash compensation rather than for cash compensation. Employees who succeed in persuading employers to replace cash compensation with non-cash compensation under the Arme y Flat Tax are not likely to receive as much compensation as they would have received if they had been willing to take cash.¹⁰⁶ They will thus bear the economic burden of the tax whether they take a greater amount in cash compensation and pay the tax, or a lesser amount in non-cash compensation, free of tax. As analysis of the social security tax has revealed, the effect of adopting a tax system that provides for a narrow base by limiting inclusions, rather than providing deductions, is to leave those

103. Treasury's Office of Tax Analysis so assumed when it attempted to distribute the burden of the Arme y Flat Tax. See DEPARTMENT OF THE TREASURY, OFFICE OF TAX ANALYSIS, *New Arme y-Shelby Flat Tax Would Still Lose Money, Treasury Finds*, 70 TAX NOTES 451 (1996). Jane Gravelle does likewise in her analysis in this issue, although she takes issue with, and refines, Treasury's position. GRAVELLE, *The Distributional Effects of Fundamental Tax Revisions*, *supra* note 37. See also Gale, et al., *supra* note 100, at 284.

104. See *supra* note 52 and accompanying text for a discussion of taxation of non-cash wages under the Arme y Flat Tax.

105. See *supra* text following note 53.

106. For example, an employer who is willing to pay \$100 in cash compensation might not be willing to pay \$100 in non-cash compensation. The \$100 of cash compensation is deductible and thus costs her only \$83 (a \$100 deduction for an employer who pays taxes at the rate of 17%, as all employers will under the Arme y Flat Tax, brings the cost of the expenditure to \$83 (100 minus 17)). However, the \$100 in non-cash compensation is not deductible and therefore costs her the full \$100. Although such an employer should be willing to pay the employee \$83 in non-cash compensation, for the employee the receipt of \$83 in non-cash compensation is precisely equivalent to the receipt of \$100 in cash compensation. In both cases the employee is left with \$83 after taxes, assuming the cash compensation otherwise received exceeds the standard deduction provided under the Arme y Flat Tax. (The tax rate for individuals is also 17%.)

who cannot control the type of inclusions they receive with scant avoidance or burden powers.¹⁰⁷

In addition to providing employers with burden power with respect to the tax on non-cash wages, the Arme y Flat Tax gives businesses in general, even those businesses that have no employees, significant amounts of burden power with respect to the tax on the proceeds of business activity. Under the Arme y Flat Tax, income other than cash wages will be taxed at the business level only. The Arme y Flat Tax thus has a narrower base at the individual level than does the current income tax. However, by eliminating the taxation of the business income of pass-through entities at the individual level and replacing it with taxation of that income at the business level, the Arme y Flat Tax also creates a broader base at the business level for such entities. This shift from primary taxation of some business income at the individual level to primary taxation of that income at the business level will also shift the allocation of burden power.

It is, of course, axiomatic that only people can bear the economic burden of taxes. While the economic burden of taxes imposed on individual income is generally borne by the individuals on whom the tax is nominally imposed, the economic burden of taxes nominally imposed on businesses can be borne by different categories of individuals. Thus, the economic burden of business taxes can be borne by holders of material capital, in the form of lower returns, by providers of labor, in the form of lower wages, by consumers, in the form of higher prices, or by some combination of the foregoing.

Under the current income tax this analysis has been restricted to the corporate income tax.¹⁰⁸ Because it is a separate tax imposed on distinct entities, the corporate income tax is easy to isolate, and its economic burden therefore cries out for separate distribution.¹⁰⁹ By

107. Although the additional standard deduction provided by the Arme y Flat Tax (*see supra* note 78), is analogous to the dependency exemptions of current law and might conceivably be considered to provide some avoidance power through the acquisition of dependents, any such claim would be spurious. It is difficult to imagine that the economic cost of acquiring a dependent would not exceed the tax benefit of an additional deduction.

108. *See*, Thomas A. Barthold et al., *A Comparison of Distribution Methodologies*, in DISTRIBUTIONAL ANALYSIS OF TAX POLICY 96, 108-09 (David F. Bradford ed., 1995); STAFF OF JOINT COMM. ON TAXATION, 103D CONG., 1ST SESS., METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS 48 (Joint Comm. Print 1993).

109. The Joint Committee on Taxation, the Office of Tax Analysis of the Department of the Treasury and the Congressional Budget Office, each of which produces "burden tables" that show the expected distribution of the economic burden of a tax among the population, all produce such tables for the corporate income tax, although each uses somewhat different assumptions in compiling its tables. *See*

contrast, the income tax that results from the business activities of proprietorships and pass-through entities is hard to distinguish from either the corporate or individual income taxes and generally blends with those taxes in burden tables.¹¹⁰ In addition, recent data shows that C corporations generate more income than S corporations, partnerships, and non-farm proprietorships combined, making the separate distribution of the tax imposed on them more of a social and economic imperative than the distribution of a tax that is smaller and that is blended with the individual income tax.¹¹¹ This combination of factors explains why the federal income tax imposed on the business activities of proprietorships and pass-through entities has not been separately distributed, but the corporate income tax has.¹¹² Nevertheless, if the economic burden of the entity-level corporate tax is shifted, it is reasonable to suppose that the economic burden of a separate, entity level, Armey Flat Tax on non-corporate business entities will be shifted as well.

That all businesses, whether or not in corporate form, could shift the economic burden of the business portion of the Armey Flat Tax, leads to the conclusion that the business portion of the Armey Flat Tax would be high in burden power and that it would bestow such power on the owners of businesses. Since the same could be said of the currently effective federal income tax, the existence of burden power at the

Barthold, *supra* note 108, at 107-09.

110. Income of pass-through entities that have corporate owners would be taxed to those corporate owners and would thus blend with the corporate income tax, and income of pass-through entities that have individual owners would be taxed to those individual owners and thus blend with the individual income tax. While the corporate and individual income taxes are distributed, the amount of such taxes attributable to the income of pass-through entities is not. See Barthold, *supra* note 108, at 108-09; see *JCT Pamphlet*, *supra* note 9, at 72-73.

111. See, Tom Petska, *Taxes and Organizational Choice: An Analysis of Trends, 1985-1992*, in INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULLETIN 86, 91, Figure H (Spring, 1996) [hereinafter SOI Bulletin]. Thus, statistics between 1985 and 1992 show that C corporations had more than seven times the business receipts of S corporations. *Id.* For example, whereas C corporations had business receipts of approximately \$8 trillion, S corporation had receipts of just over \$1 trillion in 1992. In addition, corporations generally had over eight times the business receipts of partnerships and non-farm proprietorships combined. *Id.* Figure G. In addition, C corporations generate three times more profits than S corporations, *Id.* at 91 (Figure J), and corporations generally generate three times the profit of partnerships and non-farm proprietorships. *Id.* at 91 (Figure I).

112. I include proprietorships as entities for this purpose since the Armey Flat Tax is levied on them separately from the individual tax.

business level does not suffice to distinguish the Arme y Flat Tax from the federal income tax. Something else does, however.

That *something else* is the degree of visibility of the business portion of the Arme y Flat Tax. The visibility of a tax affects the quantum of burden power it provides because power has to be perceived to be utilized.¹¹³ A tax that arguably provides the same amount of burden power as the current income tax but that is more visible than the current tax will actually provide a greater quantum of burden power than does the current income tax because the increased visibility of the tax will make it more likely that the burden power it provides will actually be exercised.

The business portion of the Arme y Flat Tax imposes a tax that is more visible than the current income tax imposed on business income earned by proprietorships and pass-through entities. The tax imposed by the business portion of the Arme y Flat Tax is more visible than the current income tax because the business portion of the Arme y Flat Tax is imposed at the entity level. Imposition at the entity level means that the amount of tax due will be determined by the business activity of the enterprise alone rather than by the vicissitudes of the owner's tax situation, as is the case under the current federal income tax insofar as it applies to proprietorships and pass-through entities. In addition, imposition at the entity level means that the tax will have to be paid by the entity, out of entity profits, and will directly reduce the amounts available for distribution to the owners of the business and perhaps even affect an owner's view of a manager's performance.

The business portion of the Arme y Flat Tax will therefore be visible in the way that the present corporate tax is visible, but that the tax imposed on the business activities of pass-through entities, which becomes part of the individual owner's tax liability and varies with the level of that liability, is not. Under the current system, the business tax liability of owners and managers of proprietorships and pass-through entities is part of the total tax liability of such individuals. Although the income from such activities is reported on separate schedules that are sometimes made a part of the individual's return, the actual tax paid on the income generated by such activities is not separately stated or computed.¹¹⁴ The amount of tax ultimately due on that business

113. See Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, at 27-32.

114. Income and deductions from the business activities of proprietorships are reported on Schedule C; income and deductions from the business activities of pass-through entities, such as partnerships and S corporations, are reported on Schedules K-1. Although the Schedules K-1 are not attached to the individual's return, items of income, and some deductions from them, appear on the individual's return. Schedule C is made

income is affected by the owner's filing status, the amount of her income from other sources, and the amount of her personal deductions, such as alimony, home mortgage interest, and charitable contribution deductions, as well as by the availability of dependency exemptions. It is therefore difficult to isolate the amount of tax attributable exclusively to the business.

Under the Arme y Flat Tax, however, the amount of tax liability attributable to business activity will not only be separately stated but will be unaffected by the personal circumstances of the individual owners of the business. Owners and managers of proprietorships and pass-through entities will probably develop a level of business-related tax sensitivity that currently exists primarily for owners and managers of C corporations.¹¹⁵ The increased visibility that will result from entity-level taxation is therefore likely to result in an increase in the quantum of burden power at the entity level.

In sum, the Arme y Flat Tax will not greatly affect the burden power of individual wage earners since they currently have little, and the Arme y Flat Tax does not give them much more. However, the business portion of the Arme y Flat Tax will result in increased utilization of burden power by the owners and managers of proprietorships and pass-through entities. Such increased utilization will have the effect of shifting an increased amount of the economic burden of the taxes imposed on the business activity of proprietorships and pass-through entities from the owners of such entities to other individuals. Those

a part of the individual's Form 1040.

115. I ascribe the difference in the exercise of burden power not to the notion that the current corporate income tax is thought to be a second tax that must be avoided at all costs, but to the notion that it is a highly visible tax for those who are directly affected by the profitability of the enterprise. See Arlen & Weiss, *supra* note 91 (arguing that the self-interest of corporate managers explains the longevity of the corporate income tax). Once other taxes on businesses activity achieve the same degree of visibility as the corporate income tax, I believe that they will be subject to the same level of scrutiny as the corporate income tax—a level of scrutiny that they manage to escape under the current income tax system. With increased scrutiny will come increased incentive to shift the economic burden of the tax. Although I know of no empirical work that would support this conclusion, I believe that Professor McCaffery's work on cognitive theory and tax system design, and Professors Arlen and Weiss' work on the attractiveness of the corporate income tax for corporate managers, suggests that an important attribute of a tax is its visibility by those who manage a business and feel directly responsible for its bottom line. See McCaffery, *supra* note 99; Arlen & Weiss, *supra* note 91.

other individuals, whether they be consumers or providers of labor, will therefore end up bearing an increased portion of the economic burden of the tax, although neither they nor economists will know exactly how much more. By imposing a separately stated, and therefore highly visible, tax at the entity level, the Armev Flat Tax will make it easier for holders of material capital to shift the economic burden of taxes to consumers and providers of labor.

B. *The Nunn-Domenici Tax*

Like the Armev Flat Tax, the Nunn-Domenici Tax imposes two separate taxes, one at the individual level and another at the business level. Like the Armev Flat Tax, the Nunn-Domenici Tax treats proprietorships as entities,¹¹⁶ but the business portion of the Nunn-Domenici Tax would be imposed at a much lower rate (eleven percent) than the individual portion, which would be imposed at graduated rates of up to forty percent.¹¹⁷ In addition, the Nunn-Domenici Tax does not provide a deduction for wages at the business level, although it includes wages in the tax base of the individuals who receive them. The Nunn-Domenici Tax thus taxes wages twice, once at the business level by not providing a deduction, and again at the individual level by including them in the tax base of recipients. The double taxation of wages under the Nunn-Domenici Tax appears to be ameliorated somewhat by the provision of a credit, at both the individual and business levels, for payroll taxes paid on those wages. Nevertheless, the Nunn-Domenici Tax will yield an allocation of burden power that differs significantly from that provided by the current income tax.

The current income tax reserves most of the burden power it provides for the holders or managers of material capital. It does this in two ways. First, it imposes the entity level corporate tax, which is shifted to individuals in ways that economists do not yet fully understand.¹¹⁸ Second, it imposes the payroll tax, which is shifted to the providers of labor in ways that economists do claim to understand.¹¹⁹ By imposing an entity-level business tax, the Nunn-Domenici Tax increases the visibility of the business tax and is likely to increase the exercise of burden power by owners or managers of proprietorships and pass-through entities.¹²⁰ Like the Armev Flat Tax, then, the Nunn-

116. Nunn-Domenici Tax, *supra* note 10, § 206(a).

117. See *supra* note 58 for a discussion of rate structure and phase-ins.

118. See Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, at 30-32.

119. See *id.* at 44-45 & n.96.

120. See *supra* notes 113-15 and accompanying text.

Domenici Tax will probably increase the degree to which burden power is exercised and will thus exacerbate the effects of the grant of burden power to the owners and managers of material capital.¹²¹

The Nunn-Domenici Tax differs significantly from the Armev Flat Tax in that it integrates the income and payroll tax systems. Integration at the individual level has no significant implications for the existence of burden power because individuals do not have burden power with respect to payroll taxes under the current system and integration does not add any. Because the payroll tax credit provided to individuals by the Nunn-Domenici Tax is a refundable credit,¹²² its effect would be to remove the economic burden of the employee's portion of the payroll tax.¹²³ Employees who had income tax liability would be relieved of that liability to the extent of payroll taxes withheld, and employees who had no income tax liability would receive a check refunding the amounts of payroll taxes paid.

Integration of the income and payroll taxes at the business level should eliminate burden power for employers because it will largely eliminate the economic burden of the tax for them. If there is no burden to bear, there should be no burden to shift.¹²⁴ The Nunn-Domenici Tax should therefore eliminate the economic burden of the payroll tax in all cases in which the employer can fully utilize the credit to reduce its income tax liability. When employers cannot fully utilize the credit in a current year and must instead carry it over to subsequent years,¹²⁵ they will bear the economic burden of the payroll tax for that current year. Nevertheless, such employers are not likely to have much burden power with respect to that tax, not because they might be relieved of its

121. It is difficult to speculate on the extent to which the reduced rate of the business level tax under the Nunn-Domenici Tax (11% vs. 17% under the Armev Flat Tax) will offset the absence of full integration of that tax with the individual level tax and thus affect the exercise of burden power. My suspicion is that neither the difference in the rate nor the failure of integration will significantly affect the exercise of burden power because it is always better to pay no tax rather than some tax; clearly, it is also preferable to pay a smaller tax rather than a larger tax.

122. See Nunn-Domenici Tax, *supra* note 10, § 20(b).

123. For an analysis of the role of taxpayer choice in allocating the economic burden of the payroll tax, see Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, at 39-50.

124. See *supra* notes 68-72 and accompanying text (discussing the operation of the payroll tax credit); see also *supra* note 123 (explaining the payroll tax).

125. See Nunn-Domenici Tax, *supra* note 10, § 281(a).

economic burden in the future as a result of the carryover,¹²⁶ but because they are unlikely to be able to act to shift its economic burden in the short run.¹²⁷ This inability, coupled with the difficulty of determining whether a particular employer will end up in an excess credit position in any given year, suggests that the Nunn-Domenici Tax payroll tax credit will eliminate the need for employers to consider shifting the economic burden of the payroll tax.

The Nunn-Domenici Tax thus appears to eliminate a significant source of burden power in the current system: the power of employers to shift the economic burden of payroll taxes to generally unknowing and unsuspecting employees. An important question is whether the Nunn-Domenici Tax replaces the lost burden power with any other power. It does. The Nunn-Domenici Tax replaces the power to shift the economic burden of the payroll tax with the power to shift the economic burden that results from the non-deductibility of wages at the employer level.

The effect of the payroll tax credit mechanism for employers, which removes the economic burden of the payroll tax and therefore the need to shift it, cannot be analyzed in isolation but must be considered in conjunction with the denial of a deduction for wages. By denying employers a deduction for wages but providing them with a credit for payroll taxes paid, the Nunn-Domenici Tax takes burden power away from employers with one provision but gives it with another. It takes burden power away by removing the economic burden of the payroll tax, as explained above. It gives burden power because it makes employers bear the nominal burden of the tax imposed at the employer level on wages paid; employers, who pass on the economic burden of payroll taxes to employees under the current system, are almost certain to pass on the economic burden of the increased income tax occasioned by the nondeductibility of wages under the Nunn-Domenici Tax.¹²⁸ It is therefore likely that employees will end up bearing the economic burden of the double taxation of wages perpetrated by the Nunn-Domenici Tax,

126. Of course, the carryover can never make a taxpayer whole because it fails to account for the time value of money.

127. See *JCT Pamphlet*, *supra* note 9, at 43.

128. Examples of non-deductible wages exist under the current income tax (*e.g.*, I.R.C. §§ 162(m) (compensation in excess of \$1 million), 280G(a) (excess parachute payments) (West 1996)), but no evidence of the extent to which employees bear the resulting burden of the employer-level tax appears to be generally available. While employees almost certainly bear the burden of wages not paid because they would be non-deductible, it is less clear that they bear the burden of non-deductibility by, for example, receiving a smaller amount of non-deductible wages than would otherwise be the case. It is difficult, however, to imagine that they would be able to escape that burden in the long run.

and will do so as unknowingly as they currently bear the economic burden of the employer's portion of the payroll tax.¹²⁹

The grant of burden power to employers with respect to the taxation of wages under the Nunn-Domenici Tax is even more insidious than the grant of burden power to employers with respect to payroll taxes under the current system because the grant of power under the Nunn-Domenici Tax is achieved under a system that appears to provide employees with more favorable treatment than the current tax system: It provides the individual level payroll tax credit to eliminate the economic burden of the employee portion of the payroll tax, and it appears to eliminate the burden power that attends the employer portion of the payroll tax by eliminating its economic burden through the mechanism of the employer-level payroll tax credit. Nevertheless, employees do not receive additional burden power under the Nunn-Domenici Tax, and employers retain the same burden power they have under the current system, although it will sometimes apply to a smaller amount of tax.¹³⁰ Employers and individual owners of material capital will enjoy burden power, providers of labor will not, and providers of labor will continue

129. The additional burden that the Nunn-Domenici Tax imposes on employers is substantial. By denying employers a deduction for wages, the Nunn-Domenici Tax imposes a tax of 11% on those amounts. For wages up to \$62,700, the social security wage base, the tax would be 11% of \$62,700, or \$6,897. The economic impact of that additional tax would be ameliorated by the grant of a credit for the amount of payroll taxes paid. At the current rate of 7.5%, the payroll tax, and the resulting credit, would amount to \$4,702.50. Thus, whereas non-deductibility of wages up to the social security wage base will cost employers \$6,897 in tax, the provision of the payroll tax credit will only save them \$4,702.50 in tax. The difference, \$2,194.50, is the tax attributable to each employee who earns an amount precisely equal to the social security wage base. For employees who earn more than that, the cost of the Nunn-Domenici Tax is simply 11% of the additional amount of wages. For employees who earn less, the cost will be less, but it will always amount to 3.5% of wages paid (the difference between the 11% cost and the 7.5% credit). In both the over- and under-base cases, the actual cost is likely to exceed my rough calculations. This is because the non-deductibility of some currently deductible fringe benefits will also add to the cost of labor and those costs will likely be shifted, if they continue to be incurred. Another possibility is that they will be transferred to employees outright if employers simply stop providing the benefit.

130. An employer's burden power under the Nunn-Domenici Tax will amount to 3.5% of compensation up to the social security wage base, whereas an employer's burden power under the current system amounts to 7.5% of the social security wage base. Employers who pay compensation in excess of the social security base (\$62,700), which would not be subject to section 162(m), will experience an increase in burden power under the Nunn-Domenici Tax—from 7.5% of compensation up to the social security wage base to 7.5% of compensation up to the social security wage base plus 11% of compensation above it. See *supra* note 129.

to bear the economic burden of taxes that they do not know they are bearing. *Plus ça change, plus c'est la même chose.*

V. SIMPLE OUTLINES, HIDDEN VALUES, AND COMPLEX CHOICES

A. *The Arme y Flat Tax—Simple Outline, Complex Effects*

The foregoing examination has revealed that the Arme y Flat Tax provides scant avoidance power for wage earners, but provides substantial avoidance power for individuals, who, through their ownership of material capital, own businesses.¹³¹ In addition, although

131. Following is a tabular presentation of the foregoing analysis. It divides the universe of affected taxpayers into individuals (with and without material capital) and businesses, and summarizes the foregoing discussion.

INDIVIDUAL OWNERS OF HUMAN CAPITAL—
NEGLIGIBLE MATERIAL CAPITAL

	CURRENT SYSTEM	ARMEY FLAT TAX	NUNN- DOMENICI TAX
AVOIDANCE POWER	Low	Low	Moderate (inc. w/ability to save)
BURDEN POWER	Low	Low	Low

**INDIVIDUAL OWNERS OF HUMAN CAPITAL—
SUBSTANTIAL MATERIAL CAPITAL**

	CURRENT SYSTEM	ARMEY FLAT TAX	NUNN- DOMENICI TAX
AVOIDANCE POWER	Moderate (inc. w/ ownership of material capital)	High	High
BURDEN POWER	Low	Low	High

BUSINESSES

	CURRENT SYSTEM	ARMEY FLAT TAX	NUNN- DOMENICI TAX
AVOIDANCE POWER	Moderate (inc. w/inv. in material capital)	High	High
BURDEN POWER	High	High	High

the Arme y Flat Tax bestows almost no burden power on wage earners, the tax system that would result from enactment of the Arme y Flat Tax would be rich in burden power. By retaining the current payroll tax system, which is lavish in its provision of burden power to employers, and imposing a business tax that owners and managers of material capital alone will be able to shift, enactment of the Arme y Flat Tax would produce a tax system richer in burden power than is the current system. As with the current tax system, that richness of power would be reserved for the holders and managers of material capital.

The failure of the Arme y Flat Tax to provide much avoidance power to wage earners is likely to be a significant impediment to its enactment. By eliminating much of the avoidance power that individuals have under the current income tax system, the Arme y Flat Tax will remove individuals' ability to act in ways that allow them to affect, and therefore control, their tax destinies. It will deny individuals the ability to exercise personal autonomy in connection with the determination of their tax liability. While individuals might be willing to give up personal autonomy under certain circumstances, thoughtful analysis of the Arme y Flat Tax reveals that it fails to provide such circumstances. Even if individuals were willing to surrender personal autonomy in exchange for a simpler tax system, before endorsing such a system, they would need to ask whether the system really made up in simplicity what it cost in personal autonomy.

The Arme y Flat Tax purports to achieve greater simplicity by eliminating deductions. To the extent that individuals will not need to learn what items are deductible, keep the necessary records, and fill out the necessary forms, the filing of tax returns under the Arme y Flat Tax will unquestionably be simpler than under the current income tax system. Nevertheless, such surface simplicity belies not only the deeper complexities that lurk in the determination of the tax base, but also the values implicated by the elimination of surface choice and the retention of interior complexity. In other words, while the Arme y Flat Tax might be simple enough to cause significant loss of personal autonomy when compared to the current tax system, in many respects the Arme y Flat Tax is not dramatically simpler than the current income tax system. There are three reasons for this.

First, for over seventy percent of individual taxpayers, filling out tax forms under the Arme y Flat Tax will not be significantly simpler than

The pattern that emerges is stark: material capital is the favored child of each of these tax systems, but the favors are greater under either of the reform proposals than under the current system.

filling out tax forms under the current system. Preliminary data for 1994 returns shows that over seventy percent of taxpayers claimed the standard deduction, and that the standard deduction accounted for nearly half of all deductions claimed.¹³² For most taxpayers, filling out tax forms is so simple now that the IRS has established a TeleFile program, which allows taxpayers to file their tax returns using the telephone, and hopes to increase its availability during future filing seasons.¹³³ Indeed, whatever complexity exists for those taxpayers stems not from the income tax system proper but from the operation of the earned income tax credit, a program designed not to raise revenue but to ameliorate the effect of the payroll tax by providing positive cash assistance to low income working parents.¹³⁴

Second, for many taxpayers, complexity will not disappear. For business owners, the need to define deductible inputs and to distinguish active business income (taxable) from returns on investment (not taxable) is likely to keep alive the issues that spawned *Corn Products*,¹³⁵ and later, *Arkansas Best*.¹³⁶ Individuals with hobbies that generate any income at all will also be subject to the business tax reprieve and will therefore need to know which costs qualify as inputs deductible from income and which do not. While the problem of distinguishing business from personal expenses will disappear for individuals with no non-wage

132. Therese M. Cruciano, *Individual Income Tax Returns, Preliminary Data, 1994*, SOI BULLETIN, *supra* note 111 at 6. Martin A. Sullivan, *The Average Tax Return: \$25,000 and No Deductions*, 71 TAX NOTES 1409 (1996).

133. In December 1996, the IRS announced plans to invite over 22 million taxpayers to participate in TeleFile. IR 96-48, 96 TNT 236-17 (December 5, 1996). By April 12, 1996, the IRS had received an estimated 2.7 million returns through its TeleFile program, up from approximately 650,000 in 1995. Ryan J. Donmoyer, *Filing Season Was 'Smooth,' But Electronic Returns Are a Bit Stale*, 71 TAX NOTES 580 (1996). The IRS "expect[ed] to receive 3 million TeleFile returns" by the end of the 1996 tax season. Ryan J. Donmoyer, *Filing Season Stats Show Electronic Filing Rebound*, 70 TAX NOTES 1216 (1996). *See also* Lawrence Summers, *Summer's Thoughts on Tax Cuts, Tax Administration, and Tax Reform*, 72 TAX NOTES 927, 929 (1996) (stating that "[a]n additional 2.8 million people using the E-Z form" used TeleFile program); George Guttman, *TeleFile—Great Idea, but Still a Money Loser*, 70 TAX NOTES 789 (1996); Dave Skidmore, *IRS Expands Phone Filing for Simple Tax Returns*, CHI. SUN-TIMES, Dec. 5, 1995, at 3 (announcing IRS's expansion of TeleFile program to every state).

134. *See* Anne L. Alstot, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 540 n.29 (1995). The Armev Flat Tax repeals the EITC and thus further increases the tax burden on low income individuals.

135. *Corn Prod. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955).

136. *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

income, the need to make the sorts of distinctions now made in many section 183 and 262 cases, essentially distinctions between taxable consumption and non-taxable business inputs, will not disappear. The need for rules that help to make those distinctions means, of course, that lawyers and accountants, and those studying to become lawyers and accountants, will have to learn the rules, and that somebody will have to teach them.

While the inclusion of only cash wages in the individual tax base is an unquestionable simplification, even that dramatic step will not eliminate the need for complex distinctions. By incorporating the definition of the term wages currently provided by section 3121(a) and providing no definition of the term "cash," the Arme y Flat Tax imports not only the entire employee/independent contractor controversy, one of the most intractable problems of the current system,¹³⁷ but probably all of the case law on what constitutes the receipt of cash under the current system as well.¹³⁸ Taxpayers and tax return preparers will need to understand the doctrines of constructive receipt and assignment of income under the Arme y Flat Tax, just as they must under the current system,¹³⁹ and employers and employees will need to know whether amounts paid in cash *on behalf* of employees will be treated as having been paid in cash to employees. In addition, since fringe benefits would not be deductible to employers but wages and the costs of business

137. See Arme y Flat Tax, *supra* note 9, § 63(a)(1)(A) (referring to the definition of wages in section 3121(a) of the Code). For a good exploration of the ways in which the complexity of current law not only remains but is exacerbated under the Arme y Flat Tax, see Michael J. Calegari et al., *Flat Tax Ramifications For Self-Employed Taxpayers*, 72 TAX NOTES 641 (1996); Lawrence H. Summers, *An Evaluation of the Flat Tax*, 71 TAX NOTES 1555, 1557 (1996).

138. Since the Arme y Flat Tax does not repeal, but only purports to amend, the Code, all of the common law that has developed under that statute would presumably remain relevant under the Arme y Flat Tax, to the extent that the concepts it addresses retain their viability. Issues of timing and identity of recipient, while less important under a tax system with a flat structure, will not be rendered irrelevant under the Arme y Flat Tax because that tax contains at least two brackets—a zero bracket and one taxable bracket. As long as the system has a zero bracket, the system retains at least some avoidance power and taxpayers will have at least some incentive to manipulate the timing of the inclusion of income and the identity of its recipients. See Section II.A., *supra*.

139. Tax teachers need not fear unemployment in the unlikely event that the Arme y Flat Tax is adopted. During the fall of 1995, I placed copies of the Arme y Flat Tax, as well as the Nunn-Domenici Tax and several other tax reform proposals, on reserve in the Temple Law School library. At the end of every segment of the basic tax course, I assigned students the task of going to the library, reading through the text of the proposed statutes, and determining whether the issues we had just studied would become moot upon adoption of a given proposal. My students were dismayed to discover for themselves that few of the issues we covered in the course would be rendered irrelevant by adoption of any of the proposals.

inputs would be, the need for many of the distinctions that bedevil current law will remain.¹⁴⁰ Employees will also have to understand the complex relationship between taxes and wages, as they strain to receive more non-wage compensation while employers strain to provide less of it.

Many of the most confounding questions of current law will therefore remain under the Arme y Flat Tax even in the unlikely event that it managed to become law in a form that was anything like that of its birth. As yet another example, the problems of determining what organizations should be exempt from tax, and what portions of their income will be so exempt, all will remain under the Arme y Flat Tax. Indeed, not only does the Arme y Flat Tax retain the provisions relating to tax exempt organizations, but it adds substantial complexity by imposing a separate tax on some of the fringe benefits paid by exempt organizations to their employees.¹⁴¹

Furthermore, the Arme y Flat Tax also provides an entirely new and different set of rules for the treatment of income from "financial intermediation services," which it does not bother to define, and the income from which will be "equal to the value of the intermediation services provided."¹⁴² Valuation questions have many characteristics, but simplicity is not one of them.

Failure to define terms and address difficult issues by statute does not a simple system make. In its failure to address the many difficult definitional and other questions that have arisen under the current system

140. While section 132 of the Code has made life easier for many tax advisors because it has provided answers to many frequently asked questions, its absence, coupled with the non-deductibility of fringe benefits and the deductibility of wages, would doubtless lead to many controversies regarding whether particular non-cash benefits provided by employers to employees should be treated as cash compensation because they are paid in cash on the employee's behalf, or as non-cash, because they are not paid directly to the employee.

141. See Arme y Flat Tax, *supra* note 9, § 101(b) (amending I.R.C. § 4977 (West 1996)). The likely reason for this is the equalization of the treatment of fringe benefits paid by exempt and non-exempt entities. Since non-exempt entities cannot deduct the cost of fringe benefits, and cannot otherwise be taxed themselves, the taxation of fringe benefits to employees is the only way to provide treatment equivalent to that which follows the non-deductibility of such benefits to non-exempts. The taxation of the fringes at the employee level could cause exempts to have to pay additional compensation to tax-effect the taxation of the fringes at the employee level, and that need to provide additional compensation would make the provision of fringes as expensive for exempts as it would be for non-exempts, and thus equalize their treatment.

142. See Arme y Flat Tax, *supra* note 9, § 102(a) (adding section 11(e) to the Code).

and that will certainly arise under Arme y Flat Tax, the Arme y Flat Tax is like an ostrich hiding its head in the sand. Proponents of the Arme y Flat Tax may not want to see the issues, but that will not make the issues disappear. Instead, the issues will remain, and they will have to be resolved outside of the legislative process. That will have profound consequences for tax administration and for the implementation of tax policy: Rather than having less power than it does under the current system, the Internal Revenue Service might well have more power under the Arme y Flat Tax. The absence of the constraints imposed by a detailed statutory structure and a long history of interpretation might not only force the Service to be even more active in interpreting the law and providing guidance to taxpayers, but might make it more difficult for courts to reject the Service's interpretations.¹⁴³ As Frederick Schauer has so astutely observed, rules function as allocators of power, and decisionmakers constrained by rules have less power than decisionmakers not so constrained.¹⁴⁴ It follows that decisionmakers constrained by few rules have more power than decisionmakers constrained by many rules. Ironically, while attempting to simplify the tax system and move the Internal Revenue Service farther away from people's lives, the Arme y Flat Tax might actually increase the agency's interpretive power.

Third, conceptually, the Arme y Flat Tax will be even more difficult to understand than the current income tax. Because it permits complete expensing of business inputs and does not tax income from capital at all, the Arme y Flat Tax is principally a consumption tax.¹⁴⁵ Nevertheless, most of those who will bear the economic burden of the tax will not understand that. Not only does the tax proclaim itself to be an income tax, but it will be calculated and paid in much the same way as the current income tax, thus luring individuals into the misguided belief that the biggest difference between the new tax system and the old is the flatness of the rates. That belief is simply wrong.

143. For an interesting and informative debate on the extent to which courts defer to IRS interpretations, see Paul L. Caron, *Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 57 OHIO ST. L.J. 637 (1996); Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 OHIO ST. L.J. 1037 (1995); Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U..L. REV. 841 (1992); Linda Galler, *Judicial Deference to Revenue Rulings: What It's All About*, 72 TAX NOTES 769 (1996); Paul L. Caron, *The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 72 TAX NOTES 359 (1996). For a thorough exploration of judicial constraints on regulatory action by administrative agencies, see Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51 (1996).

144. FREDERICK SCHAUER, *PLAYING BY THE RULES* 159 (1991).

145. THE FLAT TAX, *supra* note 12, at 40.

The biggest difference between the Armev Flat Tax and the current system is that one is principally an income tax while the other is not. The systems therefore differ dramatically in what they include in the tax base. The individual portion of the Armev Flat Tax does not need deductions because it does not include very much in the tax base to begin with. This technique for defining the tax base (not including, rather than including and then deducting) makes it difficult for individuals to understand what is being taxed because they have to imagine what other amounts might be taxed. Individuals who have only wage income will likely know that all of their income is being taxed, but it might not be obvious to them that someone who has only income from capital is paying no tax at all. By contrast, individuals who have income from capital will understand very well that they are not being taxed. Under the current system, which excludes items from the tax base by the mechanism of deductions, even individuals who cannot utilize the deductions tend to know that they are there. They may covet the deductions and strive to obtain them, but they know that they exist and that knowledge allows them to understand what is, and what is not, subject to tax. The very feature of the current law that is so maligned—its complexity—forces individuals to learn about it and thus to understand exactly how much their government is requiring of them, and of their neighbor. Under the Armev Flat Tax only consumption will be subject to tax, and most individuals will not even know it.

This feature of the Armev Flat Tax, its ability to tax consumption while purporting to tax income, might fit well with our cognitive biases,¹⁴⁶ but it is bad tax policy. It is bad tax policy because opaque taxes undermine personal autonomy. Those who do not understand how they are being taxed are not in a position to opine on the merits of a tax system, much less to vote, however indirectly, for it. The Armev Flat Tax thus denies individual non-owners of material capital personal autonomy in three ways. It provides little avoidance power, no burden power, and hides the contours of the very tax system that is imposing its burden on them, so that they are unlikely to act to alter or replace it.

However complex the current system is in application, it is relatively straightforward in concept. The Armev Flat Tax strikes precisely the opposite balance: It might be relatively simple in application, but it is

146. See McCaffery, *supra* note 99, at 13; Geier, *supra* note 37, at 13.

extraordinarily complex in concept. It denies personal autonomy to an even greater degree than the current income tax system. It should be eschewed for that reason alone.

For taxpayers, particularly for non-holders of material capital, the Armev Flat Tax presents a particularly difficult array of theoretical choices. Is the apparent simplicity of the tax—seventeen percent of cash wages—worth the loss of personal autonomy that proceeds from the absence of avoidance power and the opacity of the tax structure? Is the ability to make choices that affect the level of the tax burden (buying a house rather than renting, paying alimony rather than child support or a property settlement, working more or less), worth the price of having to learn about the choices and taking responsibility for them? The answer will vary with the degree to which individuals value personal autonomy, but the existence of the choice should be made clearer than it has been made thus far.¹⁴⁷

B. The Nunn-Domenici Tax—Choosing to Save

The Nunn-Domenici Tax is not appreciably simpler than the current tax. Not only does it contain somewhat truncated versions of many provisions, such as sections 132 and 119, but by providing a deduction for amounts saved, the Nunn-Domenici Tax requires an entirely new set of definitional provisions and anti-abuse rules. By distinguishing between active business income and return on business investment, the Nunn-Domenici Tax also keeps alive many of the definitional issues that have fueled the capital gains debate for years.

Perhaps because it is not simpler, the Nunn-Domenici Tax provides more avoidance power than either the Armev Flat Tax or the current income tax. For owners of material capital, the Nunn-Domenici Tax provides significantly more avoidance power than the current income tax and somewhat more burden power as well. For some providers of labor, the Nunn-Domenici Tax provides about the same amount of avoidance and burden powers as the current income tax, but for others, specifically, those whose labor commands a high price, it provides significantly more.

147. A look at the current tax system might help to provide the answer for anyone inclined to undertake the empirical work because the current tax system contains a metaphor for the Armev Flat Tax: the social security tax. Like the Armev Flat Tax, the social security tax is imposed on cash wages at a flat rate. It is not imposed on returns from capital and its economic burden is passed on to the providers of labor. Joel Slemrod has recently provided a thorough study of the compliance costs associated with various alternative tax systems. Joel Slemrod, *Which is the Simplest Tax System of Them All?*, in *FUNDAMENTAL TAX REFORM*, *supra* note 30, at 355. Slemrod's work ties compliance costs to complexity.

By providing increased avoidance and burden powers to the owners of material capital, however, the Nunn-Domenici Tax affirms both the value of personal autonomy and the value of the ownership of material capital, or of high income from labor that can be converted into material capital. Even though the Nunn-Domenici Tax boasts a progressive rate schedule roughly equivalent to that provided by the current system, at least before it becomes fully phased in,¹⁴⁸ the Nunn-Domenici Tax would be less progressive than the current system overall because the increased choice holders of material capital receive will reduce their net burden. For holders of material capital then, the question whether to favor replacement of the current system with the Nunn-Domenici Tax has a simple answer. The answer is yes. For low and average income labor providers, who typically find it more difficult to convert income from labor into material capital, the answer is substantially more complicated.

The Nunn-Domenici Tax will treat all saving in much the same way as current law treats saving through employer-sponsored pension plans. That is, neither the amount saved nor the return on that amount will be taxed to the employee who earns it until withdrawn for consumption.¹⁴⁹ While employer-sponsored plans now restrict participants' ability to withdraw contributions prior to retiring or attaining a certain age, they also provide some advantages over private savings. These

148. See Nunn-Domenici Tax, *supra* note 10, § 15.

149. Under the Arney Flat Tax contributions to retirement plans will not be treated as they are treated under current law. Thus, employer contributions to pension plans will be deductible to the employer (Arney Flat Tax, *supra* note 9, § 11(d)(1)(C)) and will not constitute income to the employee (*id.* § 63(a)(1)(A)), but distributions from retirement plans will be included in income. Nevertheless, the Arney Flat Tax does not present the same choice issues for employees because the Arney Flat Tax retains a significant preference for employer-sponsored pension plans. It does this by including all cash wages in the tax base, whether saved or consumed. Amounts that might have been paid as wages but that are contributed to an employer-sponsored pension plan instead will enjoy a tax benefit because they will be excluded from the tax base. Exclusion will result in a larger investment because the amount of the compensation will not have to be reduced by taxes (either income or payroll) before investment. Thus, although the Arney Flat Tax is more favorable to saving than the current system because of its failure to tax the return on investment, it is not indifferent as between saving through employer sponsored plans or private saving. By contrast, the Nunn-Domenici Tax is indifferent. Because all amounts saved are excluded from the tax base, private savings will enjoy the same tax advantages (versus consumption) as savings made through employer-sponsored plans. For a more detailed discussion of the implication of this point, see notes 165-67 and accompanying text.

advantages include enforced periodicity and protection from the claims of creditors. For purposes of this discussion, I will assume that enforced periodicity and the benefits of inalienability combine to render employer-sponsored savings roughly equivalent to private savings outside of the tax advantages. Since the tax advantages that now attend employer-sponsored savings may largely account for their popularity, it is important to think through the consequences of withdrawing those advantages.

Employer-sponsored plans are costly to set up and maintain. The intricate web of rules developed to prevent their exploitation by employers and highly compensated employees has kept thousands of lawyers and accountants busy, on both the government and taxpayer sides, for many years. While some employer-sponsored plans provide substantial immediate benefits to employers whose stock is publicly traded (ESOPs, many varieties of stock options, and phantom stock plans),¹⁵⁰ and all provide human resources benefits,¹⁵¹ employers

150. ESOPs are Employee Stock Ownership Plans, permitted under the current Code. I.R.C. § 409 (West 1996). They are qualified plans funded with employer securities. They provide substantial advantages to employers, not the least of which is the knowledge that substantial amounts of stock, the value of which the employer has been allowed to deduct, rests in possibly friendly hands. See Michael A. Conte et al., *Financial Returns of Public ESOP Companies: Investor Effects vs. Manager Effects*, 52 FIN. ANALYSTS J. 51 (July-Aug. 1996) (indicating that the presence of an ESOP is a good signal to buy the sponsor's stock); Roberta C. Yafie, *Pass the 10Q, Partner*, 17 J. BUS. STRATEGY 53 (Jan.- Feb. 1996) (stock options induce employees to think like owners) [hereinafter *Pass the 10Q*]; Anne Beatty, *The Cash Flow and Informational Effects of Employee Stock Ownership Plans*, 38 J. FIN. ECON. 211 (June 1995); Michael A. Conte & Jan Svejnar, *Productivity Effects of Worker Participation in Management, Profit-Sharing, Worker Ownership of Assets and Unionization in U.S. Firms*, 6 INT'L J. INDUS. ORG. 139 (1988) (indicating that profit sharing increases productivity) [hereinafter *Productivity Effect of Worker Participation*]; Deidra-Ann Parrish, *Sharing the Wealth—it's not just good for employees—it's good for business*, 12 VARBUSINESS 121 (Sept. 15, 1996) (profit sharing plans are an ideal way to reward employees while conserving a company's cash) [hereinafter *Sharing the Wealth*]. Stock options, whether incentive stock options permitted by Code section 421A or non-qualified stock options taxable under Code section 83, provide similar benefits. See *supra*, *Pass the 10Q*; *Productivity Effects of Work Participation in Management*; *Sharing the Wealth*. Phantom stock plans, which provide benefits that track the performance of employer stock, allow employers to give employees a financial stake in the performance of the business, without having to give up voting control. The benefits that employers receive from ESOPs, stock options, and phantom stock plans may make such plans attractive candidates for retention even in a world where the tax law does not provide an advantage for employer-sponsored and controlled savings over privately controlled and directed savings.

151. Much business literature supports the notion that pension plans provide incentives in hiring and retaining workers and in encouraging retirement at suitable time. See Edward Lazear, *Pensions as Severance Pay*, in FINANCIAL ASPECTS OF THE UNITED STATES PENSION SYSTEM 57 (Bodie Zvi & John B. Shoven eds., 1983) (suggesting that firms use pensions to encourage retirement at the end of a delayed payment contract);

might be less willing to assume the administrative costs of sponsoring employee retirement plans in a world where the tax law did not provide an advantage for employer-sponsored savings over private savings, and thus failed to make such saving particularly attractive. Indeed, elimination of the tax advantages of employer-sponsored saving might eliminate the human resources advantages as well. Whether it does so might depend on employees' willingness to have increased control over the decision to save or to consume.

Employers who sponsor pension plans take amounts that would otherwise be paid to employees as wages and instead invest them on the employee's behalf, often in vehicles of the employee's choosing, and always in ways that inure to the ultimate benefit of the employees.¹⁵² In a world where employer-sponsored savings receive no tax advantages, employer-sponsored plans would lose much of their attractiveness, and the human resources advantages that attractiveness begets, if employees preferred to control the choice between saving and consuming.¹⁵³ In

Steven G. Allen et al., *Pensions, Bonding and Lifetime Jobs*, 28 J. HUM. RESOURCES 463 (1993) (finding that worker turnover is half as high for workers covered by pensions); Robert M. Hutchens, *A Test of Lazear's Theory of Delayed Payment Contracts*, 5 J. LAB. ECON. 5153 (1987) (indicating that pension plans increase worker effort and productivity); Donald O. Parsons, *Aging and the Employment Contract* (Nov. 1988) (unpublished manuscript, Ohio State University) (positing that firms use pensions as an inducement to retire when worker productivity becomes increasingly variable with age).

152. Although employers make contributions to employee pension plans in addition to paying the employee's salary, pension contributions are more appropriately regarded as a substitute for additional salary. See JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW*, 27 (1990); Alan L. Gustman et al., *The Role of Pensions in the Labor Market: A Survey of the Literature*, 47 INDUS. & LAB. REL. REV. 417, 426 (1994) ("[E]mployees are hired until labor costs . . . are equal to the workers' marginal product in each period.").

153. It is interesting to note that employer-sponsored plans existed before such plans received any tax advantages because few workers actually incurred much federal income tax liability, suggesting that they would continue to exist even in the absence of such advantages. LANGBEIN & WOLK, *supra* note 152, at 14-15. Nevertheless, the rising importance of the tax advantages that attend employer-sponsored pension plans is probably a significant factor in the dramatic growth of such plans. Professors Langbein and Wolk report:

In 1950 pensions held less than 1 percent of all corporate equity; in 1984 they held 22.8 percent. In 1950 pensions held 13.1 percent of all corporate bonds; in 1984, they held 49.9 percent. [Pension] assets have been growing rapidly compared to the economy as a whole: in 1950, pensions held 3 percent of all financial assets; in 1984 they held 16.7 percent.

Id. at 20 (quoting RICHARD A. IPPOLITO, *PENSION, ECONOMICS AND PUBLIC POLICY* 123-24 (1986)). More recently, Engen and Gale report that since the mid-1980's, tax-

such a world, employer-sponsored savings would remain attractive, and would provide the non-tax advantages that would fuel their retention, only if employees preferred them for non-tax reasons.¹⁵⁴ Whether employees would prefer employer-sponsored savings to private savings would depend in large part on employees' attitudes toward the existence of choice with respect to the decision whether to save or to consume.¹⁵⁵

C. Values and the Architecture of Tax Reform for Increased Savings

Attitudes toward the existence of choice are at the core of the tax reform debate and provide much of the complexity the reformed tax systems would spawn, although they have thus far not been framed as such. Both the Nunn-Domenici Tax, which presents the issue of choice most starkly, and the Armev Flat Tax, which presents it somewhat more obliquely,¹⁵⁶ are, like all consumption tax proposals, rooted in the belief that they will increase the rate of savings in the United States.¹⁵⁷ That belief proceeds from the unstated assumption that individuals have a choice whether to spend or save, and that a tax incentive for saving either will cause them to exercise that choice in the direction of saving or is necessary to counter the ways in which the tax system disfavors saving.¹⁵⁸ Commentators have often noted that only individuals with enough disposable income to save can do so and have thus concluded

preferred savings, which they define to include preferred retirement and life insurance savings, has accounted for one hundred percent of personal savings. Eric M. Engen & William G. Gale, *The Effects of Fundamental Tax Reform on Savings*, in *FUNDAMENTAL TAX REFORM*, *supra* note 30, at 86.

154. Employer-sponsored plans might give employers significant secondary gains from having indirect control over the plan assets. Nevertheless, the requirement that the plans be structured as trusts and managed by trustees with fiduciary duties to the beneficiaries of the plan, not to the employer, makes the extent of such gains difficult to ascertain or quantify. There are acknowledged non-tax benefits to employer-sponsored pensions, such as promoting employee bonding to the firm, facilitating the departure of older workers (to paraphrase Professors Langbein and Wolk, benefits paid by employer-sponsored pension plans serve as the permissible carrot that induces retirement, even when the Age Discrimination in Employment Act prohibits the use of a stick), providing economies of investment scale and allowing employees to benefit from an investment professional's business acumen. LANGBEIN & WOLK, *supra* note 152, at 29-31.

155. See LANGBEIN & WOLK, *supra* note 152, at 31 (suggesting that the forced employee savings that result from employer-sponsored pension plans may be one of their non-tax advantages.)

156. See *supra* note 149 for a discussion of choice under the Armev Flat Tax.

157. See *supra* note 11 for scholarship on the impetus for flat tax proposals.

158. BRADFORD, *UNEASY COMPROMISE*, *supra* note 28, chap. 10.

that consumption taxes are inherently regressive.¹⁵⁹ Commentators have also debated the extent to which the rate of saving is responsive to tax incentives.¹⁶⁰ Notwithstanding the amount of scholarship that assumes the existence of a choice with respect to the decision whether to save or consume (because incentives are irrelevant with respect to nondiscretionary outlays), nobody has yet asked whether that is a choice that individuals either want or should have.¹⁶¹ The current tax reform debate poses that question starkly.

Surprisingly, answering the question is quite difficult because determining whether individuals prefer choice is quite complex.¹⁶²

159. For a sampling of recent commentary to this effect, see, e.g., Jonathan Barry Forman, *Simplification for Low-Income Taxpayers: Some Options*, 57 OHIO ST. L.J. 145, 196 (1996) (outlining arguments for opposition to consumption taxes based on regressivity); Marjorie E. Kornhauser, *Equality, Liberty and a Fair Income Tax*, 23 FORDHAM URB. L.J. 607, 644 (1996) (discussing regressivity of sales taxes); John S. Nolan, *The Erwin N. Griswold Lecture: The Merit of an Income Tax Versus a Consumption Tax*, 12 AM. J. TAX POL'Y 207, 215 (1995) (explaining regressivity of consumption taxes); David G. Raboy, *Consumption Tax Preferential Treatment: Poor Cure for Regressivity*, 72 TAX NOTES 901 (1996) (stating general principle that consumption taxes are regressive); Jendi B. Reiter, *Citizens or Sinners?—The Economic and Political Inequity of "Sin Taxes" on Tobacco and Alcohol Products*, 29 COLUM. J.L. & SOC. PROBS. 443, 461 (1996) (demonstrating that sales taxes are regressive because "they bring into the tax base individuals whose income is so low that it is not even taxed"). See also Fullerton & Rogers, *supra* note 30.

160. The considerable debate over the desirability of more universally available IRAs provides a rich exposure to the debate over the effectiveness of savings incentives. For a concise summary of much of the relevant empirical literature, see Steve F. Venti & David A. Wise, *Government Policy and Personal Retirement Saving*, 6 TAX POLICY AND THE ECONOMY 1, 3 (James M. Poterba ed., 1992); see also Daniel Feenberg & Jonathan Skinner, *Sources of IRA Saving*, 3 TAX POLICY AND THE ECONOMY 25, 27-29 (Lawrence H. Summers ed., 1989). Alan Auerbach and Larry Kotlikoff have examined the impact of demographics on the savings rate and have noted that ostensible savings incentives, such as IRAs, can sometimes have precisely the opposite effect and have typically been removed before their full effects could be studied or detected. Alan J. Auerbach & Laurence J. Kotlikoff, *Demographics, Fiscal Policy, and U.S. Saving in the 1980's and Beyond*, 4 TAX POLICY AND THE ECONOMY 73, 95 (Lawrence H. Summers ed., 1990). For a study of the likely effects of tax reform on savings, which concludes that the resulting increase be small, see Engen & Gale, *supra* note 50, at 83. Robert Triest concludes that tax reform would probably result in reduced pension coverage and that would cause workers to save less for retirement and delay retirement as a result. Robert K. Triest, *Fundamental Tax Reform and Labor Supply*, in FUNDAMENTAL TAX REFORM, *supra* note 30, at 247, 266.

161. For a glimpse of the level and amount of this scholarship, see *supra* notes 159-60.

162. For an expanded version of this discussion, see Abreu, *Taxes, Power, and Personal Autonomy*, *supra* note 6, at 50-57.

Making that determination is complex because having choice is sometimes good, but sometimes bad. Choice is good to the extent it allows individuals to feel empowered. Choice allows the exercise of personal autonomy, something Americans generally value. But choice carries with it the need to make the choice and to be responsible for its consequences. Sometimes people would rather leave decisions to someone else.¹⁶³ This may be particularly true when the decisions involve choosing between present, and therefore certain, comfort, and future, and therefore uncertain, comfort. The decision to save or to consume presents precisely such a choice.

For individuals, then, choosing between saving and consuming is complex, and choosing who should decide is likewise complex. Choosing who should decide requires weighing the value of empowerment and personal autonomy against the knowledge that choices made by individuals with incomplete information and with the ability to be swayed by feelings may result in decisions that may be detrimental to the individuals in particular and the economy as a whole in the long run. Choosing the tax system that would result from enactment of the Nunn-Domenici Tax over the current system is therefore complicated by the increased choice that the Nunn-Domenici Tax would provide and by the difficulty of determining whether that increased choice is a good thing for individuals to have. Even if the Nunn-Domenici Tax were simpler than the current income tax system (which it is not), it might not be more desirable because of the increased complexity of the choices it would pose. Even if increased choice were desirable, the Nunn-Domenici Tax might not be desirable if we felt that those who would receive the increased choices—the owners of material capital—should not have more choice. That decision can only be made by reference to the value placed on the ownership of material capital.

Virtually all of the foregoing can also be said of the Armeij Flat Tax. While the Armeij Flat Tax would continue to provide a tax incentive for saving through employer-sponsored pension plans, the incentive would be smaller than that provided under the current income tax system. Since all returns on material capital would be exempt from tax under the Armeij Flat Tax, savings effected through employer-sponsored plans would not enjoy a greater rate of return than private savings. The only tax incentive for employer-sponsored savings under that system would come from the exemption of plan contributions at the time they are made. While the existence of a tax incentive for employer-sponsored

163. See *id.* for a discussion of the complicated nature of choice that uses the story of SOPHIE'S CHOICE as an example. WILLIAM STYRON, SOPHIE'S CHOICE (1979).

savings makes the choice between employer-sponsored and private savings easier under the Arney Flat Tax than under the Nunn-Domenici Tax, the reduced preference makes the choice harder than it is under the current income tax. Nevertheless, the choice remains, and it remains primarily for those who own material capital directly.

Economists cannot yet tell us the fate of the employer-sponsored pension system under tax reform.¹⁶⁴ Recent work by respected economists concludes that “the pension system could face nontrivial shrinkage under a wide variety of plausible assumptions . . . [although] fears that tax reform will largely eliminate the pension system cannot be supported using the parameter estimates in the literature.”¹⁶⁵ Apparently, almost none of the simulations that predict dramatic increases in savings under a consumption tax account for the existence of tax incentives for savings under the current system. The one that does suggests that “the reduction in saving due to changes in pensions could substantially offset any induced increase in non-pension saving.”¹⁶⁶

At this point in the tax reform debate, I do not intend to take sides in what promises to be, at minimum, a continuing dispute among economists. Nevertheless, even at this preliminary stage it is important to recognize that consideration of two significant factors appears to be missing from all of the simulations and from the ongoing scholarly debate. Those factors are the extent to which the various tax reform proposals increase the opportunity for the exercise of choice for certain classes of taxpayers and the extent to which more or less choice is something that those taxpayers want or should have. In other words, the debate should include a discussion of the value of choice.

Isolating choice as an important factor in the policy debate will help to untangle a maxim that has achieved the status of near gospel—that

164. See Eric M. Engen & William G. Gale, *Comprehensive Tax Reform and the Private Pension System*, 72 TAX NOTES 345 (1996); Jon Newberry, *Watch Out for Flat Tax Pitfalls: Changes could affect insurance coverage, investments, retirement plans*, 82 A.B.A. J. 103 (1996) (analyzing these investments under flat tax proposals). In October, 1996, a Labor Department advisory council called for the establishment of a national commission to study the impact of tax policy on the private pension system, and specifically, the impact of the various tax reform proposals on employer-sponsored and other savings. 1996 BNA DAILY TAX REPORT 199d4 (October 15, 1996). For a good analysis of the effect of tax reform on saving generally, see Engen & Gale, *supra* note 50.

165. *Id.* at 350.

166. *Id.*

consumption taxes provide an incentive for savings. The maxim is tangled because it assumes that to encourage saving a tax system must provide incentives to save for those who hold potential savings directly. It thus equates the act of saving with the direct ownership of material capital. Yet, as the current tax system has proven so dramatically, the act of saving can be performed indirectly, as it is when employers contribute amounts to pension plans on their employees' behalf under the current system, and still produce substantial total savings. In other words, *from a desire to increase savings it doesn't follow that savings incentives must be provided in a way that gives maximum choice to those who hold material capital directly.*

The current system provides incentives for savings that have caused many to dub it a hybrid income/consumption tax.¹⁶⁷ While the hybrid nature of the system has caused its own set of problems, the fact that a system with what so many acknowledge to be a consumption tax component exists, shows that savings can be increased (or, put another way, that a consumption tax can be adopted), in a way that does not involve providing maximum ability to choose to those who own material capital directly. Like an income tax, a consumption tax can be designed so as to provide great amounts of choice to those who own material capital directly, or it can be designed so as to constrain that choice. The Arney Flat Tax and the Nunn-Domenici Tax are examples of the former type of consumption tax. The pension provisions of the current system are examples of the latter type. The real question is therefore not whether we should adopt a tax system that provides increased incentives for saving, but whether we should adopt a tax system that provides increased incentives for saving by giving maximum choice to those who own material capital directly. It is time to untangle, and separately discuss, each of those questions.

If *both* an increase in savings and the egalitarian distribution of the power to choose were important values, the current tax reform debate would look very different from the way it looks now. The discussion would be about ways of encouraging employer-sponsored savings even more and providing equivalent incentives for the self-employed. That the discussion has instead been about ways in which to exempt returns on savings for everyone, so that private saving becomes more attractive than employer-sponsored saving, reflects not the value of savings, but the value of choice for those who hold material capital directly.

167. See *supra* note 28 for a discussion of the hybrid nature of the current income tax system.

Both the Arme y Flat Tax and the Nunn-Domenici Tax allocate maximum choice to those who own material capital directly. In doing so, both exacerbate the allocation of choice that exists in the current tax system. Like the current system, both the Arme y Flat Tax and the Nunn-Domenici Tax affirm the value of the ownership of material capital. If either the Arme y Flat Tax or the Nunn-Domenici Tax is embraced as the tax system for the next millenium, it should be embraced with full awareness of the values that will also be embraced thereby, and not under the confused notion that it should be embraced because of the value of saving.

VI. CONCLUSION

Proponents of the Nunn-Domenici Tax and of the Arme y Flat Tax decry the low rate of savings in the United States and tout the benefits that will flow from adopting a tax system that aggressively favors saving over consumption. Although each proposal employs a different mechanism to achieve its end and neither would result in the enactment of a pure consumption tax (each fails to tax debt- and gift-financed consumption), both more closely resemble a consumption tax than does the current income tax system. Scholars have pondered whether consumption taxes can deliver on their promise of increasing savings and, if so, which type of consumption tax would best achieve that objective. They have debated the merits of yield exemption and consumed income taxes, concluded that one is economically equivalent to the other in present value terms, and offered administrative and structural reasons to favor one over the other. I have tried to develop a different approach.

I have studied not theoretical structures, but the detailed statutory language that would be necessary to put any such system in place and that serves as the congressional blueprint for any such change—the text of the proposed statutes. I have then sought to determine the extent to which the proposals differ from one another and from the current system in one important respect: the extent to which they give taxpayers the power to choose the level at which they will pay taxes and to determine whether they will bear the economic burden of the taxes imposed. The results of my inquiry demonstrate that even if yield exemption and consumed income taxes are equivalent in present value terms, they differ greatly from each other, and from the current system, in the amount of

power they give taxpayers, particularly taxpayers who do not own material capital directly. While the Armev Flat Tax gives providers of labor less power to choose than does the current system, the Nunn-Domenici Tax gives them more. Under my analysis, the choice among the three systems reduces to a decision about the extent to which specific taxpayers should have the power to choose the level of their tax liability. If too little power is bad, and too much is also bad, the question is how much is just right, and for whom.

The current system may have endured over fourscore and three years at least in part because the balance struck by its hybrid nature feels just right for many.¹⁶⁸ Despite its many flaws, the current system may have withstood the nearly constant criticism hurled at it and the calls for fundamental reform that seem to produce significant legislative changes at least once every ten years precisely because it reflects fundamental values.¹⁶⁹ Those values are the value of material capital and the value of personal autonomy. By giving direct owners of capital the greatest amount of power to choose the level of their tax liability, the rules that make up the current Internal Revenue Code reflect those values.

168. Although I have focused much of the discussion in this piece, and in my prior writing, on the amount of choice provided to owners of material capital, because I believe they are the people who receive the largest amount of choice under the current system, I do not mean to imply that other, deserving groups are bereft of choice. Books like Steven B. Mendelsohn's *TAX OPTIONS AND STRATEGIES FOR PEOPLE WITH DISABILITIES* (2d ed. 1996), show not only that some taxpayers can exercise choice regardless of the ownership of their capital, but that some people value the ability to exercise personal autonomy that the current tax system provides. The grant of choice to disabled taxpayers, like the provision of choice to the owners of material capital, empowers those taxpayers and reflects our values. Insightfully, Mr. Mendelsohn notes not only that substantial amounts can be saved by tax planning, but that:

[M]astery of the tax law [is] an important dimension of the self-help and the consumer movements. For those willing and eager to take full responsibility for their own destinies, financial planning, of which tax planning is in turn a key component, is surely an appropriate place to start.

STEVEN B. MENDELSON, *TAX OPTIONS AND STRATEGIES FOR PEOPLE WITH DISABILITIES* 5 (2d ed. 1996). The disabled would be among the groups who would experience reduced opportunities for the exercise of choice under the Armev Flat Tax and Nunn-Domenici Tax. Perhaps that is consistent with the other values those proposals represent.

169. It is interesting to note that the years 1966, 1976, and 1986 have each produced significant tax legislation, some of which was even labeled "Tax Reform." The Foreign Investor's Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539 (codified as amended in scattered sections of 26 U.S.C.) significantly changed the taxation of transnational transactions. The Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.) brought major, if short-lived, changes, such as the enactment of carryover basis. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.) broadened the tax base for individuals, repealed the *General Utilities* doctrine for corporations and significantly altered the rate structure.

Nevertheless, the veneration of the direct ownership of material capital under the current system is not unbridled. Perhaps because of the high value placed on the direct ownership of material capital, the system contains important provisions that make the accumulation of material capital—and the eventual direct ownership thereof—possible for many for whom it might not otherwise be so. The pension rules of the current system accomplish that objective by encouraging the establishment of a private pension system that benefits many whose primary asset is the ability to provide labor. The pension system denies providers of labor the opportunity to choose whether to consume or save specific amounts. In doing so, it adopts a paternalistic approach to savings so that even providers of labor can eventually become owners of material capital.¹⁷⁰ By removing the incentive for employer-sponsored pension plans, the Nunn-Domenici Tax (and, to a lesser extent, the Armev Flat Tax) removes the paternalism that inheres in the current system, but in doing so it changes the distribution of the power to choose.

Rules, like those that comprise the Internal Revenue Code, function as allocators of power.¹⁷¹ Compared to those of the current system, the rules of the Armev Flat Tax would allocate less power to individuals who lack material capital and more power to the Internal Revenue Service. The rules of the Nunn-Domenici Tax would allocate more power to individual holders of material capital, as well as to the Internal Revenue Service. Although I regard none of those changes as desirable, my objective has not been to argue for retention of the status quo; the status quo is far from perfect and there are many changes that I would endorse.¹⁷² Rather, my objective has been to expose the allocation of power that the proposed changes would effect and thus to move the

170. Twenty years ago Peter Drucker posited that the growth of pension funds has accomplished the objectives of socialism. Peter F. Drucker, *Pension Fund Socialism*, THE PUBLIC INTEREST 44 (Win. 1976). Drucker's thesis is that as a result of pensions funds "a larger sector of the American economy [(outside of farming)] is owned today by the American worker, through his investment agent, the pension fund, than Allende in Chile had brought under government ownership to make Chile a 'Socialist country,' than Castro's Cuba has actually nationalized, or than had been nationalized in Hungary or Poland . . ." See also PETER DRUCKER, THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA 2 (1976).

171. See, FREDERICK SCHAUER, PLAYING BY THE RULES 159-62 (1991).

172. These include changes to features that hide the full level of taxation, such as floors and phaseouts (see, e.g., I.R.C. §§ 67, 68, 151 (West 1996)), as well as the addition of features that would encourage increased savings through business-sponsored plans. (I have deliberately not used the phrase "employer-sponsored plans.")

debate toward a discussion of the values that such an allocation would endorse. What we think about the current crop of tax reform proposals depends not on what we think about simplicity and the desirability of increased savings but on what we think about the allocation of power.

A tax system can provide incentives for saving in ways that do not allocate power to the direct holders of material capital and high income providers of labor and away from low and middle income providers of labor. A tax system can also encourage savings through the allocation of power exclusively to the direct holders of material capital. The Armev Flat Tax and the Nunn-Domenici Tax would each enact systems of the latter type. The current income tax is not such a system, at least not exclusively. Since both types of systems can be said to encourage savings, the choice between them cannot depend solely on whether we want to encourage savings. The choice must instead depend on whether we want to encourage savings in ways that reserve increases in power to the direct holders of material capital rather than in ways that distribute power in different directions. We should discuss the power question explicitly.