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Tax Reform Interrupted: The Chaotic State of Tax Policy in 2003

Robert J. Peroni*

I. INTRODUCTION

The federal income tax system has served the United States reasonably well for some nine decades.[1] The income tax system is based on a tax fairness theory that the federal tax burden should be allocated on the basis of each taxpayer's ability to pay tax and that a taxpayer's income is an appropriate reflection of his or her ability to pay.[2] For all its problems (including declining taxpayer compliance and an understaffed and underfunded tax collection agency), this system enables the U.S. Treasury to collect significant amounts of revenue, at comparatively low administrative costs, for use in funding the U.S. government's direct expenditure programs.[3] Yet, during the past decade, this system has been under an unrelenting attack from some members of Congress, economists,

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1. The modern federal income tax system essentially began with the ratification of the Sixteenth Amendment to the U.S. Constitution in 1913 and the subsequent enactment of the Revenue Act of 1913. Although there has been significant tax legislation throughout the period since 1913, the three most fundamental tax bills relating to the income tax occurred with the enactment of the Internal Revenue Code of 1939, the Internal Revenue Code of 1954, and the Internal Revenue Code of 1986.

2. *See, e.g.*, JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 24-25, 30-32 (2d ed. 1999). The theoretical ideal for an income-based or accretion-based tax system is based on the work of economists Schanz, Haig, and Simons (sometimes called the Schanz-Haig-Simons model or the Haig-Simons model). Under that model, the income tax base would include both consumption and savings (i.e., the change in the fair market value of the taxpayer's property rights during the taxable year). Our current income tax system is, of course, not a theoretically pure income-based system and contains many departures from this theoretical model, including some features that reflect a consumption tax approach. Thus, it is more accurate to describe our system as a hybrid income-based system.

3. The U.S. tax system collects more money than any other tax system in the world and probably does so at the lowest administrative costs of any major system in the world. *See, e.g.*, N. Jerold Cohen, Remarks at the College of William & Mary's Annual Tax Conference (Dec. 6-7, 1996), in TAX ANALYSTS' DAILY TAX HIGHLIGHTS & DOCUMENTS, Dec. 18, 1996, at 2942. This fact should be kept in mind as we seriously consider other alternatives to the current income tax system.

business leaders, tax academicians,[4] and even Treasury Department tax policy officials in the current Bush Administration,[5] who argue that the system is near collapse and that a radical overhaul of the system is required.

Many of these politicians and commentators go so far as to argue that the system needs to be replaced by a national sales tax or other consumption-based tax system.[6] One prominent version of these proposals, the Hall-Rabushka Flat Tax,[7] is often mislabeled as a flat-rate income tax, when in fact it represents a form of consumption-based tax system with only one nominal rate.[8] One supposed selling point of this and other "flat tax" plans is that a taxpayer's tax return could fit on a postcard. However, of course, a significant number of U.S. taxpayers already use the equivalent of a post-card return on the Form 1040A or Form 1040EZ, both of which are quite simple, and a significant number of taxpayers who file the Form 1040 have a relatively simple return, using the

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4. *See, e.g.*, MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX (1997); MICHAEL J. GRAETZ, THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE (1999) [hereinafter GRAETZ, WHERE DO WE GO FROM HERE]; Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261 (2002) [hereinafter Graetz, *A Fresh Start*]. Professor Graetz has offered an intriguing proposal to replace the current income tax system, estate and gift tax system, and Social Security (i.e., payroll) tax with the following: (1) a 10-15 percent federal credit-method, value added tax; (2) a 20-25 percent individual income tax that applies only to people with incomes in excess of $100,000 ($50,000, in the case of an unmarried taxpayer), treating large testamentary and inter vivos gratuitous transfers as income, and (3) a 20-25 percent corporate income tax. *See* GRAETZ, WHERE DO WE GO FROM HERE, *supra*, at 303-14; Graetz, *A Fresh Start*. This proposal recognizes, among other things, that most individual taxpayers whose incomes are under $100,000 consume currently a large part of their incomes, so that for those taxpayers an income-based system and a consumption-based system could produce substantially the same tax base. The payroll tax is a significant burden for these taxpayers so the Graetz proposal might well reduce the overall federal tax burden for many taxpayers at this income level. By retaining a significant income tax for those whose incomes exceed $100,000, the Graetz proposal, unlike many consumption tax proposals, retains a progressive distribution of the federal tax burden that reflects ability-to-pay considerations. There are numerous technical questions about the Graetz proposal as well as policy criticisms that can be made about various aspects of it (e.g., why not use a two- or three-rate income tax instead of a single rate, but keep the top rate under 30 percent?), but it certainly presents an interesting alternative to the current system.

5. For example, on March 10, 2003, at a conference sponsored by the Federal Bar Association, Pamela Olson, then Assistant Treasury Secretary for Tax Policy in the Administration of George W. Bush, hyperbolically stated her belief that the federal income tax code is so complex that "the system is nearing collapse." Alison Bennett, *Olson Defends Bush Dividend Proposal, Urges Simplification of Corporate Tax Rules*, BNA DAILY TAX REP., Mar. 11, 2003, at G-1. Such overstatements by government officials in charge of the tax system are not helpful.

6. *See, e.g.*, LAWRENCE SEIDMAN, THE USA TAX (1997).

7. ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995). The Hall-Rabushka Flat Tax appears deceptively simple and all of its provisions fit on a small number of printed pages. However, this simplicity is deceptive because the Hall-Rabushka Flat Tax is short on definitions, apparently delegating that difficult but necessary task to the Treasury and the courts (which delegation, of course, involves separation-of-powers and allocation-of-powers issues). Moreover, the Hall-Rabushka Flat Tax proposal contains virtually no procedural or administrative provisions, which, of course, would have to be added if the proposal were to be enacted into law. It is unclear whether these omissions are intended to mislead or represent an economist's inability to translate his or her ideas into a workable system of legal rules.

8. The Hall-Rabushka Flat Tax, like most so-called flat tax proposals, is not really a single-rate system because it contains a generous personal exemption, which exempts a certain amount of income from the tax and, therefore, creates a bracket of income with a zero rate of tax. It would be more accurate to describe it as a "flatter" tax proposal.

standard deduction (instead of itemizing deductions).[9] The Bush Administration seems headed in the direction of a consumption-based tax system with its proposals to provide several new savings initiatives,[10] to exempt most corporate dividends from taxation at the shareholder level,[11] and to provide more rapid depreciation and increase the expensing of depreciable business assets.[12] In addition to these legislative proposals, the Bush Treasury Department has issued proposed regulations that allow many types of intangible expenditures with significant future benefits to be treated as current expenses rather than capital expenditures, a treatment more consistent with a consumption-based system than an income-based system.[13] Taken together, these legislative proposals and

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9. *See* IRS, STATISTICS OF INCOME BULLETIN, Winter 2002-2003 Publication 1136 (Rev. 4-2003) (indicating that of 130,456,253 individual income tax returns filed in 2001, 50,112,314, approximately 38%, were returns on Form 1040A or 1040EZ; also indicating that approximately 65 percent of the individual income tax returns filed in 2001 used the standard deduction). Perhaps the IRS has hesitated in putting the Form 1040EZ return on a post-card because it does not want to cause eyestrain for the taxpayers who would have fill it out or the IRS personnel who would have to process it.

10. *See* U.S. TREAS. DEP'T, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 118-127 (Feb. 2003) [hereinafter GENERAL EXPLANATION OF BUSH PROPOSALS].

11. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 11-22. Congress did not enact this proposal in 2003. Instead, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Act") added Section 1(h)(11) to the Code. In the case of noncorporate taxpayers, Section 1(h)(11) reduces the double tax on corporate earnings by treating "qualified dividend income" as "net capital gain" for purposes of section 1(h) only. The net result is that such dividend income, while remaining ordinary income for most purposes in the Code (including the capital loss limitation in section 1211), is taxed at the preferential tax rates applicable to long-term capital gains—namely, under current law, 15 percent for taxpayers whose other income is taxed at rates of 25 percent or higher and 5 percent (0 percent for taxable years starting after 2007) for taxpayers whose other income is taxed at rates of 15 percent or below. Section 1(h)(11) sunsets in 2009, i.e., the provision will no longer apply for taxable years starting after 2008, unless Congress extends the effective date in subsequent tax legislation. Integration of the corporate and individual tax systems is consistent with either an income/accretion-based tax system following the Schanz-Haig-Simons ideal or a consumption-based tax system, although a number of commentators have developed theoretical defenses of the corporate income tax. *See* authorities cited *infra* note 56. Stated differently, double taxation of corporate earnings is not consistent with either an income-based or consumption-based tax system. Nonetheless, given the context in which the Bush Administration is advancing this dividend exemption proposal, it is fair to describe it as part of the Administration's push for a consumption-based tax system.

12. In 2002, Congress enacted the Bush Administration's proposals for more rapid depreciation in the hope that these provisions would serve as an economic stimulus that helps pull the economy out of recession. *See* Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21, § 101(a) (adding the original bonus depreciation provisions in Section 168(k) to the Code). In a tax giveaway bidding war in 2003, Congress enacted provisions giving taxpayers even more generous depreciation deductions than were in the Bush Administration's original 2003 proposals. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, § 201 (amending Section 168(k) of the Code), 202 (amending Section 179(b) of the Code). For a spirited critique of the bonus depreciation provisions in the 2003 Act, see Calvin H. Johnson, *Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation*, 100 TAX NOTES 713 (2003) (arguing that these provisions give taxpayers a negative tax of 27 percent for debt-financed equipment that is roughly equivalent to the government paying 27 percent of the cost of depreciable equipment purchased by taxpayers). As Professor Johnson points out, by creating a negative tax rate on debt-financed equipment, these 2003 Act provisions do serious economic harm by making inferior investments look attractive. *Id.* at 714.

13. *See* Prop. Treas. Reg. § 1.263(a)-4, 67 Fed. Reg. 77701 (Dec. 19, 2002). These proposed regulations purport to interpret the Supreme Court's decision in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), which held that intangible expenditures providing a taxpayer with significant future benefits have to be capitalized (instead of currently deducted), notwithstanding that such expenditures do not create or enhance a separate and distinct asset. However, the proposed regulations basically adopt the industry/taxpayer position on

administrative actions seem to signal the Bush Administration's intent to abandon the income tax and attempt to shift the federal tax system toward a more consumption-based approach. The Administration, however, to date has failed to overtly present a comprehensive consumption-based reform proposal. Instead, the Administration has made piecemeal proposals with a consumption-tax flavor that if enacted would amount to a poorly designed partial consumption tax system.

The thesis of this article is that, to paraphrase Mark Twain, the reports of the death of the income tax system are much exaggerated.[14] It has significant problems to be sure, but we should not forget that our income tax system remains in many ways the envy of the world. The system needs to deal with a continuing decline in corporate tax payments due in part to corporate tax avoidance and (in some cases) tax evasion, including the cancerous corporate tax shelter problem. It needs modernized and expanded enforcement and collection capabilities. And it desperately needs reform and simplification of its increasingly complicated provisions. But that is a far cry from saying that it "should be torn out by its roots" and replaced in its entirety with some kind of unproven consumption tax or other alternative tax system.

Congress should reject attempts by the Bush Administration to adopt a consumption tax by incremental steps without undertaking a careful study of this issue, developing a proposal for an overall consumption tax system, and disclosing and discussing the pros and cons of such a proposal. Moreover, any proposed new tax system needs to be revenue neutral or raise more revenue than the current system does, not lose roughly $675 billion over ten years[15] as the Bush Administration's original 2003 tax proposals would have done.[16]

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most of the issues that have come up after the *INDOPCO* decision and attempt to construe the capitalization mandate of *INDOPCO* as narrowly as possible. Allowing a current deduction for what is essentially a capital expenditure is consistent with a consumption-based tax system but inconsistent with an income-based system. The future value portion of a capital expenditure is savings or investment, which should be included in the tax base if one is using an income-based system but excluded if one is using a consumption-based system. For spirited critiques of these proposed regulations, see Calvin H. Johnson, *Destroying Tax Base: The Proposed* INDOPCO *Capitalization Regulations*, 99 TAX NOTES 1381 (2003); Lee A. Sheppard, *Bringing the Separate-Asset Test Back from the Dead*, 97 TAX NOTES 1655 (2002). For other commentary on these proposed regulations, see Laurence M. Bambino & Richard M. Nugent, *The Proposed* INDOPCO *Regulations: A Primer*, 99 TAX NOTES 259 (2003). These proposed regulations were modified and issued in final form in December 2003. *See* T.D. 9107, 2004-7 I.R.B. 447.

14. The modest aim of this article is to discuss why I think that the Bush Administration's tax proposals are fundamentally flawed and that a more deliberate tax reform process is necessary. This article is not intended to be a comprehensive discussion of the pros and cons of a consumption base versus an income base.

15. This is probably a conservative estimate that understates the revenue losses that would come from tax planning moves designed to take advantage of the new savings initiatives as well as the Bush Administration's dividend exemption proposal. Moreover, the revenue loss from the savings proposals would increase over time because in the early years potential revenue losses are exceeded by the revenue gains from taxpayers shifting funds from tax-deductible savings vehicles to after-tax savings vehicles the income from which is exempt from income tax.

16. It was estimated that the Bush Administration's original 2003 tax proposals also would have caused states to lose up to $64 billion in tax revenues over a ten-year period at a time when most states were in fiscal crisis, partly as a result of the 2001 tax law changes and mostly as a result of the weak economy. *See* Iris J. Lav,

The Reagan Administration's tax reform efforts are the way to proceed. Start with a carefully thought out academic study of how to proceed, which sets forth all of the options and frankly and fully discusses the pros and cons of each option (including various consumption-based systems).[17] Then develop a proposal based on that study, which reflects some (but not too much) compromise based largely on issues of administrative feasibility.[18] Next, build public support for tax reform through public hearings and town hall meetings regarding the reform proposals. The philosophy of the Reagan tax reform effort was to retain the income tax system, but broaden the base of the tax system by eliminating tax preferences and lower marginal tax rates, thereby simplifying the system and enhancing its fairness and economic efficiency.[19] Those tax reform efforts resulted in what is one of the best pieces of tax legislation ever enacted—namely, the Tax Reform Act of 1986.[20]

The 1986 Act was certainly not perfect by any means. It was defective in a number of respects, some of which I will mention here. First, it continued the tendency of Congress to enact separate limitations on total deductions arising from a particular activity instead of eliminating or reforming the underlying deductions themselves,[21] thus increasing the complexity of the tax system. Second, it missed an opportunity to do something about corporate integration,

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President's Tax Proposals Would Reduce State Revenues by $64 Billion over 10 Years, 27 STATE TAX NOTES 521 (2003). The estimated state revenue loss from the 2003 Bush proposals resulted from the fact that most states have "piggyback" state income tax systems, which use federal adjusted gross income as the starting point for determining the state tax base. For such states, federal tax changes that reduce federal adjusted gross income, such as the President's dividend exclusion proposal, the increased expensing of depreciable assets by small businesses, and proposed consolidation of employer-based retirement savings accounts, reduce the state tax bases as well.

17. *See* U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984) (vols. 1-3) [hereinafter TREASURY I].

18. From a strategic point of view, it is best to start out with a relatively pure proposal because whatever is proposed will be further compromised through the tax legislative process.

19. *See* TREASURY I, *supra* note 17, at 37-43; U.S. TREAS. DEP'T, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 1-8 (May 1985).

20. Pub. L. No. 99-514 (1986).

21. *See, e.g.*, I.R.C. § 469 (2002). Although the passive loss rules of Section 469 were successful in shutting down the most prevalent tax shelters of the 1980s, they had a number of policy problems and certainly did not end the use of tax shelters by all taxpayers. *See* Joseph Bankman, *The Case Against Passive Investments: A Critical Appraisal of the Passive Loss Restrictions*, 42 STAN. L. REV. 15 (1989); Mona L. Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?*, 40 ARIZ. L. REV. 615 (1998); Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988); Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499 (1989); *cf.* Daniel N. Shaviro, *Selective Limitations on Tax Benefits*, 56 U. CHI. L. REV. 1189 (1989). *But see* Calvin H. Johnson, *Why Have Anti-Tax Shelter Legislation? A Response to Professor Zelenak*, 67 TEX. L. REV. 591 (1989); Cecily W. Rock & Daniel N. Shaviro, *Passive Losses and the Improvement of Net Income Measurement*, 7 VA. TAX REV. 1 (1987). For example, Section 469 does not prevent the use of passive losses from one shelter investment to offset the passive income from another shelter investment. Moreover, the passive loss rules do not apply to corporate taxpayers (except in a modified way to certain closely held C corporations) and, not surprisingly, corporations are the primary customers for tax shelter products today. These modern tax shelter products are in many ways more sophisticated than the tax shelters of the 1980s and Section 469 has had no significant effect on them.

ending the double taxation of corporate earnings, and, exacerbated the bias against the corporate form by increasing taxes on corporations to pay in part for the individual rate cuts. Third, it brought into the tax code the section 67 two-percent floor on miscellaneous itemized deductions[22] and a rate schedule bump to phase out the benefits of the 15% rate bracket for high-income taxpayers, both of which amounted to hidden marginal rate increases that applied to some taxpayers.[23] Fourth, it did little about reforming the treatment of debt in the tax system, except that the interest deduction was substantially limited for noncorporate taxpayers (which did remove some of the incentive in the income tax system for borrowing). Fifth, it eliminated the capital gain preference, perhaps the single biggest source of complexity in the tax system, but did so effectively only on a temporary basis. That meant that the preference could easily reappear again, as it did just four years later in 1990 when the first President Bush signed into law the Revenue Reconciliation Act of 1990.[24] The 1990 Act raised the top individual marginal rate to 31% and thereby reinstated the capital gain preference at a preferential rate of 28%. The Revenue Reconciliation Act of 1993[25] and the Taxpayer Relief Act of 1997[26] then proceeded to increase the complexity of the capital gain preference by creating several different preferential capital gains rates. Finally, the 1986 Act reformulated the alternative minimum tax rules into a substantial side-by-side alternative tax system to our regular income tax system. Although done with meritorious motives, this move added substantial complexity to the tax system and created an alternative system that threatens to engulf the regular

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22. Pub. L. No. 99-154, § 132(a) (1986). To be fair, Congress intended section 67 as an indirect way of disallowing deductions that it viewed as of questionable validity. For example, section 67 has the effect of disallowing the deduction for unreimbursed employee business expenses, which Congress thought was often erroneously claimed by taxpayers. Of course, the direct solution to that problem is to increase the substantiation requirements for employee business expenses, not disallow the deduction for such expenses indirectly through a floor. Alternatively, if Congress thought the abuses to be great, it could amend section 162 to provide that employee business expenses are not deductible unless they are reimbursed. The other targets of section 67 are section 212(1) and (2) expenses that are not related to rent or royalty income and section 212(3) expenses relating to tax preparation, planning, and litigation. If Congress wants to disallow deductions for such expenses, it should amend section 212 to so provide. Using a floor instead of the direct disallowance-of-deduction approach is less effective and adds complexity to the tax system, but allows Congress to attempt to avoid some political accountability for the tax change.

23. The 1986 Act changed the individual rate schedule in section 1 to contain only two explicit rates: 15% and 28%. The phase-out of the 15% bracket for high-income taxpayers was accomplished through the use of a 5% surcharge on income within a certain range, which resulted in an effective marginal rate of 33% (28% plus 5%) on income within that range. The Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, added a new 31% rate and eliminated the 5% surcharge to phase-out the benefits of the 15% bracket for high-income taxpayers, but added two new phase-out provisions that increase the effective marginal rates of some high-income taxpayers with income above a specified amount and within certain ranges—namely, the section 68 three-percent-of-adjusted-gross-income phase-out of itemized deductions and the section 151(d)(3) phase-out of the personal exemption deductions.

24. Pub. L. No. 101-508. The tax reform lesson is clear—temporary fixes do not work well.

25. Pub. L. No. 103-66, 107 Stat. 312.

26. Pub. L. No. 105-34, 111 Stat. 788.

tax system for a significant number of taxpayers within a few years, unless something is done to remedy this problem.

Remedying these and other defects in the 1986 Act and in subsequent tax legislation enacted in the first Bush Administration and the Clinton Administration should be part of the agenda for the next major tax reform effort. However, the Bush tax bills actually enacted by Congress in 2001,[27] 2002,[28] and 2003[29] had a significant negative effect on the prospect for fundamental tax reform. The 2001 Act allocated a substantial share of the then projected budget surpluses for uses only tangentially related to tax reform and simplification (most prominently, the tax rate cuts in the bill), making less revenue available for future tax reform efforts. Those projected surpluses are now gone and have been replaced with significant projected budget deficits for the foreseeable future. The 2002 and 2003 tax acts further increased those projected budget deficits. This makes future tax reform and simplification efforts more difficult because, for tax reform to be politically viable, it is often necessary to include tax cuts as part of the reform package to reduce the number of taxpayers who have increased taxes as part of the reform effort.[30]

To be completely fair, the 2001 and 2003 tax acts did achieve some measure of simplification. First, the 2001 Act simplified the earned income tax credit in section 32, by simplifying the definitions of earned income and a qualifying child for purposes of the credit and simplifying the ridiculously complicated calculation of the credit. These changes achieve tax simplification for low-income taxpayers.

Second, the 2001 Act repealed the estate tax provisions over a period of ten years, with actual repeal taking place in 2010. This change eventually will be a simplification move, but only if the sunset provisions of the 2001 Act are repealed and the estate tax repeal becomes permanent.[31] However, there are other efficiency and equity issues that make repeal of the estate and gift tax provisions a controversial and questionable tax policy move.[32]

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27. The title of this tax act is the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 [hereinafter EGTRRA].

28. As earlier noted, the title of this tax act is the Job Creation and Worker Assistance Act of 2002. *See supra* note 12.

29. As earlier noted, the title of this tax act is the Jobs and Growth Tax Relief Reconciliation Act of 2003. *See supra* note 12.

30. WILLIAM G. GALE, TAX SIMPLIFICATION: ISSUES AND OPTIONS (July 17, 2001) (Brookings Institution publication of revised testimony of William G. Gale before the House Committee on Ways and Means on July 17, 2001).

31. As is true of all of the 2001 Act provisions, the estate tax repeal provision sunsets at the end of 2010, Pub. L. No. 107-16, § 901, and, unless made permanent in some other tax bill (as is proposed by the Bush Administration in its 2003 tax proposals), the estate and gift tax provisions as in place prior to the 2001 Act will become law again in 2011. The 2001 Act sunsets in this way because President Bush could get more than fifty votes in support of the bill in the Senate, but not the supermajority sixty votes needed to cut off debate on permanent tax cuts. This is a shameful way to legislate and President Bush should have been able to reach agreement with congressional leaders of both political parties on a tax proposal that could be enacted into law on a permanent basis.

32. Any further discussion of the repeal of the estate and gift tax provisions in the 2001 Act is beyond

Third, the 2001 Act repealed the section 68 overall limitation on itemized deductions and the section 151(d)(3) phase-out of the personal exemption deductions. These phase-outs represent hidden marginal rate increases for the taxpayers to whom they apply, which add significant complexity to the tax system.[33] Unfortunately, two features of the 2001 Act substantially limited the simplification potential of these changes. One is that the Act did nothing about another phase-out provision—the section 67 two-percent floor on miscellaneous itemized deductions. That provision subjects certain of a taxpayer's itemized deductions to a two-percent-of-adjusted-gross-income floor, including a taxpayer's expenses of the trade or business of being an employee. The second is that the 2001 Act only phases these provisions out over time, instead of eliminating them immediately for the 2001 tax year.[34] This was presumably done to minimize the revenue effects of eliminating the phase-out provisions. It also allows Congress to hedge its bet, as it were, and possibly prevent the repeal from ever taking place, or further delay the effective date of the phase-out repeal provisions, if Congress decides it needs additional revenue and does not want to raise that revenue more directly by further base broadening or rate increases. This approach to tax legislation breeds public cynicism toward the tax legislative process and the tax system. Any new tax legislation should move up the effective date of the phase-out repeal provisions. Moreover, serious thought should be given to repealing the two-percent floor in section 67 as well.

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the scope of this article. For a sampling of the commentary on the pros and cons of estate tax repeal, including the economic considerations, see RETHINKING ESTATE AND GIFT TAXATION (William G. Gale, James R. Hines & Joel Slemrod eds., 2001); AICPA Tax Division, *Reform of the Estate and Gift Tax System*, 91 TAX NOTES 307 (2001); Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69 (1990); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539 (1993); Joel Friedman & Andrew Lee, *Estate Tax Repeal Would Be Costly, Yet Benefit Only a Few*, 95 TAX NOTES 1984 (2002); William G. Gale & Joel Slemrod, *The Estate Tax: Not Dead Yet*, 93 TAX NOTES 807 (2001); Michael J. Graetz, *To Praise the Estate Tax, Not To Bury It*, 93 YALE L.J. 259 (1983); Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183 (1983); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994); Martin A. Sullivan, *Estate Tax Repeal Will Create 200,000 Jobs—Or Will It?*, 100 TAX NOTES 11 (2003); Stephen Vasek, *Death Tax Repeal: Alternative Reform Proposals*, 92 TAX NOTES 955 (2001); Dennis J. Ventry, Jr., *Straight Talk About the 'Death' Tax: Politics, Economics, and Morality*, 89 TAX NOTES 1159 (2000).

33. *See, e.g.*, Glenn E. Coven, *Congress as Indian-Giver: "Phasing Out" Tax Allowances Under the Internal Revenue Code of 1986*, 6 VA. TAX REV. 505 (1987); Calvin H. Johnson, *Simplification: Replacement of the Section 68 Limitation on Itemized Deductions*, 78 TAX NOTES 89 (1998); Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415 (2001); William D. Popkin, *Phantom Tax Rates*, 78 TAX NOTES 1409 (1998). *But see* Reed Shuldiner & David Shakow, *Lessons From the Limitation on Itemized Deductions*, 93 TAX NOTES 673 (2001) (concluding that the section 68 limit is equivalent to an increase in marginal tax rates on adjusted gross incomes for most taxpayers subject to the limit, but that for a significant portion of taxpayers with adjusted gross incomes in excess of $1 million, section 68 operates as a true restriction on itemized deductions; also concluding that the standard deduction acts as an empirically important limitation on section 68).

34. In addition, as is true of all of the 2001 Act provisions, this phase-out of the phase-out provisions sunsets at the end of 2010, and, unless made permanent in some other tax bill (as was proposed by the Bush Administration in its 2003 tax proposals), the tax system as in place prior to the 2001 Act will become law again in 2011 and the phase-out provisions will become law again.

Fourth, by reducing (but not eliminating) temporarily the shareholder-level tax on dividends paid to noncorporate shareholders, the 2003 Act reduced the double tax on corporate earnings. This reduction in the double tax on corporate earnings should simplify the tax system by reducing the importance of the distinction between dividend distributions and redemptions of stock treated as sale or exchanges of the shareholder's stock and by reducing the tax bias in favor of debt financing (instead of equity financing) of corporations. However, this legislative change does nothing to help mitigate the corporate tax shelter problem. Dividends paid by a corporation to noncorporate shareholders are taxed at the lower capital gains rates without regard to whether the earnings out of which they are paid bore any tax at the corporate level.

Nevertheless, the 2001 and 2003 tax acts were largely significant steps in the wrong direction and certainly did not help the cause of fundamental tax reform. Those missteps in tax policy are likely to continue with two Bush tax proposals that were not enacted in 2003 but are likely to resurrected in subsequent tax proposals by the Administration—the dividend exemption proposal and the proposals for new tax-favored savings vehicles.

II. CORPORATE INTEGRATION WITHOUT FUNDAMENTAL TAX REFORM: THE BUSH ADMINISTRATION'S DIVIDEND EXEMPTION PROPOSAL

Under current law, the earnings of a corporation are, at least theoretically, subject to two levels of tax, one at the corporate level and a second at the shareholder level.[35] The shareholder-level tax is imposed either on corporate distributions to the shareholder (which for the years 2003-2008 are taxed to individual shareholders at the lower capital gains rates and thereafter are taxed at ordinary income rates if the distribution is a dividend[36] and at the lower capital gain rates if the distribution qualifies as a sale or exchange redemption[37]) or on the shareholder's gain from the sale of the stock (which normally qualifies for the lower capital gains rates).[38] As discussed below, this double taxation of corporate earnings generates economic inefficiencies and is inequitable, leading to proposals to eliminate the double tax and "integrate" the corporate and individual income tax systems. In fact, however, large amounts of economic income earned by corporations is not subject to any tax at the corporate level, due to corporate tax preferences, corporate tax sheltering activity, and defects in the corporate tax

35. This approach to taxing corporate earnings is sometimes referred to as the "classical" system for taxing corporations. For studies of corporate integration, see U.S. TREAS. DEP'T, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 39-58 (1992) [hereinafter U.S. TREAS. DEP'T, TAXING BUSINESS INCOME ONCE]; FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES (ALI 1993).

36. If the shareholder is a corporation, the corporation may not be taxed on the dividend or taxed on only a portion of the dividend by reason of a 70%, 80%, or 100% dividends-received deduction. *See* I.R.C. § 243.

37. *See id.* §§ 302, 303, 1221, 1222, 1(h).

38. *See id.* §§ 61(a)(3), 1221, 1222, 1(h).

accounting provisions in the Code.[39] And, the supposed second, shareholder-level tax may be either nonexistent or minimal (in the case of stock held by tax-exempt charitable organizations or tax-deferred pension funds, or by foreign persons who pay a reduced tax on dividends under tax treaties and generally pay no tax on their capital gains from stock sales) or at the low capital gains rates (in the case of taxable individual shareholders). These facts make corporate integration a less compelling and less appealing tax policy agenda item than would otherwise be the case.

In addition, despite the positive effects of corporate integration (discussed below), integration proposals have gone nowhere over the years. There are three primary reasons. First, there is an agency problem vis-à-vis managers and shareholders of a publicly traded corporation, namely, that managers want to retain earnings for use in corporate projects and not pay dividends and the double tax on corporate earnings creates a tax disincentive for shareholders to demand dividends.[40] Thus, historically the managements of publicly traded corporations have not been big supporters of corporate integration proposals and some believe that this opposition will continue to serve to undermine the Bush Administration's dividend exemption proposal.[41] Second, there are an increasing number of alternative forms of business entity that combine some corporate attributes (e.g., limited liability) with a single level of tax, such as limited partnerships, limited liability partnerships, and limited liability companies. The proliferation of these types of entities over the years has reduced the pressure to adopt an integration proposal. Third, closely held corporations have alternative, "self-help" methods of achieving a single level of tax through payment of deductible salary, rent, or interest to shareholders who work for, lease property to, or lend money to the corporation. Accordingly, small business owners, who have a potent political lobby, may not care that much about corporate integration. Thus, these political realities mean that the Administration's dividend exemption proposal will continue to face an uphill struggle to be enacted in anything like the form it was presented in the Bush Administration's 2003 tax proposals.

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39. *See* MIHIR A. DESAI, THE CORPORATE PROFIT BASE, TAX SHELTERING ACTIVITY, AND THE CHANGING NATURE OF EMPLOYEE COMPENSATION, NBER WORKING PAPER NO. 8866 (Apr. 2002) (stating that "the regression evidence suggests that efforts by firms to circumvent tax payments are becoming more significant, cheaper to implement, and harder to detect"); Joel Friedman & Robert Greenstein, *Exempting Corporate Dividends From Individual Income Taxes*, TAX NOTES TODAY, 4-33, Jan. 7, 2003; William G. Gale & Peter R. Orszag, *The Administration's Proposal to Cut Dividend and Capital Gains Taxes*, 98 TAX NOTES 415, 416 (2003); Robert McIntyre, *New Gang, Old Myths*, THE AMERICAN PROSPECT, Jan. 13, 2003; Gretchen Morgenson, *Waiting for the President to Pass the Tax-Cut Gravy*, N.Y. TIMES, Jan. 5, 2003.

40. *See, e.g.*, Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995); Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167 (2002); John K. McNulty, *Reform of the Individual Income Tax by Integration of the Corporate Income Tax*, 46 TAX NOTES 1445, 1446 (1990); James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971, 1034-35 (1992); Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 411 n.8 (2000).

41. *See* Martin A. Sullivan, *Dividend Déjà Vu: Will Double Tax Relief Get Canned—Again?*, 98 TAX NOTES 645 (2003).

Nevertheless, Glenn Hubbard, the former chair of the Council of Economic Advisers in the current Bush Administration and a top Treasury official in the first Bush Administration, who had worked on corporate integration in that Administration, developed a corporate integration proposal that had become one of the centerpieces of the President's tax proposals for 2003.[42] The proposal would allow a corporation to distribute nontaxable dividends to its shareholders to the extent that the dividends are paid out of earnings that have been taxed at the corporate level.[43] This proposal would apply to both publicly traded and closely held corporations.

Under this proposal, for each year, a corporation would calculate an excludable dividend amount (EDA). This reflects the amount of corporate income subject to tax minus any taxes paid by the corporation on the income and is the amount of dividends that the corporation can distribute tax-free to its shareholders. For example, suppose that a corporation has $1,000 of taxable income on which it pays $350 of federal income tax. The corporation's EDA would be $650 and that is the amount of dividends that the corporation could distribute tax-free to its shareholders.[44]

As a mechanical matter, EDA is the amount of income that the corporation would have had after-tax if it had paid tax on its income at a 35% rate. The corporation's EDA is based on the federal income tax shown on the corporation's federal income tax return filed in the immediately prior calendar year.[45] Thus, in the example above, if the corporation pays a tax of $350, the EDA of $650 is computed based on the assumption that the corporation had paid a 35% tax on a pre-tax income of $1,000. The corporation's EDA here would be $650 and that is the amount of dividend that could be excluded at the shareholder level, regardless of what the corporation's actual pre-tax income was and at what rate it paid tax

42. The background to this proposal makes it seem that the proposal was developed largely at the White House, with technical development of the proposal at the Treasury Department's Tax Policy Office coming after the fact.

43. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 12. For detailed analyses of this proposal, see Lorence L. Bravenec & Fred Feucht, *The Bush Administration's Proposed Dividends Exclusion*, 98 TAX NOTES 1251 (2003); Merle Erickson & James Smith, *The President's Proposed Dividend Exemption and Closely Held Companies*, 98 TAX NOTES 1244 (2003); Calvin Johnson, *The Bush 35 Percent Flat Tax on Distributions from Public Corporations*, 98 TAX NOTES 1881 (2003); Michael L. Schler, *The Administration's Dividend Exclusion Proposal*, 98 TAX NOTES 1895 (2003). For a critique of the dividend exclusion proposal on economics grounds, see Friedman & Greenstein, *supra* note 39. For a critique of the dividend exclusion proposal on equity grounds, see Samuel C. Thompson, Jr., *President's Dividends Plan Undertaxes High-Income Taxpayers*, 98 TAX NOTES 389 (2003). For an analysis of the practical implications of the President's proposal, see Burgess J. W. Raby & William L. Raby, *Tax Practitioners and the Dividend Exclusion*, 98 TAX NOTES 553 (2003). For a proposal for an incremental investment credit as a substitute for the President's dividend exclusion proposal, see Samuel C. Thompson, Jr., *An Alternative to the Flawed Bush Dividend Plan, Financed by ETI Repeal*, 99 TAX NOTES 117 (2003).

44. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 12.

45. *Id.* at 14. For example, if a corporation uses the calendar year, its return for calendar year 1 would be filed on March 15 of year 2, and the tax shown on that return would affect the corporation's EDA for year 3. *Id.* These timing differences in the calculation of EDA would create tax-planning opportunities, some of which are discussed later in this article.

on that income.[46] Notice, therefore, that this proposal would exclude a dividend at the shareholder level in full only to the extent that the corporation has paid a 35% tax at the corporate level. To illustrate: if the corporation's pre-tax income was $2,333 and was taxed at the lowest corporate rate bracket of 15% (thus resulting in a corporate tax of $350), the corporation's EDA would still be only $650. If it paid a dividend of $1,983 (its after-tax income), only $650 of it would be excluded at the shareholder level and the remaining $1,333 would be taxable at the shareholder level (at the shareholder's marginal tax rate).

If a corporation's distributions during the year exceed its EDA, the EDA would be allocated to all distributions during the year pro rata and part of each distribution would be excludable and part would be taxable. Under this proposal, therefore, a shareholder would likely not know the actual tax consequences of the dividend at the time it is received because the shareholder cannot know how much of the EDA would be allocated to that dividend. This fact would make preferred stock an unattractive equity holding for taxable shareholders because they would not be able to calculate their likely after-tax return on the stock.[47]

This proposal would retain the capital gains tax on a shareholder's gain from the sale of the stock and the preferential rate of tax on a shareholder's capital gains (currently 15% for high-bracket shareholders and 5% for lower-bracket shareholders).[48] However, the Bush Administration was concerned that this aspect of the proposal would create an incentive for the corporation to distribute dividends to its shareholders (who would not be taxed under the proposal) instead of retaining the earnings at the corporate level (which would result in a capital gain tax to the shareholder upon a sale of the stock at a gain). Accordingly, the proposal would allow shareholders to increase their basis in the shares of stock in the corporation to reflect retained earnings taxed at the corporate level. The proposal accomplishes this by allowing the corporation to elect a dividend reinvestment plan (DRIP) and allocate all or some portion of its EDA to these basis increases.[49] This DRIP is elected at the corporate level without any involvement by the corporation's shareholders. With respect to EDA allocated to the DRIP, the corporation treats its income as if it had been distributed to its shareholders (tax-free as would other dividends attributable to EDA), who then contribute the income back to the corporation as a contribution to capital and, thus, increase the bases of their stock. These allocated basis increases reflecting the corporation's retained earnings are referred to as REBAs (namely, retained earnings basis adjustments). These basis increases will reduce the amount of the shareholder's gain from the sale of the stock to the extent that the sales price for the stock reflects retained earnings that were previously taxed at the corporate

46. *See* Johnson, *supra* note 43, at 1888 (noting that, under this proposal, the EDA is always 65/30 or 186 percent of the tax actually paid at the corporate level).

47. *See* Schler, *supra* note 43, at 1900.

48. *See* I.R.C. § 1(h) (amended 2003).

49. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 14; Johnson, *supra* note 43, at 1884.

level. These basis increases reduce the corporation's EDA and its earnings and profits. The proposal requires a corporation to keep records of the total REBAs made with respect to its stock in prior years and refers to the cumulative amount of REBAs for all years as the corporation's CREBA. The proposal requires that the basis increases be allocated in the same manner as would a distribution and does not allow the corporation to allocate basis increases to preferred stock.[50]

Suppose that a corporation's EDA is less than the distributions that it wants to make during a year. The proposal treats the distribution as essential reversing the basis adjustments made in the prior years. To that extent, the distribution is nontaxable and reduces the shareholder's adjusted basis in the stock and reduces the corporation's CREBA.[51] This gives the corporation a great deal of flexibility in how it allocates its EDA and how it treats its distributions for tax purposes. Unfortunately, that flexibility also provides tax planners with ample opportunities for tax minimization schemes based on the dividend exemption proposal. The ordering rules for the treatment of distributions under this proposal are as follows:

(1) Distributions treated as dividends are excludable to the extent of the corporation's EDA. (Excludable dividends reduce both the corporation's EDA and earnings and profits.)

(2) To the extent that the distribution exceeds EDA, it is treated first as a return of basis and then as capital gain to the extent of the corporation's CREBA.

(3) Any excess of the distribution is treated as a taxable dividend to the extent of the corporation's earnings and profits.

(4) To the extent that the excess of the distribution exceeds the corporation's earnings and profits, it is treated as a nontaxable return of capital to the extent of the shareholder's basis in the stock and then as capital gain.[52]

The proposal would retain the current Code's rules for determining whether a redemption is treated as a sale or exchange of stock or a distribution. If a redemption is treated as a sale or exchange of stock, it would reduce pro rata the redeeming corporation's EDA and CREBA. For example, if a corporation redeems 5% of its stock in a redemption that is treated as a sale or exchange, the corporation would reduce its EDA for the year of the redemption and its CREBA by 5%.[53]

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50. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 14-15, 22.

51. If this nontaxable portion of the distribution due to reversal of the prior basis adjustments exceeds the shareholder's basis in the stock, the excess is treated as capital gain from the sale of the shareholder's stock.

52. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 15.

53. *See id.*

If a U.S. corporation receives an excludable dividend from another corporation, it would not be taxable but would increase the recipient corporation's EDA.[54] Thus, it would remain excludable when the recipient corporation, in turn, distributes the amount to its shareholders. The proposal would retain the 100% deduction for dividends received by a corporation from another corporation of which it owns 80% or more of the stock. The 70% and 80% dividends received deductions of current law would be retained only for distributions of pre-2001 earnings and profits distributed before January 1, 2006, with respect to stock issued before February 3, 2003.[55]

How would I evaluate this dividend exemption proposal from a tax policy point of view? Let me start this analysis by stating my belief that corporate integration is a worthy goal of tax reform and simplification efforts. The current system of double taxation of corporate earnings is difficult to defend on theoretical grounds.[56] This is true regardless of whether the tax base used is income, consumption, or some hybrid approach. The current system of double taxation of corporate earnings has a number of negative economic effects, which would be eliminated or at least ameliorated by corporate integration. First, double taxation distorts choice-of-entity decisions, encouraging taxpayers to choose the noncorporate form over the corporate form in order to avoid the double taxation of earnings, thus resulting in a deadweight loss.[57] Eliminating or significantly reducing the double taxation of corporate earnings will allow taxpayers to choose the entity for their business ventures based on nontax business and legal considerations, rather than tax considerations. It will eliminate or reduce the deadweight loss that comes from tax planning maneuvers designed to utilize the corporate form for the business activity but avoid the double taxation of corporate earnings.

The Bush Administration's dividend exemption proposal, however, would not completely eliminate the tax incentive to use a pass-through entity rather than

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54. *See id.* at 20.

55. *See id.*

56. For an interesting article defending the double taxation of corporate earnings, see Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613 (1990) (taking the position that the classical system for taxing corporate earnings is necessary as a backstop to the progressive distribution of the federal income tax). For an article that defends the double taxation of business earnings based on the "benefit" fairness norm, see Herwig J. Schlunk, *Double Taxation: The Unappreciated Ideal*, 102 TAX NOTES 893 (2004). In another article, two commentators argue that the double tax on corporate earnings may provide a mechanism for minimizing a firm's agency costs. Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 277 (1991).

57. STAFF OF JOINT COMM. ON TAX'N, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2004 BUDGET PROPOSAL 28 (Mar. 2003) [hereinafter JOINT COMM. ON TAX'N DESCRIPTION]. There is disagreement regarding the extent of this deadweight loss, given that publicly traded corporations must use the corporate form, regardless of whether double taxation exists, in order to have access to the public equity markets and the concomitant liquidity. *See* Reuven S. Avi-Yonah, *Back to the 1930s?: The Shaky Case for Exempting Dividends*, 97 TAX NOTES 1599, 1601 (2002); *see also* AUSTAN GOOLSBEE, THE IMPACT AND INEFFICIENCY OF THE CORPORATE INCOME TAX: EVIDENCE FROM STATE ORGANIZATIONAL FORM DATA, NBER WORKING PAPER No. 9141 (Sept. 2002).

the corporate form.[58] If a pass-through entity is used to conduct a business venture, the income of the venture will be taxed once at the investor level and at the investor's marginal tax rate. By contrast, under the Bush Administration's dividend exemption proposal, if the corporate form is used to conduct the venture, the income would be taxed once at the corporate level at a 35% rate, or, if the corporation pays less than a 35%, only part of the income would be protected from taxation at the shareholder level when it is distributed (because EDA would be less than the amount of the pre-tax income minus the corporate tax actually paid) and the income would bear at least a partial second, shareholder-level tax. The total of the corporate-level and shareholder-level taxes on this income could exceed a single tax on all of the income at a lower-bracket investor's marginal tax rate. Thus, this dividend exemption proposal would have the effect of reducing the benefits of the lower corporate rate brackets for distributed (but not retained earnings) and retaining a bias against the corporate form for lower-bracket investors.[59]

Second, double taxation of corporate earnings also encourages a corporation to use debt financing, rather than equity financing, to fund its operations and acquisitions, because interest payments are deductible while dividend payments are not.[60] This leads to corporate capital structures that are heavily laden with debt. Depending on the form of corporate integration chosen, ending the double tax on corporate earnings will reduce or eliminate the tax bias in favor of debt over equity financing. The maximum benefit in this regard would come from corporate integration in the form of a dividend deduction at the corporate level or, alternatively, a proposal under which neither dividends nor interest are deductible by the corporation (but interest and dividends received from a corporation are exempt from tax at the bondholder/shareholder level).[61] By contrast, the Bush Administration's shareholder-level dividend exemption proposal would reduce, but not really eliminate, this bias. Under the Bush proposal, dividends would still not be deductible at the corporate level, whereas corporate interest payments would continue to be deductible. Corporations would still be encouraged to fund their operations and acquisitions through debt financing rather than equity financing although the tax bias in favor of debt financing would be reduced.[62]

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58. The model of corporate integration that probably would be most effective in equalizing the tax treatment of different forms of business enterprise is the Comprehensive Business Income Tax (CBIT) model discussed in the Treasury Department's comprehensive integration study released in early 1992. *See* U.S. TREAS. DEP'T, TAXING BUSINESS INCOME ONCE, *supra* note 35, at 39-58.

59. *See* Johnson, *supra* note 43, at 1882-83.

60. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 11.

61. The latter was the approach taken in the CBIT model in the Treasury Department's 1992 study of corporate integration, which would accomplish a more complete equalization of debt and equity financing by corporations. *See* U.S. TREAS. DEP'T, TAXING BUSINESS INCOME ONCE, *supra* note 35, at 39-58.

62. In addition, the bias in favor of debt over equity is one that pervades our tax system and any serious tax reform proposal needs to do something about this bias throughout the system, not just in the corporate arena. *See* Avi-

Third, the current double taxation system encourages retention of earnings at the corporate level instead of distribution of earnings to the shareholders, i.e., provides a tax incentive for corporations not to make dividend distributions to its shareholders.[63] In many cases, this earnings retention enables the corporation to fund expansion of its existing business or the acquisition of valuable new business opportunities that will contribute to the long-term growth of the corporation's earnings. In other cases, however, as recent corporate scandals have shown, this factor leads to the hoarding of cash by the corporation and use of that cash to make acquisitions or undertake growth strategies to boost stock price, some of which would not have taken place but for the fact that a second, shareholder-level tax encourages retention of corporate earnings. Stated differently, if the corporation uses the earnings to pay dividend distributions, two taxes may result, both of which are imposed currently. If the corporation instead uses the earnings to fund growth in the stock price, the second tax is postponed until the shareholder sells the stock and realizes the appreciation in the stock, and that second tax is at the lower capital gains rate, rather than at ordinary income rates.

This tax bias in favor of retained earnings is reduced by several factors. A large percentage of the stock of publicly traded corporations is held by tax-exempt investors (such as charitable organizations), other corporations that receive a dividends-received deduction, foreign shareholders (who may pay little or no tax on dividends if they are residents of foreign countries that have income tax treaties in effect with the United States) or in tax-sheltered accounts such as annuities, individual retirement accounts, qualified pension plans, and 401(k) plans.[64] These shareholders bear little or no tax on the dividend and no tax bias in favor of retained earnings exists for them. In addition, corporations can reduce the shareholder-level tax by making the distribution in the form of a redemption taxable at the lower capital gains rates,[65] instead of a dividend. Moreover, to the extent that the dividend tax is capitalized into the price of stock, the bias in favor of retaining earnings at the corporate level should apply only to new equity and such new equity often does not pay dividends for nontax reasons.[66] Finally, and most importantly, the 2003 Act has substantially reduced the tax disincentive for a corporation to make dividend distributions by lowering the tax rate on qualified dividend income to 15% (or 5% in the case of lower-bracket taxpayers).

Corporate integration removes or reduces the tax incentive for corporations to retain earnings at the corporate level. Proponents argue that corporations will

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Yonah, *supra* note 57, at 1601; Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993).

63. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 12.

64. *See, e.g.*, Jonathan Clements, *Bush Is Wrong: The Dividend Tax Break Should Go to Companies, Not Investors*, WALL ST. J., Jan. 8, 2003, at D1 (stating that "as of the end of 2001, 64% of households' stock-fund assets were held in variable annuities, individual retirement accounts and other tax-sheltered accounts"); William G. Gale, *About Half of Dividend Payments Do Not Face Double Taxation*, 97 TAX NOTES 839 (2002).

65. *See* I.R.C. §§ 302, 1(h).

66. *See* Avi-Yonah, *supra* note 57, at 1601.

therefore be less likely to accumulate cash hoards for use in funding inefficient acquisitions or ill-advised attempts at growth. Instead, elimination or reduction of the double tax on corporation earnings will encourage corporations to distribute the money to shareholders who will make more efficient use of the funds at the shareholder level than the corporate managers would at the corporate level, or so the proponents say. However, it is not at all clear that shareholders would do a better job of reinvesting corporate earnings than do the managers of the corporation, who have more expertise and better information concerning alternative investments than do most shareholders.[67] In addition, because corporate dividends may provide the shareholders with readily available cash, some shareholders will spend the money, thus reducing net savings from investments in the corporate form.[68] In any event, consistent with the Administration's schizophrenic attitude toward retained corporate earnings and reflecting its concern that the dividend exemption proposal would put *too much* pressure on corporations to pay dividends, the Bush Administration's dividend exemption plan would not fully remove the incentive to retain earnings at the corporate level. A corporation would be able to adopt a DRIP and allocate its EDA to shareholder basis adjustments, thus providing its shareholders with a reduced capital gains tax on sale without having to pay any dividends.

It is true that the fact that shareholders would no longer pay tax on dividends under this proposal would cause some of those shareholders to pressure the corporation to pay larger dividends. Some corporations would pay dividends in response to this demand on the theory that investors will reward such behavior by buying the stock and causing its price to increase.[69] However, for the many shareholders of publicly traded corporations who are already effectively tax exempt with respect to their dividend income (e.g., charities and pension funds), shareholder-level dividend tax relief makes no difference and they are not likely to put immediate pressure on corporations to pay more dividends since they pay no tax on dividends under current law.

Finally, double taxation of corporate earnings encourages the distribution of earnings through complicated transactions such as share repurchases treated as capital-gain redemptions rather than less complicated dividend distributions.[70]

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67. *See* R. Glenn Hubbard, *Capital-Market Imperfections and Investment*, 36 J. ECON. LITERATURE 193, 195 (1998); Johnson, *supra* note 43, at 1885-86.

68. *See* Johnson, *supra* note 43, at 1885.

69. By putting pressure on corporations to pay dividends, however, it will reduce the available cash held by corporations. With less cash on hand, corporations will be forced to do more borrowing or sell more stock to obtain financing for capital spending or acquisitions. That, in turn, may mean reduced capital spending for new projects and reduced merger activity because corporations will be hesitant to go into the capital markets to obtain funding for the project or merger. *See* Ken Brown, *Dividend Proposal Won't Quickly Solve Market's Problems*, WALL ST. J., Jan. 7, 2003, at C1. Of course, proponents would argue that this is an attribute of the plan—placing a check on inefficient capital spending and mergers and acquisitions by forcing the corporation to go into the capital markets to obtain funding for the project.

70. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 12.

Corporate integration will reduce or eliminate this distortion. However, as discussed below, the Bush Administration's dividend exemption proposal would spawn its own series of complicated tax planning maneuvers. It is clear that the White House proponents of this proposal did not understand or care to understand the culture of tax avoidance that pervades the financial affairs of many high-income individuals and corporations.

In evaluating the Bush Administration's dividend exemption proposal, one must keep in mind that although the proposal might well enhance the economic efficiency of the tax system, it has the potential to add tremendous complexity to the tax system. It would require millions of stockholders of publicly traded corporations to keep track of numerous basis increases and decreases on account of the allocation of EDA by DRIPs to stock basis and the later reversal of those allocations on Form 1099s that they will receive from the corporations in which they own stock.[71] Anti-abuse provisions to deal with shareholders who hold stock only for short periods of time would require many shareholders to keep track of their holding periods.[72] The corporations would have increased record keeping and administrative costs relating to this dividend exemption proposal, in addition to continuing to incur the costs of maintaining the earnings and profits account at the corporate level (which would still play an important role in the taxation of a corporation's shareholders on distributions under this proposal).[73] Almost all of the corporate tax provisions in the current Code would be retained, although the ultimate tax consequences under the rules would differ from current law. On the other hand, the repeal of the accumulated earnings tax and personal holding company tax under this proposal would reduce complexity at the corporate level.[74]

The Bush Administration's proposed system for taxing corporations also would be subject to numerous tax planning abuses, a few of which I will highlight here. High-bracket individual taxpayers could shift business or investment income to a corporation to get the benefit of the 15% corporate tax bracket.[75] The after-tax income could be distributed in part to the shareholder as a tax-free dividend to the extent of the corporation's EDA and the remainder could be retained in corporate form (with the shareholder-level tax deferred indefinitely) or distributed in liquidation at the lower capital gains rates. Thus, under this proposal, the corporation would be used as an incorporated pocketbook with no worry about the accumulated earnings tax and personal holding company tax because those provisions would be repealed.

Similarly, a taxpayer could use a corporation to reduce FICA and employment taxes by shifting business income to the corporation and receiving only a very

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71. *See, e.g.*, JOINT COMM. ON TAX'N DESCRIPTION, *supra* note 57, at 33.

72. *See* Schler, *supra* note 43, at 1896. The anti-abuse rules that would apply are in sections 246(c) and 1059(g), as modified by this dividend exemption proposal.

73. *See, e.g.*, *id.* at 1897; JOINT COMM. ON TAX'N DESCRIPTION, *supra* note 57, at 32.

74. *See, e.g.*, JOINT COMM. ON TAX'N DESCRIPTION, *supra* note 57, at 33.

75. *See* Schler, *supra* note 43, at 1897.

low salary. The corporation would owe income tax but no FICA or employment tax on the income (except with respect to the shareholder's salary) and the shareholder would owe FICA only on the salary.[76] This device has the potential to undermine the employment taxes of current law and would require anti-abuse rules for dealing with under-compensated shareholder-employees. With no double tax on corporate earnings, there would be little downside to a shareholder using a corporation in this way. The 2003 Act's treatment of qualified dividend income as taxable to individual shareholders at the preferential capital gains tax rates creates this same potential tax planning abuse.

Numerous opportunities would exist for artificial losses and tax arbitrage. For example, an individual could purchase stock of a corporation with a large EDA balance shortly before the dividend record date at a price that reflects the declared but unpaid dividend, receive the dividend tax-free, and then sell the stock at an artificial capital loss (at the price reflecting the corporation's value post-dividend) after meeting the holding period requirements of Section 246(c).[77] This would encourage tax-exempt shareholders of corporate stock to sell their stock to taxable shareholders before a dividend record date and buy the stock back after the dividend payment from another shareholder.[78] There is nothing to prevent tax-exempt investors from facilitating dividend arbitrage by taxable shareholders.

Another planning technique would involve attempts to "stream" tax-exempt dividends to taxable shareholders and sale or exchange redemptions to tax-exempt shareholders. Such streaming techniques would be made more difficult to the extent that the proposal requires redemptions to reduce current year EDA on a pro rata basis, but this rule certainly does not prevent all streaming of dividends. For example, suppose that a corporation has earnings in year 1 for which corporate tax will not be shown on a return until year 2 and, therefore, EDA will not be created until year 3. The corporation could redeem the tax-exempt shareholders' stock in year 2 (at a price that reflects the corporation's earnings in year 1) and since no EDA has yet been created, none will be allocated to the redemption. The corporation then distributes the earnings in year 3 to the taxable shareholders as tax-free dividends to the extent of the EDA.[79]

These and other planning techniques illustrate the need to carefully think through any integration proposal before (not after) it is enacted into law. In its haste to try to ram this proposal through the Congress, the Administration simply did not give sufficient thought to the potential problems with it. It never adequately explained why this proposal should have been given priority in the legislative process. Congress wisely decided to study the proposal more carefully before enacting it into law. Unfortunately, however, instead of leaving the entire

76. *See id.*

77. *See id.*

78. *See id.*

79. *See id.* at 1898.

integration issue for further study, Congress enacted a "rough justice" partial integration alternative of reducing (but not eliminating) the double tax on corporate earnings distributed to noncorporate shareholders in Section 1(h)(11), with little or no study. This provision merely reduces the dividend-level tax without eliminating any of the existing corporate tax provisions. In addition, this provision is only temporary in nature and is set to sunset for taxable years of shareholders starting after 2008.

In an attempt to sell its dividend exemption proposal to a skeptical Congress and taxpaying public, the Bush Administration made some erroneous or overstated arguments in support of the proposal. For example, the Administration advanced this dividend relief proposal in part as a proposal to jump-start the flagging economy.[80] However, corporate integration should not be presented as a short-term economic stimulus proposal because it will not provide much of a short-term stimulus.[81] Its effects on economic growth are long-term in nature.[82] Nor should it be sold as a way to boost stock prices because it is not at all clear to what extent corporate integration actually increases stock prices over the long run[83] and it is questionable whether boosting stock prices (as opposed to stimulating long-term economic growth) is an appropriate focus of government policy making. Instead, corporate integration should be undertaken because it will

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80. *See, e.g.*, Bennett, *supra* note 5, at G-1 (Pamela Olson, then Assistant Treasury Secretary for Tax Policy, argued at a conference sponsored by the Federal Bar Association that the Bush Administration's dividend relief proposal was needed to "get the economy back on its feet and growing again").

81. *See* Jane G. Gravelle, *Effects of Dividend Relief on Economic Growth, the Stock Market, and Corporate Tax Preferences*, 56 NAT'L TAX J. 653, 659-60 (2003) [hereinafter Gravelle, *Effects of Dividend Relief*]. As pointed out by one leading commentator, most taxable dividends are paid to high-income individuals who are more likely to save rather than spend the tax savings from the dividend tax relief. Avi-Yonah, *supra* note 57. Such saving obviously helps the economy in the long run but does not provide a short-term stimulus. *See also* Gregg A. Esenwein & Jane G. Gravelle, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, TAX NOTES TODAY, 198-16, Oct. 7, 2002 ("Using dividend tax reductions to stimulate the economy is unlikely to be very effective because, unlike direct government spending or tax cuts for lower and moderate income individuals, it is not as likely to directly increase spending, which is the most effective way to stimulate the economy.").

82. In addition, recent studies of the tax cuts enacted in the first year of the Bush Administration demonstrate that it is difficult to use tax cuts to stimulate the economy. *See, e.g.*, MATTHEW D. SHAPIRO & JOEL SLEMROD, DID THE 2001 TAX REBATE STIMULATE SPENDING? EVIDENCE FROM TAXPAYER SURVEYS, NBER WORKING PAPER No. 9308 (Nov. 2002); *see also* Congressional Budget Office, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, TAX NOTES TODAY, 5-11, Jan. 8, 2002.

83. There is widespread disagreement concerning the effect of corporate integration, particularly the dividend exemption form of corporate integration proposed by the Bush Administration, on appreciation in the price of stocks. Some estimate that it will little or no effect, others estimate about a 5% increase in stock prices, and proponents of the Bush plan argue that a 10% increase in stock prices will occur. *See, e.g.*, Brett Ferguson, *Treasury Renews Push for Higher Debt Limit, Warns Ceiling Could Be Hit in Late February*, BNA DAILY TAX REP., Dec. 27, 2002; Esenwein & Gravelle, *supra* note 81; Gravelle, *Effects of Dividend Relief*, *supra* note 81, at 660-63. If the dividend relief proposal were successful in increasing existing stock prices by a significant amount, one could argue that the result would be an unfair windfall for current stockholders who paid a discounted price for the stock based on the assumption that future dividends would be taxable. *See* Avi-Yonah, *supra* note 57, at 1599.

remove distortions concerning economic behavior caused by the double taxation of corporate earnings and help promote long-term growth in the economy.

Another overstated argument made by the Bush Administration is that this dividend relief plan would substantially reduce incentives for corporations to inflate their earnings through accounting gimmicks that produce earnings unmatched by cash.[84] It is argued that corporate integration would make dividends a more attractive way for corporations to attract investors. Since dividends are paid in cash, the corporation must actually have cash on hand to pay them. Accounting gimmicks can make earnings look greater than they are and thereby inflate stock prices artificially, at least for a temporary period of time, but it is hard to fake the cash necessary to pay dividends. Thus, a greater focus on dividends by investors will make corporate accounting more honest, or so the argument goes.[85] This argument certainly has some merit to it. As noted above, however, the ability of corporations to use DRIPs instead of dividends greatly reduces the pressure to pay dividends and, hence, the focus of shareholders on dividends. Moreover, for the Enron-type corporate hustler, a rapid stock price rise from inflated earnings is worth more than the slower, steadier rise in stock price on account of dividend payout policy.

The Bush Administration also overstated its argument that the dividend exemption proposal would be a significant factor in stopping corporate tax evasion and reducing the incentive for a corporation to engage in costly and questionable tax-minimization schemes.[86] The theory is that the corporation will have an incentive to properly report and pay tax on its income because only corporate earnings that have been taxed would result in tax-free distributions or a basis adjustment for the corporation's shareholders that would reduce the amount of gain subject to tax as a capital gain upon sale of the stock. This proposal undoubtedly would have some positive effects in reducing the benefits of corporate tax minimization[87] but probably would not alone do much to solve the corporate tax shelter problem. A shareholder basis adjustment that may reduce some future capital gains tax by the shareholder pales in comparison to the corporation not paying a 35% tax on the income in the first place.[88] Moreover, under the Bush Administration's proposal, distributions in excess of EDA, prior DRIP reversals, and corporate-level earnings and profits, would be tax-free to the extent that they reduce a shareholder's basis in her stock and the excess would receive sale or exchange treatment and be taxable at the lower capital gain rates. This means that tax preferences and corporate tax shelters that succeed in

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84. *Cf.* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 11-12.

85. *See, e.g.*, George Melloan, *If Democrats Want Corporate Reform, Here's How to Do It*, WALL ST. J., Jan. 21, 2003, at A19.

86. *See* GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 11-12.

87. *See, e.g.*, Robert Carroll, Kevin A. Hassett, & James B. Mackie III, *The Effect of Dividend Tax Relief on Investment Incentives*, 56 NAT'L TAX J. 629, 647 (2003).

88. *See* Johnson, *supra* note 43, at 1891; *see also* Gale & Orszag, *supra* note 39, at 418.

reducing a corporation's earnings and profits would still provide a benefit for the corporation's shareholders in the form of a tax-exempt basis recovery and gain taxable at capital gains rates (as opposed to tax on the income at the corporate level at ordinary income rates).[89]

Instead, this dividend exemption proposal would do more to advance the cause of tax reform if the Bush Administration adds proposals to seriously crack down on corporate tax preferences and tax shelters and reduce the gap between the income reported to shareholders and the income reported for federal income tax purposes, including taxing all foreign-source income earned by corporations (whether directly or through foreign subsidiaries).[90] This would improve the perceived fairness of the plan to low- and middle-income taxpayers and, more importantly, would provide revenue to help pay for the dividend exemption proposal. The net result would be a fairer tax system as well as one with fewer distortive effects on economic behavior.

The point of this discussion is certainly not that I oppose corporate integration or even that I oppose the dividend exemption proposal of the Bush Administration. In fact, I strongly favor corporate integration as a serious tax reform agenda item and I think that the Bush Administration proposal is certainly one logical alternative for achieving integration. Instead, I merely intend to make the case for more careful study of the alternatives. There are serious pros and cons to each alternative and which method of integration makes the most sense may depend on decisions made concerning other reforms of the tax system. Corporate integration should not be enacted in a vacuum. Corporate integration should be accomplished as part of a major overall tax reform effort, which attempts to remedy corporate tax sheltering and achieve proper taxation of international income earned by corporations. It should not be done in isolation as part of the annual budget reconciliation process.

III. THE BUSH ADMINISTRATION'S STEALTH (?) MOVE TO A POORLY DESIGNED CONSUMPTION TAX BASE: CONSUMPTION TAX "LITE"

There are pros and cons to adopting a consumption tax system (whether in replacement of, or as a supplement to, the income tax), including issues relating to tax fairness, economic efficiency, and complexity.[91] For example, there is

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89. *See* Johnson, *supra* note 43, at 1890.

90. *See, e.g.*, Alan Murray, *Dividend-Tax Plan Needs Fine-Tuning to Mollify Senators*, WALL ST. J., Jan. 14, 2003, at A4.

91. For thoughtful discussions of the pros and cons of moving to a consumption base, including the adoption of a value-added tax, see generally William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (2002); Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992); Edward J. McCaffery, *The Missing Links in Tax Reform*, 2 CHAPMAN L. REV. 233, 248-51 (1999); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095 (2000); Alan

widespread disagreement about the magnitude of increase in savings and investment on account of adoption of a consumption tax system in the United States.[92] There is also disagreement about the extent of the transition problems in moving to a consumption tax—certainly, some commentators have concluded that transition issues make adoption of a consumption tax in replacement of the income tax very unlikely.[93] Moreover, a significant concern about adoption of a consumption-based tax system is the possible shift in the tax burden from high-income taxpayers to low- and middle-income taxpayers because low and middle-income taxpayers generally consume a much greater percentage of their incomes than do high-income taxpayers.[94] Even a consumption tax system can be designed to be progressive in the distribution of the tax burden although it may require somewhat more steeply progressive rates to achieve such progressivity.[95] But whatever one's views concerning the use of a consumption tax system as a primary revenue source at the federal level, we should be able to agree that before adopting such a tax system careful study and vigorous public debate should occur. This is not something that should be buried in budget bills and masqueraded as a simplification measure or a short-term fiscal stimulus measure.

In early 2003, the Bush Administration proposed several new tax-free savings vehicles that appear to be moving the system in the direction of a cash-flow consumption tax base.[96] Although none of these proposals were enacted as part of the 2003 Act, there are strong indications that the Bush Administration intends to present these proposals again as part of 2004 proposed tax legislation.[97] Under one of these proposals, the Individual Retirement Accounts (IRAs) of current law would be replaced by Lifetime Savings Accounts (LSAs) that could be used for

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Schenk, *Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?*, 7 VA. TAX REV. 207 (1987); William J. Turnier, *Designing an Efficient Value Added Tax*, 39 TAX L. REV. 435 (1984); Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975) [hereinafter Warren, *Fairness I*]; Alvin C. Warren, Jr., *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980) [hereinafter Warren, *Fairness II*].

92. *See, e.g.*, JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 166-70 (2d ed. 2000); Eric M. Engen & William G. Gale, *The Effects of Fundamental Tax Reform on Saving*, *in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 83, 99-102 (Henry J. Aaron & William G. Gale eds., 1996); McNulty, *supra* note 91, at 2133-38.

93. *See, e.g.*, Ronald A. Pearlman, *Transition Issues in Moving to a Consumption Tax: A Tax Lawyer's Perspective*, *in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 393 (Henry J. Aaron & William G. Gale eds., 1996). *But see* Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53 (2003).

94. *See, e.g.*, Warren, *Fairness I*, *supra* note 91; Warren, *Fairness II*, *supra*, note 91.

95. *See, e.g.*, William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 956 (1975).

96. For detailed consideration of these savings proposals, see Leonard E. Burman, William G. Gale & Peter R. Orszag, *The Administration's Savings Proposals: Preliminary Analysis*, 98 TAX NOTES 1423 (2003); Martin A. Sullivan, *Economic Analysis: Does the Trickle-Down Theory for Pensions Hold Water?*, 98 TAX NOTES 1180 (2003) [hereinafter Sullivan, *Trickle-Down Theory*].

97. *See* Bob Davis & John D. McKinnon, *Tax-Free Savings Get Renewed Push*, WALL ST. J., Nov. 5, 2003, at A1.

any type of savings and Retirement Savings Accounts (RSAs) that could be used for retirement savings.

Under the proposal, an individual would be allowed to contribute up to $7,500 of cash per year to an LSA, regardless of the amount of wage income that he or she had.[98] The LSAs would not be subject to income limits, so both Michael Dell and the nanny for his children could contribute the same amounts to an LSA. Contributions to an LSA would not be deductible but earnings in the LSA would accumulate free of tax. All distributions from the LSA would be tax-free, regardless of the individual's age or use of the distribution. These LSAs would not be subject to minimum distribution rules during the owner's lifetime.[99]

The $7,500 contribution limit would apply to all accounts held in a particular individual's name, regardless of who made the contribution. Thus, this proposal would allow an individual to contribute up to $7,500 per year to an LSA for another individual, provided that contributions to all LSAs held in a particular individual's name could not exceed $7,500.[100]

In addition, the proposal would allow an individual to contribute in cash to an RSA the lesser of $7,500 or the individual's taxable compensation income.[101] Unlike the IRA rules of current law, no income limits would apply to these RSAs. As with contributions to an LSA, contributions to an RSA would not be deductible, but the earnings on such contributions would accumulate tax-free and qualified distributions from the plan would not be taxable. Qualified distributions would be distributions made after the age of 58, regardless of the retirement status of the individual, or on the individual's death or disability. Any other distribution would be a nonqualified distribution and would be taxable to the recipient to the extent that it exceeded the distributee's basis and would be subject to an additional tax. These RSAs would not be subject to minimum distribution rules during the account owner's lifetime.[102]

Existing Roth IRAs would become RSAs and be subject to the rules for RSAs. The proposal also would allow taxpayers to convert balances in Archer Medical Savings Accounts (MSAs), Coverdell Education Savings Accounts (ESAs), Qualified State Tuition Plans (QSTPs), Roth IRAs, and traditional deductible and nondeductible IRAs to LSA balances. Because contributions to MSAs and traditional deductible IRAs are not taxed, conversions to RSAs would be taxable, but a transition rule would allow the taxpayer to pay the resulting tax on the conversion over a four-year period in the case of a conversion of a deductible IRA to an RSA. Because contributions to ESAs, QSTPs, and traditional nondeductible IRAs are made with after-tax dollars, the conversion of

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98. GENERAL EXPLANATION OF BUSH PROPOSALS, *supra* note 10, at 119-20. The LSA contribution limit would be indexed for inflation. *Id.*

99. *Id.*

100. *Id.* at 120.

101. *Id.* The RSA contribution limit would be indexed for inflation. *Id.*

102. *Id.*

those accounts to RSAs apparently would not be included in income.[103] Although new contributions to traditional, nondeductible, and Roth IRAs would no longer be permitted, new contributions to ESAs, QSTPs, and MSAs would continue to be permitted, although contributions made after enactment of the RSA would not be eligible for conversion.

The Bush Administration also proposed a consolidation of defined-contribution accounts that permit employee deferrals or after-tax contributions, including 401(k), SIMPLE 401(k), Thrift, section 457 plans, and SIMPLE IRAs and Salary Reduction Simplified Employee Pensions ("SARSEP") into single Employer Retirement Savings Accounts ("ERSA"). These accounts would generally follow the rules applicable to 401(k) plans under current law, subject to certain simplifications. Accordingly, under this proposal, employees could defer wages of up to $12,000 per year (increasing to $15,000 by 2006). In the case of employees aged 50 and older, an additional $2,000 of wages per year could be deferred (increasing to $5,000 per year by 2006). The limit on contributions to ERSAs would be the lesser of 100 percent of compensation or $40,000. The proposal would also simplify and modify the nondiscrimination testing and minimum coverage rules.[104]

The Bush Administration justified these latter proposals as a simplification measure and asserted that the current complicated qualified retirement plan rules have led to a decline in participation in such plans.[105] These proposals are similar in many respects to those advanced by the Joint Committee Staff in 2001 as part of its simplification project. Although I have some concern about the particulars of some of the pension simplification proposals, I think that as a whole that they would constitute an improvement to the current complex rules relating to qualified retirement plans. However, I do think that careful study has to be made of the potential impact of these changes on the availability of pension plan coverage to low- and middle-income workers (sometimes called "rank-and-file" employees).

I have more major concerns with the Administration's LSA and RSA proposals. One major concern I have about these proposals is their effect of the distribution of the income tax burden. The Bush Administration attempted to maintain that these proposals would bring significant benefits to low- and middle-income taxpayers in the form of tax-free compounding and elimination of complex paperwork.[106] The Administration, however, neglected to mention that these proposals would provide most of the benefits to high-income taxpayers, who have more discretionary income to invest and for whom tax deferral means more in dollar terms (since the tax deferred for such individuals is a larger amount given their higher marginal tax rates). Most low- and middle-income

103. *See id.*

104. *See id.*

105. *See, e.g.*, Bennett, *supra* note 5, at G-1 (summarizing a speech at the Federal Bar Association by then Assistant Treasury Secretary Pamela Olson).

106. *See, e.g.*, *id.*

taxpayers have not taken full advantage of the existing tax-favored savings vehicles in the Code, so for those taxpayers, the accounts do not provide that much of an additional incentive to save.[107] Thus, the primary beneficiaries of these new tax-favored savings vehicles are likely to be high-income taxpayers who have contributed the maximum to the existing tax-favored savings vehicles and have excess savings that they can shift to these new savings vehicles.[108]

In addition, these savings proposals increase tax complexity in some respects and decrease tax complexity in other respects. For example, these proposals increase complexity to the extent that taxpayers open new LSA and RSA accounts but do not consolidate existing tax-preferred savings into such accounts.[109] By providing an increased opportunity for taxpayers to contribute to Roth-type savings vehicles, in terms of eligibility and dollar limits, these proposals will also increase tax complexity because more taxpayers will have to choose how to balance their savings between deductible and nondeductible savings.[110]

On the other hand, these proposals decrease tax complexity to the extent that they encourage taxpayers to consolidate existing tax-favored savings vehicles into the new savings vehicles.[111] These proposals also decrease tax complexity by making contributions to these LSAs and RSAs nondeductible and not placing any restrictions on withdrawals from LSAs.[112]

Another major concern with the LSA and RSA proposals is that they would undermine the retirement security program of current law. In particular, the concern is that if the owners of a small business can set aside $15,000 of savings tax free with no requirement that they include any employees in the savings program, they will have less of an incentive to set up retirement plans which include coverage for employees.[113] In addition, employers could selectively make contributions to LSAs for highly compensated employees only, thus undermining the longstanding policy of the pension laws of promoting retirement savings for rank-and-file employees.[114]

Another serious concern with the LSA proposal is that it does not place any limitation on the beneficiary's use of the funds in the account, even though it is intended that these accounts be set up in part for retirement purposes. Without such

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107. *See, e.g.*, JOINT COMM. ON TAX'N DESCRIPTION, *supra* note 57, at 217.

108. *See id.* However, proponents of the Bush Administration's savings proposals would argue that by removing income limits for both LSAs and RSAs and by not limiting withdrawals from LSAs, more taxpayers will be eligible to contribute and so banks and other sponsors of these vehicles will have an incentive to extensively market these vehicles. Thus, they argue that more taxpayers of all income levels are likely to know about these vehicles and that fact will lead to increased participation in these vehicles by taxpayers at all income levels. *See id.* at 217 n.356.

109. *See id.* at 219.

110. *See id.*

111. *See id.*

112. *See id.*

113. *See id.* at 218.

114. *See id.*

a limitation, many taxpayers, particularly low- and middle-income taxpayers, will spend the money instead of saving it for retirement, thus leaving them with far less retirement savings than they need.[115] If a taxpayer has limited resources to invest, he is more likely to place his funds in an LSA and have free use of the funds, rather than in a retirement account with restrictions. Thus, many taxpayers' contributions to accounts set aside for retirement may decrease. Given the financial strain that the baby boomers will place on the Social Security system, this is a particularly inopportune time to undertake a new tax-favored savings program that may undermine retirement savings.

Yet another concern is that because these proposed LSAs and RSAs do not provide the participant with a current deduction, as do the traditional IRAs and many other retirement savings vehicles of current law, taxpayers, particularly low and middle-income taxpayers, might psychologically view such non-deductible savings vehicles as less attractive.[116] It is, of course, difficult to measure the magnitude of this psychological effect.

The Bush Administration's savings and retirement account proposals and its decision to attempt to steer the tax system in the direction of a consumption base are based on the idea that cutting taxes on savings and putting more of the tax burden on consumers will stimulate savings and long-term growth. However, the extent to which these proposals will increase savings rates and long-term is unclear[117] and, in any event, it is difficult to predict the macroeconomic effects of tax policy changes.[118]

Moreover, even if one accepts the conclusion that a properly designed consumption tax system will stimulate long-term growth, the Bush Administration's stealth move toward a consumption tax is unlikely to generate the benefits of a true consumption-based tax system because it lacks numerous features of a theoretically consistent and properly designed consumption tax proposal. I will mention three of those features here. First, the proposal allows existing savings as well as new savings to qualify for these tax-favored savings accounts. Thus, many taxpayers with savings are likely to merely shift their existing savings from taxable accounts to tax-favored LSAs, thus resulting in no net increase in savings by such taxpayers.[119] By allowing income on existing savings as well as new savings to qualify for exemption under the proposal, it will not provide the long-term growth potential of a properly designed consumption tax system.[120] In fact, by cutting revenue and adding to the budget deficit while allowing old as well as

115. *See, e.g., id.*; Aaron Lucchetti, *Bush Retirement Proposals Alter Landscape*, WALL ST. J., Feb. 7, 2003, at C1.

116. *See* Lucchetti, *supra* note 115.

117. *See, e.g.*, Burman, Gale & Orszag, *supra* note 96, at 1438-39.

118. *See, e.g.*, John W. Diamond & Pamela H. Moomau, *Issues in Analyzing the Macroeconomic Effects of Tax Policy*, 56 NAT'L TAX J. 447 (2003).

119. *See, e.g.*, JOINT COMM. ON TAX'N DESCRIPTION, *supra* note 57, at 216-18.

120. *See* Burman, Gale & Orszag, *supra* note 96, at 1439 (stating that "a consumption tax would only exempt the return to new capital investments, not to old capital").

new savings to qualify, its impact on private savings may be negative or only slightly positive during the first five to ten years and its effect on national saving (private saving plus public saving) is almost certainly negative over the first ten years of the proposal.[121] In addition, in terms of economic theory, although increasing the return to savings by cutting taxes on savings has the effect of causing some taxpayers to substitute investment for consumption (the "substitution effect"), it has the effect of causing other taxpayers to save less and consume more because less saving is necessary to achieve a targeted level of savings (the "income effect").[122]

Second, nothing in the Bush proposals purports to do anything about the distortions caused by the income tax system's treatment of borrowed funds. The proposals do not include borrowed funds in income and, therefore, are unlikely to do much to reduce borrowing for consumption, one of the appealing features of a true consumption tax system.[123] Thus, a taxpayer could use borrowed funds to pay for consumption and yet not owe any tax on the consumption until the loan was repaid.[124] This glaring omission in the Bush proposals allows a taxpayer to defer tax beyond the time of consumption, a timing mismatch that is significant given the time value of money.[125] Given the political realities of a debt-oriented society, it is not surprising that the Bush Administration has not embraced this part of a consumption-based tax system. However, a serious consumption tax proposal should deal with this issue. In any event, a properly designed consumption tax system should have consistent treatment of capital income and expense—if income from capital is exempt from tax, interest expense should not be deductible.

Third, as a theoretical matter, whether we use an income tax system or a consumption tax system, we should treat home ownership and a taxpayer's use of other consumer durables as personal consumption activities. That means, for example, that we should tax the imputed income (i.e., the fair rental value) from a homeowner's use of housing that she owns, since such income represents consumption for shelter. Similar treatment under either an income tax system or a

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121. *See id.*

122. *See* JOINT COMM. ON TAX'N DESCRIPTION, *supra* note 57, at 216-17.

123. *See, e.g.*, Greg Ip, *Bush Floats Shift to Consumption Tax*, WALL ST. J., Feb. 10, 2003, at A3 (quoting Alan Auerbach, a leading tax economist at the University of California at Berkeley).

124. Under the income tax system, a taxpayer who borrows to pay for consumption defers payment of tax on the consumption until he or she earns the income used to repay the principal on the loan (i.e., the borrowed funds are not taxed at the time of the borrowing but the income used to repay the loan is taxed with no offsetting deduction for repayment of the creditor). Thus, an income tax system distorts economic behavior by encouraging borrowing for consumption. By contrast, a theoretically consistent consumption tax proposal would include borrowed funds used for consumption in the tax base, but then allow the taxpayer to deduct the repayment of the loan. Accordingly, a theoretically consistent consumption tax does a better job of aligning the timing of the tax with the timing of the taxpayer's consumption in the case of funds borrowed for consumption and thereby removes the tax incentive to borrow for consumption.

125. *Cf.* Alvin C. Warren, Jr., *The Proposal for an "Unlimited Savings Allowance,"* TAX NOTES TODAY, 171-46, Aug. 28, 1995 (discussing the failure of the USA Tax proposal to include borrowed funds used for consumption in the tax base). This timing mismatch becomes even more important if tax rates change between the date that the loan is taken out and the date that the loan is repaid.

consumption tax system should apply to imputed income from the owner's use of other consumer durables, such as a car, because, again, such amounts represent consumption. Yet, we have never attempted to tax either item in our income tax system and are not likely to do so in any consumption tax system. In fact, many consumption tax proposals, including the Hall-Rabushka Flat Tax system, do not even attempt to tax such items. The non-taxation of imputed income from owner-occupied housing is one of the tax preferences accorded home ownership and has widespread and strong political support, even though such non-taxation distorts economic behavior[126] and causes the prices of homes to be higher than they would be in the absence of the tax preference.[127] Thus, for political reasons as well as administrability concerns, the Bush Administration has chosen not to take on this issue, despite the Administration's seeming interest in a consumption base.

Another very important tax subsidy for home ownership is the home mortgage interest deduction.[128] Since such interest represents part of the cost of maintaining one's shelter, it should not be deductible in either an income tax system or a consumption tax system. The Tax Reform Act of 1986 and subsequent legislation did cut back on the deduction, limiting it to the interest on two homes and only for acquisition indebtedness and a limited amount of home equity indebtedness. The Flat Tax and other consumption tax proposals purport to disallow any deduction for home mortgage interest expense. Yet, despite the theoretical inconsistency of allowing a deduction for such a personal consumption item, the deduction remains and is unlikely to be eliminated as part of a tax reform effort (whether we retain our hybrid income base or shift to more of a consumption base). The best one can hope for realistically is to further limit the deduction by allowing the interest to be deducted on only the taxpayer's personal residence (not two residences, as is allowed under current law) and to restrict the deduction to acquisition indebtedness or the refinancing of acquisition indebtedness and eliminate the deduction for interest on home equity indebtedness. There seems to be only a strained connection between allowing the deduction for home equity interest and the policy underlying the home mortgage deduction of fostering political stability by promoting home ownership. It does not require a move toward a consumption base to achieve this reform. The Bush Administration has done nothing to promote this reform, which would be consistent with an attempt to promote savings and move toward a consumption-based tax system.

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126. By providing a tax preference for home ownership, the non-taxation of imputed income encourages more people to own homes than if the tax system were neutral with respect to home ownership.

127. At least some of the tax benefits accorded home ownership are capitalized into the price of homes; therefore, the purchaser of the home is paying a higher price for the home than she would if the tax system were neutral with respect to home ownership.

128. The home mortgage interest deduction is intended to encourage home ownership and the political stability that comes with such home ownership—it is a tax subsidy for home ownership. *See* S. REP. NO. 99-313, at 804 (1986). For a recent policy analysis of this tax subsidy, see Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1350 (2000).

Further subsidization by the tax system of home ownership and the ownership of other consumer durables is provided by the current deductibility of state and local real property taxes and personal property taxes. Such taxes arguably should not be deductible in a theoretically pure income tax system or consumption tax system. Yet, Congress decided in 1986 to retain this deduction (while at the same time eliminating the deduction for state and local sales taxes). The Flat Tax and other consumption tax proposals often include an attempt to eliminate this deduction. However, the deduction has widespread support and the deduction would likely survive any tax reform efforts (at least the portion relating to the state and local real estate taxes). In any event, despite its apparent interest in promoting a move to a consumption base, the Bush Administration has shown no interest in taking on this issue.

At the end of the day, I believe that it may be both desirable and politically feasible for Congress to enact some type of federal consumption tax (such as a low-rate value added tax) as a supplement to, not in replacement of, the income tax system. Congress could use the revenue from such a consumption tax to reform and simplify the income tax system, repeal the alternative minimum tax provisions, and repeal or substantially reduce the regressive payroll taxes. Moreover, if Congress adopted a consumption tax as a supplement to, rather than replacement for, the income tax, Congress and the Treasury Department could study various aspects of this supplementary consumption tax, including how much revenue it raises, the costs of implementing it for both taxpayers and the government, its distributional effects, and its economic and social effects. Congress could use the results of that study to gradually expand the role of the consumption tax and concomitantly reduce the role of the income tax as a revenue raiser if it determines that such a move is desirable (after considering tax fairness as well as economic efficiency and administrability issues).[129]

This is not the approach being taken by the Bush Administration. It is proposing neither a theoretically consistent consumption tax system as a replacement for the income tax system nor a value-added tax or other consumption tax as a supplement to the income tax. Both of those approaches would produce a vigorous debate concerning the positive and negative aspects of consumption taxes and would require a lengthy and deliberative legislative process. Instead, the Bush Administration is trying to avoid that debate by masking its piecemeal consumption tax proposal as nothing more than a modest expansion of existing savings features of our hybrid income tax system. In fact, however, if all of the Bush proposals were enacted into law (including the tax-favored savings account proposals as well as the dividend exemption proposal), a significant portion of the investment income realized by most taxpayers would be exempt from the income tax, just as it would under a

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129. *See* Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 976 n.2 (1997). Although I disagree with some significant elements of Professor Graetz's proposals to replace the current income tax, discussed earlier in this article, we obviously also are in agreement on significant other aspects of how we should proceed with tax reform.

consumption tax system. These proposals, therefore, are a significant step in the direction of a consumption tax system and should be analyzed and debated by members of Congress as such. If these proposals are enacted into law, one can imagine that the Administration's next step in a couple of years (assuming that President Bush is re-elected) would be to argue that it is unfair that high-income taxpayers who have investment income in excess of the LSA and RSA limits have to pay income tax on such income and, therefore, propose exempting all investment income from the income tax. Once principle is ignored in drawing a line, it is indeed difficult to hold the line. We should not abandon all taxation of income from capital and our hybrid income-based tax system so cavalierly.

We have pressing needs for revenue to support the government's direct expenditure programs, including large amounts of revenue for increased defense expenditures, homeland security, Medicare and Medicaid reform, health care reform, and Social Security reform. Any new tax system will need to raise as much, or probably more, revenue as the current system and should do so at the same or reduced administrative costs. The proponents of substituting a consumption-based system for our current system bear the burden of demonstrating that this requirement has been met.[130] Alternatively, if any proposed new tax system is projected to lose revenue, then the proponents should come up with specific proposed cuts in government spending to pay for it.[131] The fiscal health of our nation depends on it.

One last point bears mention here. The pace of federal tax legislation increased dramatically in the 1980s and that pace seems to have continued unabated throughout 1990s and the first three years of the 21st Century. Frequent and extensive tax changes are a major contributing factor to the increasing complexity of the federal income tax system and serve to undermine its stability. We should keep in mind that this phenomenon is not likely to change with the

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130. This requirement should be met without relying on an Enron-like revenue estimation process, which attempts to mask huge revenue losses by assuming unrealistic and highly speculative increases in investment and income as a result of a tax cut. Dynamic analysis (i.e., considering the macroeconomic effects of tax policies) has its place in the legislative process, but using so-called "dynamic scoring" should not be used as primary revenue estimation device because of the uncertainties inherent in attempting to predict changes in behavior. Conservatism in revenue estimation is the safer course. For recent commentary on dynamic scoring, see William G. Gale & Peter R. Orszag, *Making the Right Case for Dynamic Analysis*, 99 TAX NOTES 417 (2003); Martin A. Sullivan, *AEI Conference Examines the Future of Revenue Estimating*, 101 TAX NOTES 683 (2003).

131. Many members of Congress of both political parties, including some of the most conservative members of Congress, who rail against the tax system and government spending have far less enthusiasm for actually reducing government spending. These congressional representatives continue to support budget bills, such as the recently-passed 2003 omnibus spending bill, containing embarrassing budget items of $1 million for the Iowa Historical Society for exhibits relating to the world food prize and $750,000 for the Please Touch Museum in Philadelphia. The 2003 omnibus spending bill passed in February 2003 with only thirty-one Republicans in the House voting against, causing conservative commentator Stephen Moore to comment: "Congress has now sent to the president one of the ugliest spending bills in a decade—a $400 billion 'omnibus spending bill' that busts the budget and sets Olympic records for the levels of pork barrel spending." Stephen Moore, *Congress Packs More Pork than Ever in Budget Bill*, CHI. SUN-TIMES, Feb. 23, 2003, at A33.

adoption of a new tax system such as a consumption tax system.[132] Congress would likely tinker with it as much as it has tinkered with the current income tax system, producing increased complexity and instability in any new system. So we should not delude ourselves by assuming that adoption of a consumption tax system will somehow automatically result in tax stability.

IV. THE U.S. INTERNATIONAL TAX RULES

Let me say a few words about the U.S. tax rules for taxing cross-border transactions by its citizens, residents, and corporations. The United States employs a worldwide system of taxation of its citizens, residents, and domestic corporations, and, thus, taxes such persons on their worldwide incomes. To prevent international double taxation from interfering with efficiency enhancing cross-border transactions, however, the United States grants a dollar-for-dollar credit for foreign income taxes paid on foreign-source income. To prevent the foreign tax credit from offsetting the U.S. tax on U.S.-source income or the residual U.S. tax on low-taxed foreign-source income, the foreign tax credit is subject to a complicated limitation provision, which limits the foreign tax credit to the pre-foreign tax credit U.S. tax on various categories of foreign-source income. The foreign tax credit provisions, including the limitations on the foreign tax credit, are complicated, but they serve the important policy objective of limiting the role of tax considerations in determining the location of investment. If working properly, these rules should neither favor or disfavor foreign investment by U.S. taxpayers; instead, the economics of the domestic versus foreign investment opportunities should determine whether the taxpayer invests at home or abroad.[133]

One important defect in the current international tax rules is the concept of international tax deferral for income earned abroad through a foreign subsidiary. A U.S. person who conducts business abroad through an unincorporated branch, limited liability company, partnership, or sole proprietorship must pay a current tax on its foreign-source earnings, with a foreign tax credit for foreign taxes paid. By contrast, a U.S. person who conducts business abroad through a foreign subsidiary bears no U.S. tax on the foreign-source earnings until they are repatriated to the United States through a distribution, i.e., the U.S. tax is deferred until repatriation.[134] This deferral privilege creates a bias in favor of locating business abroad in low-tax foreign countries and conducting that business through a

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132. *See* Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 926-45 (1987); Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 659-60 (2003).

133. The label that economists traditionally have put on this approach for taxing international transactions is "capital export neutrality," and it is the approach that is most consistent with the economic theory of comparative advantage that supports free trade.

134. *See, e.g.*, CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 399-400 (2d ed. 2001).

foreign subsidiary. It can be thought of as a tax subsidy for U.S. multinationals' operations abroad.[135] This deferral privilege is subject to a complicated set of anti-deferral rules, which seek to end or cut back on deferral in situations involving mobile passive income or business income having little connection with the country of incorporation of the subsidiary (so-called "base company income").

Recent attention has focused on "corporate inversion" transactions as a noteworthy example of the tax-avoidance planning opportunities that result from the defects in our international tax rules.[136] There are several ways to accomplish the inversion transaction, but the result is that a group of affiliated corporations that formerly had a U.S. parent corporation at the top of the structure is changed so that the ultimate parent of the corporate group is a publicly held foreign corporation that is located in a low-tax or no-tax country.[137] The foreign parent corporation is not subject to U.S. tax on its income (except to the extent that it has U.S.-source income that is not exempt from U.S. tax under a U.S. tax treaty) and the U.S. public shareholders of the foreign parent corporation will not pay tax on the foreign parent's income until the income is repatriated through distributions from the foreign parent or until those shareholders sell their stock in the foreign parent. (The foreign parent corporation is not a "controlled foreign corporation" subject to the rules of Subpart F[138] because its share ownership is widely dispersed.[139]) The corporate group may further reduce its U.S. tax liability

135. In fact, the Staff of the Joint Committee on Taxation treats international tax deferral as a tax expenditure and keeps track of the revenue loss from deferral as part of its tax expenditure budget. *See* STAFF OF JOINT COMM. ON TAX'N, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2004-2008, at 20 (Dec. 22, 2003) (estimating that the total tax expenditure cost of deferral of U.S. tax on active income of controlled foreign corporations for 2004-2008 is $25 billion and the tax expenditure cost of deferral of U.S. tax on certain active financing income is $8 billion). As a tax expenditure, the deferral privilege should undergo a rigorous cost-benefit analysis to determine whether the costs of the subsidy exceeds its benefits and, if the subsidy is justified, whether it makes sense to implement the subsidy through the tax system rather than through a direct expenditure program.

136. For commentary on the corporate inversion problem, see Lorence L. Bravenec, *Connecting the Dots in U.S. International Taxation*, 97 TAX NOTES 562 (2002); N.Y. St. Bar Ass'n Tax Sec., *Outbound Inversion Transactions*, 96 TAX NOTES 127 (2002); Jim A. Seida & William F. Wempe, *Market Reaction to Corporate Inversion Transactions*, 97 TAX NOTES 1098 (2002); Lee A. Sheppard, *Preventing Corporate Inversions*, 95 TAX NOTES 29 (2002); Lee A. Sheppard, *Preventing Corporate Inversions: Part 2*, 95 TAX NOTES 816 (2002); Lee A. Sheppard, *Preventing Corporate Inversions: Part 3*, 95 TAX NOTES 1864 (2002); Martin A. Sullivan, *Economic Analysis: Thomas's Inversion Proposal: Short, Sweet, and Incomplete*, 96 TAX NOTES 192 (2002); Willard B. Taylor, *Corporate Expatriations—Why Not?*, 78 TAXES 146 (Mar. 2000); Samuel C. Thompson, Jr., *A Critical Perspective on the Thomas Bill*, 96 TAX NOTES 581 (2002); Samuel C. Thompson, Jr., *The Non-Wimpy Grassley-Baucus Inversion Bill*, 95 TAX NOTES 1515 (2002); Samuel C. Thompson, Jr., *Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions*, 94 TAX NOTES 1505 (2002); Samuel C. Thompson, Jr., *Treasury's Inversion Study Misses the Mark*, 95 TAX NOTES 1673 (2002).

137. *See* U.S. TREAS. DEP'T, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 4-7 (May 2002).

138. *See* I.R.C. §§ 951-964. *See generally* 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ch. B3 (1992).

139. *See* I.R.C. § 957(a) (defining a controlled foreign corporation as a foreign corporation more than 50 percent of the total voting power or total stock value of which is held by one or more U.S. shareholders holding 10 percent or more of the voting power).

through so-called "earnings stripping" transactions, typically involving interest and royalty payments from the U.S. subsidiary corporation to the foreign parent. If everything goes according to plan, those payments will be deductible by the U.S. subsidiary-payor (assuming they do not run afoul of the various limitations on deductions, including, in the case of interest, the earnings stripping rules in Section 163(j)) and will be exempt from U.S. tax or subject to a reduced rate of U.S. tax in the hands of the foreign parent-payee if the foreign parent is incorporated in a foreign country that is a U.S. treaty partner.[140]

Although the Bush Administration and Congress determined in 2002 that corporate inversions were a problem, they did nothing to solve the problem. One of the Bush Administration's tax proposals in 2003 that did not get enacted would have resulted in a "band aid" approach to dealing with the problem by tightening the earnings stripping rules in Section 163(j), a change that I support but believe does not go far enough. Incredibly, the Bush Treasury Department, in its report on corporate inversions, blamed the inversion problem not on taxpayer abuse of the system and ill-advised tax rules that operate to tax foreign-source income too lightly, but instead on the failure of the U.S. international tax rules to enhance the "competitiveness" of U.S. multinational corporations in the global marketplace.[141] Proponents of gutting the U.S. worldwide system of international taxation are attempting to use this corporate inversion problem and the FSC/extraterritorial income exclusion regimes fiasco in the WTO as a vehicle for modifying the U.S. international tax rules in such a way as to reduce the already low effective rate of tax on U.S. multinationals' foreign-source income.

The current U.S. international tax rules do require reform and simplification. However, Congress and the Bush Administration seem to be moving in the direction of gutting the foreign tax credit limitations in Section 904(d) by reducing the number of foreign tax credit limitation baskets to two or three categories and gutting the anti-deferral rules in Subpart F by enacting more exceptions to their reach. They seem to be basing this move on their uncritical acceptance of the claims made by U.S. multinationals and their lobbyists that the current rules are putting U.S. multinational corporations at a competitive disadvantage.[142] This claim lacks strong empirical support and should not be the

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140. *See* U.S. TREAS. DEP'T, *supra* note 137, at 13.

141. *See* U.S. TREAS. DEP'T, *supra* note 137, at 29-30. In fact, some of the language in this report reads more like a brief in support of U.S. multinationals' arguments in favor of preferential tax treatment of foreign-source income than an analytical report by the tax policy office of the U.S. Treasury Department. *See, e.g., id.* at 2 ("Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy."). For another critique of this Treasury report, see Martin A. Sullivan, *Economic Analysis: Treasury's Inversions Report Rocks the Boat*, 95 TAX NOTES 1289 (2002) ("Treasury reports are usually long on analysis and short on conclusions. The May 17 'preliminary' report on corporate inversion transactions seems to take the opposite tack.").

142. *See, e.g.*, Bennett, *supra* note 5, at G-1 (summarizing then Assistant Treasury Secretary for Tax Policy Pamela Olson's attack on the current international tax rules as impairing the competitiveness of U.S. corporations, in essence repeating the assertion of multinational corporate lobbyists, without citing any empirical evidence for this assertion). The economic model supporting a move toward an exemption system or

basis for reform and simplification of the international tax rules. The effect of these proposed changes is to significantly reduce the effective U.S. tax rate on foreign-source income and either further increase the budget deficit or make up the lost revenue by shifting the tax burden to other types of income. This would create a bias in favor of foreign investment. The proponents of such a move bear a heavy burden to justify special treatment of foreign-source income under our income tax system. Something more than unsupported and rather vague assertions about "competitiveness" problems of U.S. multinationals should be required before we further reduce the effective U.S. rate of taxation on the foreign-source income of U.S. persons.[143]

Instead, I would favor a move toward shoring up our worldwide taxation system. We should end deferral completely for income earned by a U.S. person through a foreign corporation[144] and we should tighten up the foreign tax credit rules to ensure that they are mitigating double taxation but not eliminating U.S. tax on low-taxed foreign-source income.[145] We should also tighten up the earnings stripping rules for interest in Section 163(j) and formulate treaty amendments or statutory anti-abuse rules in the treaty context that prevent taxpayers from using the treaties to reduce all tax on a transaction (rather than merely eliminating double taxation) contrary to the intent of the treaty partners.[146]

V. THE GROWING REACH OF THE ALTERNATIVE MINIMUM TAX PROVISIONS

One complicating feature of our current income tax system is the alternative minimum tax provisions. These provisions were first enacted in much more

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other statutory changes that reduce the U.S. taxation of foreign-source income is called "capital import neutrality" or sometimes "competitiveness." It is based on the premise that the international tax rules should focus on the ability of U.S. persons to compete in a particular foreign market. This approach to taxing international transactions may have the effect of distorting economic behavior by encouraging taxpayers to shift income and assets abroad to low-tax foreign countries.

143. In fact, some leading lobbyists for the tax position of multinational corporations have come to understand that a properly designed exemption or territorial system for taxing foreign-source income would actually raise more revenue than our current "compromise" international tax system and now favor retaining our current international tax system, but with modifications that would weaken the reach of Subpart F and the impact of the foreign tax credit limitations. *See* National Foreign Trade Council, Inc., *The NFTC's Report on Territorial Taxation*, 27 TAX NOTES INT'L 687, 707 (2002) (concluding "that, on balance, legislative efforts to improve current international tax rules are better spent on reform of our current deferral and foreign tax credit system and on finding a WTO-compatible replacement for FSC/ETI than on adopting a territorial exemption system").

144. *See* Peroni, *supra* note 129, at 989-90; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral*, 20 TAX NOTES INT'L 525 (2000); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

145. *See, e.g.*, Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003); Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture: "What's Source Got to Do With It?"—Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81 (2002); Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391 (2003).

146. *See, e.g.*, U.S. TREAS. DEP'T, *supra* note 137, at 24-25.

limited form in 1969, and then considerably broadened and strengthened in 1982 and 1986.[147] Even as broadened in the 1980s, they were intended to apply to only a small percentage of largely high-income individual taxpayers and corporations who used an accumulation of tax preferences to reduce their federal income tax liability to unacceptably low levels. They comprise a second, complicated income tax system containing its own rules and rates, which stands side by side with the regular income tax system. The existence of this shadow income tax system is an admission by Congress of its failure to design a regular tax system that accurately measures a taxpayer's net income. The alternative minimum tax provisions take pressure off Congress to reform the regular income tax system. Congress can leave the tax preferences in the Code and feel that it has accomplished something by eliminating or scaling back the preferences for alternative minimum tax purposes.

These provisions were enacted for a worthwhile purpose, namely, to prevent high-income taxpayers from combining their tax preferences to reduce their taxable income to an unacceptably low level. In effect, they operate as a check against the overuse of tax preferences by any particular high-income taxpayer. However, over the years, more and more taxpayers have become subject to these provisions. Congress has enacted tax cuts and new tax preferences for regular tax purposes without altering the minimum tax provisions. For example, the enactment of the child credit in 1997 and the tax rate cuts in 2001 substantially reduce over time many taxpayers' regular income tax liabilities. It is estimated that if Congress makes no adjustment, approximately one-third of all taxpayers will be subject to the alternative minimum tax provisions by the year 2010.[148] Like the Blob in the classic horror film, these provisions threaten to overwhelm and overtake the regular tax provisions[149] and undermine respect for the income tax system. Intentionally or unintentionally these provisions threaten to nullify the 2001 and 2003 rate cuts for many middle-income taxpayers. This will breed public cynicism and foster disrespect for the federal income tax system.

Any permanent solution to this problem will be costly but needs to be done. Subjecting large numbers of taxpayers (particularly middle-income taxpayers) to the complications of the alternative minimum tax provisions threatens to undermine public support for the tax system and is unacceptable. The partial and temporary solution proposed by President Bush in his budget proposal is not good enough. As a starting point, Congress should reduce the rates in the individual alternative minimum tax provisions, increase the income level at which the highest individual minimum tax rate kicks in, increase and index for inflation

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147. Congress put more teeth into the alternative minimum tax in the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1986.

148. *See* Graetz, *A Fresh Start*, *supra* note 4, at 262; Leonard E. Burman, William G. Gale & Jeffrey Rohaly, *By 2008, the AMT Will Cost More to Repeal than the Regular Income Tax*, 96 TAX NOTES 1641 (2002).

149. One commentator has noted that this phenomenon may result in the alternative minimum tax becoming "the flat tax rate for more and more Americans." Mark A. Luscombe, *Alternative Minimum Tax—Our Future Flat Tax?*, 81 TAXES 3, 4 (Nov. 2003).

the exemption amount, and make the child credit an allowable credit for alternative minimum tax purposes on a permanent basis. Better yet, as persuasively argued by other commentators,[150] the alternative minimum tax provisions should be repealed altogether as part of a comprehensive income tax reform effort.[151] One complicated tax system is more than enough and now is the time to take care of this problem. Hopefully, other base-broadening moves undertaken as part of that tax reform effort in the form of direct elimination and reduction of the underlying tax preferences will undercut the theoretical justifications for the alternative minimum tax.

VI. OVER-RELIANCE ON THE MYTH OF SELF-ASSESSMENT

We should be honest about our tax system and not delude ourselves into thinking it is something it is not. Regardless of the base we choose for the tax—income, consumption, or some hybrid—we have to recognize that some taxpayers will try to avoid fulfilling their legal obligation to pay tax.[152] Undoubtedly some of that noncompliance is attributable to the complexity of the current system. Some of it also is attributable to concerns about the fairness of the tax system, i.e., taxpayers not complying because they perceive that other taxpayers are engaging in maneuvers (in many cases, legal maneuvers) to avoid paying tax. However, we have to recognize that a good part of the noncompliance is intentional in nature—taxpayers who know what they are doing is wrong but who nevertheless take their chances in order to cheat the government. For example, one of the largest areas of noncompliance is by self-employed individuals, who tend to underreport receipts and overstate deductions.[153] Those self-employed who cheat on their taxes do so because they believe that they can get away with it. By contrast, tax compliance by employees who earn wages paid by employers is relatively high, largely because

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150. *See, e.g.*, Daniel Shaviro, *Tax Simplification and the Alternative Minimum Tax*, 91 TAX NOTES 1455 (2001); STAFF OF JOINT COMM. ON TAX'N, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, VOLUME II: RECOMMENDATIONS OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION TO SIMPLIFY THE FEDERAL TAX SYSTEM 13-16 (Comm. Print Apr. 2001) (recommending the repeal of both the individual and corporate alternative minimum tax provisions on the grounds that they are complex and do not necessarily accurately measure a taxpayer's net income).

151. The only exception to this might be a revised alternative minimum tax provision based on a comparison between a corporation's financial (i.e., "book") income and its income reported under for federal income tax purposes. For example, a tax of 10 percent of the difference between the two figures could be added to the corporation's regular tax liability. For a proposal to use adjusted book income as the tax base for public corporations, see George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209 (2001). For a discussion of the difficulties in using the traditional measures of book-tax disparity to determine the magnitude of the corporate tax shelter problem, see George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405 (2002). By contrast, Michael Graetz has suggested that it might make more sense to repeal the regular tax and leave the alternative minimum tax in place. *See* Graetz, *A Fresh Start*, *supra* note 4, at 302-03.

152. *See* Jerome Kurtz, *Woodworth Lecture: Two Cheers for the Income Tax*, 27 OHIO N.U. L. REV. 161, 172 (2001).

153. *See, e.g.*, *id.*

the income tax is essentially collected through withholding by the employer and employees tend to have few expenses to deduct.[154]

Thus, contrary to what some tax reform commentators assume (particularly those who favor a shift to a consumption base),[155] fundamental tax reform will not end the need for a well-funded and vigorous tax administrative agency. Adoption of the Flat Tax or some other form of consumption tax will not change human nature and will not end tax cheating. State and local sales taxes are low-rate, typically single- or dual-rate, relatively simple tax systems that many Americans perceive to be fair tax systems (however misguided that perception may be). Yet, state and local sales tax evasion apparently is rampant.[156] A recent celebrated case involved the government alleging sales tax evasion of $1 million on art purchase of $13 million by the former chairman and chief executive officer of a major public corporation.[157] This noncompliance with the state sales tax provisions is happening presumably because the parties involved believe that they can get away with it, not because of any perceived unfairness of state and local sales taxes.

This fact means that we must have resources devoted to enforcement and expect the Internal Revenue Service (IRS) to be vigorous in its enforcement of the tax laws. The IRS and all of its employees should, of course, observe taxpayers' constitutional rights and treat all taxpayers in a professional manner. But the thought that the IRS should use a Nordstrom's-like approach to tax collection and enforcement and treat tax cheats as customers is utterly absurd. The IRS Restructuring Law enacted in 1998 achieved some desirable reforms but it also had the effect of undercutting the enforcement efforts of the IRS. The fact that this legislation is flawed should surprise no one. The legislation came out of shameful Senate hearings in 1997 on IRS abuses, chaired by the late Senator William Roth, in which taxpayers made unsubstantiated allegations against the IRS without being required to waive taxpayer privacy rights as to their returns so that the IRS could respond to the allegations. The hearings had the atmosphere of a witch-hunt. The General Accounting Office later found that most of these allegations of IRS abuse were unwarranted[158] but incalculable damage was done to the public image of the IRS and to the morale of IRS personnel.

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154. For many employees, the two-percent floor in section 67 for "miscellaneous itemized deductions" disallows all or a significant part of most employees' unreimbursed employee business expenses. This reduction in the potential for tax cheating by employees with respect to the deductions for unreimbursed employee business expenses is one of the most important reasons that Congress enacted section 67.

155. *See, e.g.*, HALL & RABUSHKA, *supra* note 7, at 16 (stating that "perhaps someday the government will recognize that lower tax rates are a better solution to taxpayer compliance than stricter enforcement").

156. *See, e.g.*, Glenn R. Simpson, Jeff D. Opdyke & Ann Zimmerman, *Sales-Tax Indictment Targets Common Practice*, WALL ST. J., June 5, 2002, at D1.

157. *See, e.g.*, Mark Maremont & Jerry Markon, *Ex-Tyco Chief Evaded $1 Million in Taxes on Art, Indictment Says*, WALL ST. J., June 5, 2002, at A1.

158. *See, e.g.*, Amy Hamilton, *Alleged IRS Harassment: No Misconduct Found in 95 Percent of Cases*, 88 TAX NOTES 978 (2000); John D. McKinnon, *Some IRS Abuse Charges Are Discredited*, WALL ST. J., Apr. 25, 2000, at A2.

This incident is part of a pattern of shameful conduct by various political figures toward the IRS. Members of Congress often disingenuously refer to the "IRS Code," instead of the Internal Revenue Code, implying that the IRS is the originator of the Code and attempting to shift blame for the complexities and inequities in the Code from the legislative branch to the administrative agency in charge of administering the tax laws. Of course, Congress, not the IRS, has enacted every provision of the tax code and Congress has the power to overturn by legislation any regulation issued by the IRS that it does not like. Yet, it rarely does so. Instead, members of Congress like to use the IRS as a "whipping boy" at the same time they are pressuring the IRS to step up its revenue collection efforts. Often, this anti-IRS rhetoric is employed by political figures to mask their true aims—antagonism toward the government programs they have failed or are unwilling to eliminate directly through spending cuts.[159]

The IRS is understaffed and needs more resources to accomplish its enforcement effort. This resource starvation of the tax enforcement system is a scandal that threatens to undermine the tax system and our government. Whether we retain our hybrid income tax system or move to more of a consumption tax base, we must have vigorous enforcement efforts by the IRS, the government agency charged with enforcement of the tax laws.

One last point bears mention. In recent years, IRS personnel have been under pressure by lawmakers and by some high-ranking officials in the agency both to engage in alternative dispute resolution and to settle more cases as a way of increasing revenue and reducing administrative costs. In theory, this makes sense. However, one must be careful not to set up a pattern where cases are routinely settled for fifty cents or sixty cents on the dollar, even where the IRS has a reasonable argument that the taxpayer's claimed tax treatment is erroneous. Such a settlement pattern will encourage noncompliance and reduce the transaction costs for aggressive taxpayers and their advisers to enter the audit lottery. It also rewards those taxpayers who have the resources to engage high-cost, aggressive practitioners to challenge IRS deficiencies, however reasonable they are, and, because they are repeat players in the tax controversy setting, have an incentive to do so.

VII. Reinvigoration of The Tax Expenditure Concept

The late Professor Stanley Surrey of the Harvard Law School is primarily responsible for the prominence of the tax expenditure concept in tax policy analysis. The idea is that tax code provisions that have a programmatic purpose (i.e., some economic or social policy purpose other than determining the taxpayer's net income subject to tax) should be treated as government programs

159. *See* Marjorie E. Kornhauser, *Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric in America*, 50 BUFF. L. REV. 819 (2002).

that need to be identified, quantified, and evaluated under a rigorous cost-benefit analysis. A significant purpose of the tax expenditure analysis is to bring transparency to government programs advanced through the tax system, recognizing that these indirect government programs often pass under the radar screen with far less scrutiny than direct government programs receive. It has become fashionable in academic[160] and government circles[161] to bash the tax expenditure concept as outdated, simplistic, and lacking analytic value. Politicians of all philosophical bents dislike the tax expenditure concept and like to use tax expenditure provisions in the tax code to achieve various policy objectives. Liberals dislike the tax expenditure concept because, if rigorously applied, it undercuts the ability of legislators to use the tax system to achieve government programs. In an era of budget deficits, when new direct government programs are very difficult to get approved, tax expenditures may be the only way to get a program through the Congress. Conservatives dislike the tax expenditure concept because they view tax subsidies as involving less government bureaucracy and more taxpayer autonomy than direct government programs. Conservatives also dislike the tax expenditure concept because they argue that it is based on the erroneous assumption that the government has a pre-existing claim on the taxpayer's income and that any reduction in that claim is somehow suspect.[162]

These criticisms largely miss the point of the tax expenditure concept. The major point is that if a government program to be administered through the tax system is being proposed everyone ought to understand that is what is being done and the program should undergo the same scrutiny as would any direct government program. If the program cannot satisfy a rigorous cost-benefit analysis, it should not be enacted or should be terminated if it has already been enacted. Part of that calculus involves a serious determination of whether it makes sense to accomplish the program through the tax system, rather than through some other government mechanism. The fact that the government program masquerades as a technical tax provision in a complicated tax bill should not change the level of scrutiny that the proposed program will receive.

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160. *See, e.g.*, Bruce Bartlett, *The End of Tax Expenditures as We Know Them?*, 92 TAX NOTES 413 (2001); Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973 (1986); Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993).

161. *See, e.g.*, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2004, 101-40 [hereinafter ANALYTICAL PERSPECTIVES] (in chapter on tax expenditures, the budget makes clear the skepticism of the Bush Administration's Treasury Department toward the tax expenditure concept); ANALYTICAL PERSPECTIVES, *supra*, at 87-99 (in chapter on tax expenditures, the budget refers to "so-called" tax expenditures of "questionable analytic value").

162. *See, e.g.*, Heidi Glenn, *Bush Administration Questions Value of Tax Expenditures List*, 91 TAX NOTES 535 (2001); Kornhauser, *supra* note 159, at 896 n.218 (stating that "the tax expenditure concept implies that the government, not the taxpayer, is entitled to that [revenue lost as a result of a tax expenditure provision] under a normal income tax. . . ."). One commentator has described this argument as "peculiar." *See* Leonard E. Burman, *Is the Tax Expenditure Concept Still Relevant?*, 56 NAT'L TAX J. 613, 620 (2003).

The point is not that the taxpayer's income belongs to the government, but, instead, that tax expenditures constitute funds spent on a government program and ought to be carefully evaluated as such.

If sensibly applied, the tax expenditure concept can properly serve as a constraining force on Congress's enactment of costly tax preferences aimed at narrow constituencies.[163] In an era where tax deductions and credits are being proposed for virtually every pet project of the President or members of Congress,[164] it has never been more necessary to have that constraining force present. And the need for an effective tax expenditure-type analysis of tax preferences will not disappear should we adopt a consumption-based tax system,[165] although the baseline for applying the concept would change.

VIII. FINAL CONCLUDING THOUGHTS

The case for scrapping our hybrid income tax system and replacing it with some unproven consumption tax system has not been adequately made, at least as a complete replacement for our current system.[166] Our current system still raises more money than any other system in the world and is the envy of the world. Rather than trying some new, unproven consumption tax system as the main source of revenue for the federal government, we should continue the efforts to substantially reform and simplify the income tax system that resulted in the passage of the Tax Reform Act of 1986. Instead of tearing the income tax system out by its roots, we should prune and nurture it by reforming the income tax system into a more broad-based system with lower rates. In this regard, the Bush Administration's major tax proposals to date largely have been steps in the wrong direction and signal the Administration's decision to abandon the income tax system without proposing a properly designed consumption tax alternative in its place. Instead of simplifying the tax system, they generally have added tremendous complexity to it. Instead of preserving the progressive distribution of the tax burden that was in place when the Bush Administration took office, these proposals will result in a shift of the burden downward from high-income

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163. *See* Burman, *supra* note 162, at 621.

164. This is a bipartisan problem. The Clinton Administration was notorious for its support of tax preferences as a means of achieving non-revenue raising social or economic purposes. For example, the Taxpayer Relief Act of 1997, signed into law by President Clinton, was responsible for adding many new tax preferences to the Code, thus increasing the complexity of the tax system.

165. For example, the distinction between personal activities and business or investment activities would remain an important issue under a cash-flow consumption tax and the pressure on Congress to enact tax preferences that treat expenses incurred in favored personal consumption activities as non-consumption expenses for tax purposes would be as intense, if not more intense, under a cash-flow consumption tax system as under our existing system.

166. As indicated earlier in this article, use of a consumption tax as a supplement to the income tax system (e.g., as a vehicle for removing most lower- and middle-income taxpayers from the income tax system) or as a replacement for the regressive employment taxes may indeed be a desirable policy option that deserves serious consideration by policymakers.

taxpayers to low- and middle-income taxpayers.[167] Instead of reducing tax rates as part of a program of base broadening of the income tax system or a program of government spending reductions, these proposals have both reduced rates and undermined the tax base, helping to produce budget deficits in place of the budget surpluses of just three years ago.[168] Thus, the Bush Administration's tax policies to date have not advanced the cause of tax reform but in fact impeded it.

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167. Having failed to persuade low-, middle-, and even high-income taxpayers on the merits to oppose popular government programs that require significant government spending to support them (such as Social Security and Medicare), there are some members of Congress (e.g., Republican Representative Jim DeMint of South Carolina) as well as editorial page writers (e.g., the Wall Street Journal editorial page) who have cynically advocated a shifting of the tax burden downward apparently in an effort to generate antagonism toward government programs. *See* Clarence Page, *Bush reaches out to the "Needy,"* CHI. TRIB., Jan. 12, 2003, at 9. Representative DeMint stated: "You can't maintain a democracy if the people who are voting don't care what their government costs." *Id. See also* Robert J. Barro, *Bush's Tax Cuts: Reaganomics Redux?*, BUS. WK., Jan. 20, 2003, at 22 (stating that "thus, more and more, the individual income tax has been paid primarily by the well off, creating a dangerous political cleavage that promotes class warfare").

168. Of course, the Bush Administration's tax cuts in 2001 through 2003 are not the only cause of the current budget deficits. The weak economy and resulting lower economic growth would have reduced government revenues, even if the tax cuts had not been enacted. In fact, proponents of the Bush Administration's tax policies argue that the tax cuts prevented the decline in revenue from being even greater by shoring up the economy during the recession that occurred during the period 2001-02. Moreover, if the Bush Administration and Congress had been more serious about restraining government spending, the deficits would have been smaller in amount. Increased government spending is obviously a major contributor to these budget deficits. In any event, although there is some disagreement among economists concerning the economic effects of budget deficits of the type arising in the United States in recent years, it seems reasonably clear that sustained budgets deficits reduce national saving and future national income. *See* William G. Gale & Peter R. Orszag, *Economic Effects of Sustained Budget Deficits*, 56 NAT'L TAX J. 463 (2003).