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IMPLEMENTING A PROGRESSIVE  
CONSUMPTION TAX

*Michael J. Graetz* \*

*Much scholarly debate has been devoted to the theoretical merits of using an individual's consumption expenditures as the basis for measuring ability to pay tax. In this Article, Professor Graetz examines the practical problems of implementing and administering a progressive consumption tax as an alternative to the income tax. He concludes that although a consumption tax is feasible, practical implementation difficulties, together with the political unlikelihood of enacting a tax which is both administratively workable and retains the alleged theoretical advantages of a consumption-based tax, argue against its adoption.*

**A**LTHOUGH the idea of an individualized tax on consumption is not new,<sup>1</sup> it has received no serious political attention in the United States since the Second World War.<sup>2</sup> Recent years, however, have witnessed a variety of proposals to substitute such an "expenditure tax" for the existing income tax. Proponents of a progressive personal consumption tax have asserted its superior-

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<sup>1</sup> See T. HOBBS, *LEVIATHAN* 226 (M. Oakeshott ed. 1960) ; J.S. MILL, *PRINCIPLES OF POLITICAL ECONOMY* bk. V, ch. I, § 4 (Laughlin ed. 1884). The classic work is N. KALDOR, *AN EXPENDITURE TAX* (1955). See also, e.g., I. FISHER & H. FISHER, *CONSTRUCTIVE INCOME TAXATION* (1942) ; A. Marshall, *The Equitable Distribution of Taxation*, in *MEMORIALS OF ALFRED MARSHALL* 347, 350-51 (A. Pigou ed. 1925) ; A. PIGOU, *A STUDY IN PUBLIC FINANCE* 102-03 (3d rev. ed. 1949).

<sup>2</sup> See U.S. DEP'T OF THE TREASURY, *ANNUAL REPORT OF THE SECRETARY OF THE TREASURY* 93-94, 411-13, 415 (1943).

ity to the income tax in terms of fairness, economic efficiency, and simplicity of administration.<sup>3</sup> Not surprisingly, each of these contentions is quite controversial.

The debate over the relative equity of income and expenditure taxation has considered whether income or consumption is a better measure of "ability to pay,"<sup>4</sup> whether horizontal equity should be measured by reference to similarly situated earners or similarly situated consumers,<sup>5</sup> and what time frame should be used to evaluate the fairness of a progressive tax on individuals.<sup>6</sup> In more general terms, the debate has asked whether social product in the form of money returns to both capital and labor (income) is a fairer tax base than what an individual takes out of society in the form of money spent on consumption.<sup>7</sup>

Claims for consumption taxation based on economic efficiency have likewise produced lively debate.<sup>8</sup> There is general agreement

<sup>3</sup> The seminal work is Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). See also ADVISORY COMM. ON INTER-GOVERNMENTAL RELATIONS, *THE EXPENDITURE TAX* (Information Report M-84 1974) [hereinafter cited as ACIR REPORT]; INSTITUTE FOR FISCAL STUDIES, *THE STRUCTURE AND REFORM OF DIRECT TAXATION* (1978) [hereinafter cited as the MEADE REPORT]; S. LODIN, *PROGRESSIVE EXPENDITURE TAX — AN ALTERNATIVE?* (1978) (report of the 1972 [Swedish] Government Commission on Taxation) (translated into English in 1978); P. MIESZKOWSKI, *THE CASH FLOW VERSION OF AN EXPENDITURE TAX* (May 1977) (Office of Tax Analysis, OTA Paper 26, U.S. Dep't of Treasury); U.S. DEPT OF THE TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM 21-52, 113-44* (1977) [hereinafter cited as BLUEPRINTS].

<sup>4</sup> See Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975); Bradford, *The Case for a Personal Expenditure Tax*, in *WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE* (J. Pechman ed. 1979) [hereinafter cited as BROOKINGS REPORT]; Dyer, *The Relative Fairness of the Consumption and Accretion Tax Bases*, 1978 UTAH L. REV. 457; Goode, *The Case for the Income Tax*, in BROOKINGS REPORT, *supra*; Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370 (1979); Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); Warren, *Comments on The Case for the Income Tax* (by Richard Goode) and *The Case for a Personal Expenditure Tax* (by David F. Bradford), in BROOKINGS REPORT, *supra*; Warren, *Income and Consumption Taxes — The Issue of Fairness* (forthcoming 1979).

<sup>5</sup> Compare Andrews, *supra* note 4, with Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975).

<sup>6</sup> Consumption tax proponents tend to take a lifetime perspective and an ex ante view in evaluating issues of fairness, see I. FISHER & H. FISHER, *supra* note 1, at 95-98; BLUEPRINTS, *supra* note 3, at 24-25, 176; Bradford, *supra* note 4; Bradford & Toder, *Consumption vs. Income Base Taxes: The Argument on Grounds of Equity and Simplicity*, 69 NAT'L TAX A. PROC. 25 (1976), while income tax proponents tend to rely on a shorter time frame and ex post comparisons, see Warren, *Income and Consumption Taxes — The Issues of Fairness* (forthcoming 1979).

<sup>7</sup> Compare Warren, *supra* note 6, with I. FISHER & H. FISHER, *supra* note 1, at 92-105.

<sup>8</sup> See Boskin, *Taxation, Saving and the Rate of Interest*, 86 J. POL. ECON.

that a consumption tax inherently leads to fewer difficulties than an income tax in times of significant inflation, and that a consumption tax provides more evenhanded treatment of present and postponed consumption by eliminating the so-called double tax on savings.<sup>9</sup> But economists differ widely in their predictions about the effects of treating savings more favorably. The economic consequences will essentially depend upon the relative responsiveness of savings and labor to changes in after-tax interest and wages. The empirical work in this area has as yet been inconclusive.<sup>10</sup>

In contrast to these disagreements about equity and efficiency, recent commentators have generally agreed that an expenditure tax would be easier to administer than the income tax.<sup>11</sup> Although expenditure taxation has failed in the only two countries that have tried it — India and Sri Lanka — these failures are deemed of little relevance to the United States because of the sophisticated progressive income tax based upon self-assessment that already exists here. This Article will consider whether implementation and administration of an expenditure tax would in fact be sufficiently feasible to make such a tax deserving of real political attention, and will consider equity and efficiency only as these asserted advantages of an expenditure tax are implicated in the practical problems of implementation.

After a brief description in Part I of how an expenditure tax would operate, Part II will explore the type of rate schedule that would be necessary under an expenditure tax. Part III will discuss what items would be included in receipts and allowed as deductions, and Part IV will consider the timing of inclusions and deductions. Parts V, VI, VII, and VIII will suggest some of the implications of an expenditure tax for taxation of gifts and bequests, tax incentives and subsidies, corporate taxation, and international transactions, respectively. Finally, Part IX will analyze transitional problems likely to arise in shifting to an expenditure tax.

While demonstrating that workable solutions can be devised

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S3 (1978); Bradford, *supra* note 4; Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. S29, S37-S39 (1978); Howrey & Hymans, *The Measurement and Determination of Loanable Funds Saving*, in BROOKINGS REPORT, *supra* note 4.

<sup>9</sup> See Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION I, 11 (J. Pechman ed. 1977); Kahn, *The Place of Consumption and Net-Worth Taxation in the Federal Tax Structure*, in BROAD-BASED TAXES 133, 139-40 (R. Musgrave ed. 1973). See generally sources cited note 1 *supra*.

<sup>10</sup> See sources cited note 8 *supra*.

<sup>11</sup> See sources cited note 3 *supra*. *Contra*, N. KALDOR, *supra* note 1, at 222; Brazer, *The Income Tax in the Federal Revenue System*, in BROAD-BASED TAXES 3, 5 (R. Musgrave ed. 1973).



for the major issues arising under an expenditure tax, the Article suggests that the implementation problems posed by the shift to a consumption-based tax are indeed serious and emphasizes the need for caution in moving forward with this tax as an alternative to the income tax. Many of the alleged fairness and efficiency advantages of a theoretically correct expenditure tax are likely to be lost in the political process, if income tax experience is any indication. Areas in which the design and implementation of an expenditure tax are likely to prove particularly troublesome are coordination with the tax systems of other industrial nations and the creation of an acceptable and compatible replacement for the corporate income tax. Further difficulties are posed by the likely need for high nominal rates, for new or increased wealth or transfer taxes, for tax subsidies for particular kinds of investment, and for a comprehensive base of receipts and consumption. The treatment of gifts and bequests will also be problematic. Finally, although this Article suggests, contrary to the view of most commentators, that devices are available to make the transition to an expenditure tax relatively simple without undue unfairness to taxpayers, the political likelihood of enacting a simple transitional scheme is very slight.

## I. BACKGROUND

### *A. Comparison to Other Taxes*

Consumption taxes in the United States and other industrialized countries tend to take the form not of expenditure taxes, but instead of flat-rate or multiple-rate retail sales taxes, turnover taxes, or value-added taxes.<sup>12</sup> Like the expenditure tax, these taxes are imposed upon a base composed of expenditures on consumption items. The principal difficulties with the value-added tax and the sales tax are precisely those which a well-designed expenditure tax should avoid. First, value-added and retail sales taxes are invariably imposed on less than a full consumption base. Services are typically excluded from the tax base, for example, medical and hospital care services provided by state and local governments, public transportation, financial services provided by banks and savings institutions, foreign travel, and in some cases rental payments, including those for housing.<sup>13</sup> Second,

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<sup>12</sup> See generally J. DUE, SALES TAXATION (1957); D. SMITH, J. WEBBER & C. CERF, WHAT YOU SHOULD KNOW ABOUT THE VALUE ADDED TAX 11-21 (1971); Cohen, *Foreign Experience with a Value Added Tax*, 24 NAT'L TAX J. 399 (1971).

<sup>13</sup> See J. DUE, *supra* note 12, at 373-78.

value-added or retail sales tax rates are not related to an individual's total amount of consumption. An expenditure tax should avoid the narrowing of the tax base that inevitably seems to accompany value-added or sales taxes and would achieve individualization of the tax burden by imposing a tax on a consumption base at progressive rates directly related to an individual's overall level of consumption.

If only a proportional tax on consumption were desired, a value-added tax or a retail sales tax would surely be adequate, since relatively simple mechanisms exist to ensure that these taxes are roughly proportional to an individual's total consumption.<sup>14</sup> The decision to adopt a progressive rate structure is thus the principal basis for choosing an expenditure tax over other taxes levied on a consumption base. The fact that the decision to impose an expenditure tax is, in the first instance, dictated by a desire for progressivity needs to be emphasized because much of the expenditure tax literature analyzes flat-rate taxes.<sup>15</sup> Difficulties with such analysis will become apparent in subsequent sections of this Article.

An expenditure tax at progressive rates also overlaps substantially with a progressive income tax, as the Haig-Simons definition of income as consumption plus accretions to wealth suggests.<sup>16</sup> A significant portion of the income tax base is comprised of consumption expenditures, and many of the problems of implementing a consumption tax are quite similar, or even identical, to those encountered under an income tax. Because sixty years of experience with and analysis of income tax issues must necessarily serve as background to any discussion of implementation issues under an expenditure tax, this Article will concentrate on issues peculiar to an expenditure tax, with only abbreviated discussion of issues which have been explored in depth in the income tax context.

Finally, Professor Alvin Warren has suggested that a consumption tax is necessarily equivalent to a wage tax.<sup>17</sup> This argument requires one to ask whether a graduated payroll tax, perhaps with a base similar to that of the social security tax, would be an appropriate mechanism for implementation of an expenditure tax. This alternative will be explored in Part IV in connection with discussion of the two principal forms of consumption tax implementation.

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<sup>14</sup> See *id.* at 373-82.

<sup>15</sup> Andrews, *supra* note 3, at 1120-28, 1150; see BLUEPRINTS, *supra* note 3, at 9, 127-28. See also Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461 (1977).

<sup>16</sup> H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

<sup>17</sup> Warren, *supra* note 5, at 938.

### *B. General Description of an Expenditure Tax*

No one suggests direct accounting for consumption expenditures of individuals as a practical approach to a progressive tax on consumption. Recordkeeping in connection with numerous consumption purchases would simply be too onerous; Internal Revenue Service reliance on sales tax tables under the current income tax confirms this rather obvious point. Consumption expenditures would necessarily be approximated by reference to amounts available for consumption (principally income) and amounts saved.

Early discussions of expenditure tax implementation typically regarded full reporting of an individual's bank balances, other accounts, and assets and liabilities at the beginning and end of each year as essential to the consumption tax computation,<sup>18</sup> but subsequent commentators have viewed balance sheet reporting as unnecessarily complicating.<sup>19</sup> Instead, consumption expenditures would be computed indirectly by calculating each year's transactions which produce funds available for consumption or savings and eliminating savings from the tax base. Subsequent Parts of this Article will fill in the details, but the general form would be as follows: Amounts Received minus Amounts Saved equals Taxable Consumption.

## II. THE EXPENDITURE TAX RATE SCHEDULE

### *A. In General*

While the development of a specific rate schedule for an expenditure tax is beyond the scope of this Article, the details of the rate schedule have important implications for issues of expenditure tax design. Enactment of an expenditure tax could serve various purposes. It might be enacted as a replacement for one or more current sources of federal revenue, for example, the individual income tax (or both the individual and corporate income tax), payroll taxes, or estate and gift taxes (if gifts and bequests are treated as donors' consumption). Alternatively, an expenditure tax could be adopted as a supplement to existing tax sources, perhaps limited in application to high income taxpayers.<sup>20</sup>

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<sup>18</sup> See N. KALDOR, *supra* note 1, at 191-93; Kelley, *Is an Expenditure Tax Feasible?*, 23 NAT'L TAX J. 237, 238-42 (1970); Slitor, *Administrative Aspects of Expenditure Taxation*, in BROAD-BASED TAXES 227, 251-55 (R. Musgrave ed. 1973).

<sup>19</sup> See BLUEPRINTS, *supra* note 3, at 113-14, 119; Andrews, *supra* note 3, at 1119, 1149-50.

<sup>20</sup> See N. KALDOR, *supra* note 1, at 224-32; Andrews, *supra* note 3, at 1185-88; Andrews, *A Supplemental Personal Expenditure Tax*, in BROOKINGS REPORT, *supra*

Taxes on a consumption base have from time to time been suggested to finance specific federal programs. For example, Congressman Al Ullman, Chairman of the House Ways and Means Committee, has recently suggested that a national health insurance program might be financed by a value-added tax, and Senator Russell Long, Chairman of the Senate Finance Committee, has proposed a value-added tax to replace social security taxes and to reduce income taxes.<sup>21</sup> An expenditure tax might well merit consideration in such contexts.

The Treasury Department, in its study of a progressive consumption tax in *Blueprints for Basic Tax Reform*, estimated that a rather comprehensive consumption tax base would be 23% greater than the present taxable income base and 7% less than a comprehensive income tax base.<sup>22</sup> A comprehensive consumption tax base would be larger than the present income tax base because the addition of many items not now included as income would more than offset the exclusion of amounts saved. For example, capital gains would be included in full, and the Treasury would not allow deductions for charitable contributions or state sales or property taxes.

The Treasury's calculations notwithstanding, it is of course quite possible that the expenditure tax emerging from the political process might not significantly expand the present tax base, so that the major modification of the present tax base would be the exclusion of savings. If this were the case, and total revenues and distribution of the tax burden roughly equivalent to that of the present income tax were desired, a rate schedule much more sharply progressive than the current schedule might be required. The existing rate schedule for married couples ranges from 14% at taxable incomes of \$3,400-\$5,500 to 70% at taxable incomes in excess of \$215,400.<sup>23</sup> If, as is widely believed, persons in lower income brackets annually consume more than their income, and the proportion of income allocated to savings increases with income, comparable rate schedules applied to a consumption tax base would tend to start lower than those of the current income tax and rise more gradually than current income tax rates until about the \$30,000 taxable income class; over that

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note 4. The recent report of the Meade Commission in the United Kingdom, for example, considered a "two-tier" expenditure tax with a proportional value-added tax applicable to the broad class of taxpayers and a progressive expenditure tax applicable only at the higher brackets. See MEADE REPORT, *supra* note 3, at 204-15. *But see* p. 1655 & note 225 *infra*.

<sup>21</sup> See Daily Tax Report for Executives (BNA), Apr. 30, 1979, at G-6; 7 TAX NOTES 685, 705-06 (1978).

<sup>22</sup> BLUEPRINTS, *supra* note 3, at 169.

<sup>23</sup> I.R.C. § 1(a).

amount, rates would tend to rise steeply and to be at a level greater than that of current marginal income tax rates.<sup>24</sup>

Alternatively, distribution of the tax burden and revenues equal to the income tax could be achieved by combining an expenditure tax with another new tax, such as a wealth tax, or increases in other existing taxes. Attention would of course have to be given to the effect of such additional changes on the greater efficiency and equity claimed for the expenditure tax and on the feasibility of implementation. Moreover, the alleged efficiency and equity advantages of an expenditure tax may themselves be quite sensitive to the rate schedule for the tax. Sharply progressive rates, for example, may significantly affect the choice between present and future consumption, and tax-exclusive marginal rates in excess of 100% may reduce any impact of the change in increasing aggregate savings.

In analyzing problems of implementing a progressive tax on consumption, this Article assumes that such a tax is intended to produce revenues roughly equivalent to current federal income tax receipts and to distribute the tax burden in a manner roughly similar to that of the current income tax, through a rate schedule having numerous gradations.

### *B. A Tax-Exclusive Base — Deduction of Federal Expenditure Taxes*

Under the income tax, tax is imposed on a “tax-inclusive” basis; tax payments are treated in the same manner as amounts saved. No deduction is allowed for the income tax itself. Under an expenditure tax, treating tax payments in the same manner as amounts saved requires deduction for tax payments on a cash-flow basis — a “tax-exclusive” base — so that the movement of funds from savings to pay taxes would not affect the actual amount of taxes due. One major effect of the choice between

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<sup>24</sup> Regardless of the base selected, it seems unrealistic to expect rate brackets as broad as the Treasury suggests in *Blueprints*. In its proposed rate schedule (which it contended would roughly approximate the progressivity of present law), for example, the Treasury suggests one marginal rate (28%) for married couples with consumption between \$5,200 and \$30,000 and one marginal rate (40%) for consumption in excess of \$30,000. *BLUEPRINTS*, *supra* note 3, at 169. Present law contains seven different marginal tax rates for taxable income classes between \$5,200 and \$30,000, and eight different marginal rates for taxable incomes in excess of \$30,000. I.R.C. § 1(a). It seems more reasonable to assume that, whatever the consumption tax base, a progressive rate schedule would include considerably more gradations than that suggested in *Blueprints*. The number of brackets has significant implications for implementation decisions. Under the *Blueprints* schedule, the few gradations may make the allocation of consumption to a particular taxable period extremely significant for persons with consumption near the amounts where the brackets shift.

tax-inclusive and tax-exclusive bases is on the rate of tax to be applied. Significantly greater rates are required to produce equivalent revenues on a tax-exclusive base, as the following table illustrates:<sup>25</sup>

<u>Tax-Inclusive Rates</u>	<u>Equivalent Tax-Exclusive Rates</u>
35	54
40	66 <sup>2</sup> / <sub>3</sub>
50	100
75	300
83	488
98	4,900

Although actual tax liability need not be increased, the psychological and political consequences of the choice between a tax-inclusive or tax-exclusive base may prove quite disadvantageous to the adoption of an expenditure tax. A 75% tax on a base that includes the tax may be viewed differently than a 300% tax on a base that does not include the tax. It might be possible to overcome the appearance of a tax increase by a mathematical maneuver that would describe tax liability in terms of a tax-inclusive rate schedule but allow actual computations to be performed on a tax-exclusive basis.

In any event, it is important that an expenditure tax actually be calculated on a tax-exclusive base. In the first place, failure to treat payments of expenditure tax as deductible would create oscillations in the amount of tax due depending on the timing of tax payments as compared with amounts saved. To the extent that taxpayers adjust their savings to meet tax liabilities, a tax-exclusive expenditure tax base will tend to produce more stable results.<sup>26</sup> Second, divergence between current payments of tax (through withholding or through estimated tax payments) and final tax liability would create special problems under an expenditure tax imposed on a tax-inclusive basis. If the government withheld too little, for example, a taxpayer could devote to savings amounts that would otherwise be taxable and thereby reduce his tax liability.<sup>27</sup> If, on the other hand, the government

<sup>25</sup> The table in the text is taken from the MEADE REPORT, *supra* note 3, at 28. The general formula for converting tax-exclusive into tax-inclusive rates and vice versa is:

$$r_e = \frac{r_i}{1 - r_i} ; \quad r_i = \frac{r_e}{1 + r_e}$$

where  $r_i$  is the tax-inclusive rate and  $r_e$  is the tax-exclusive rate.

<sup>26</sup> See *id.* at 167. See also N. KALDOR, *supra* note 1, at 237-38.

<sup>27</sup> While the problem is not limited to divergences between amounts withheld and final tax liability, a simple example of underwithholding will illustrate the

withheld too much, a taxpayer would have no opportunity to diminish his tax burden in similar fashion. Imposing expenditure tax on a tax-exclusive base would eliminate these problems.

### III. GENERAL DESCRIPTION OF THE EXPENDITURE TAX BASE: RECEIPTS AND DEDUCTIONS

#### *A. Introduction*

Computation of the expenditure tax base requires deduction of amounts saved or invested from amounts available for consumption, with the balance treated as consumption expenditures. For many taxpayers, receipts and deductions would be treated much as they are under the current income tax, except that cash receipts from sales of assets would be fully included and savings fully deducted. In practical terms, however, it may be more critical under a consumption tax that receipts available for consumption be comprehensively defined, and that deductions of amounts properly considered consumption not be allowed.

As the previous Part suggests, because of the exclusion of savings, a consumption tax may require higher and more steeply progressive marginal rates to produce the same revenue as the current income tax. If this proved to be the case, taxpayers would have a greater incentive to avoid tax by overstating deductions or by obtaining funds for consumption in ways which do not give rise to taxable receipts. And quite apart from whether rates are higher or lower, preventing such tax avoidance would likely become more important since tax planners would likely concentrate their energies on concealing consumption. These pressures will

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advantage to taxpayers under a tax-inclusive computation of delaying payment of expenditure taxes and temporarily increasing savings. Assume a taxpayer with salary of \$100 and after-tax consumption of \$50 with expenditure tax of 50% on a tax-inclusive base. If no amount of tax were withheld, but the taxpayer put \$50 in a savings account, a tax-inclusive computation would produce an expenditure tax liability of \$25 for that year (since the tax base would be \$100 receipts minus \$50 savings). This tax liability presumably would be paid by withdrawing the \$25 from savings in the following year. Since no deduction for expenditure tax would be allowed in a tax-inclusive system, the individual's tax liability would increase in future years: by \$12.50 in year 2 (50% of the \$25 additional receipts withdrawn from savings to pay taxes), \$6.25 in year 3 (50% of the \$12.50 additional receipts withdrawn from savings in year 3 to pay expenditure tax), and so on. In contrast, an individual subject to accurate withholding of \$50 in year 1 would owe tax of \$50 for that year (\$100 of receipts and no deduction for savings).

A tax-exclusive computation, on the other hand, would allow deduction for expenditure tax payments and, with a rate of 100%, produce an identical tax of \$50 in year 1 whether taxes were withheld or saved. More detailed examples may be found in MEADE REPORT, *supra* note 3, at 162-67.



require a broad definition of consumption to prevent serious erosion of the tax base.

This Part explores several significant areas of potential exclusion and deduction which present issues under an expenditure tax parallel to those arising under the income tax. Although the issues considered here have been well ventilated in the income tax context,<sup>28</sup> differences between income and expenditure taxation will, in some instances, produce important variations in the analysis.

1. *Receipts.* — Notwithstanding the differences between expenditure tax receipts and income, the concepts are more similar than they are different. All items includible as income under the income tax would constitute receipts available for consumption under an expenditure tax. As Part IV explains, proceeds from sales of assets and from loans will typically be included in expenditure tax receipts. For many taxpayers, however, expenditure tax receipts and income in most years would be identical; this would be true, for example, where individuals receive only wages, interest, and dividends.

The following discussion proceeds from the premise that an expenditure tax should include all items in the tax base that can reasonably be viewed as satisfying personal needs and desires. Although such a perspective might theoretically merge into suggestions for taxation of leisure, prestige, or other intangible forms of personal satisfaction, this Article does not advocate extending taxation that far. Since shifting to an expenditure tax will necessarily result in a narrowing of the tax base, however, it will be more important to ensure that items within that base do not escape taxation.

2. *Deductions.* — An expenditure tax must distinguish as precisely as possible between nondeductible consumption expenditures and deductible expenditures for savings or investment. In some circumstances, the distinction is relatively easy to draw. For example, money spent on goods and services for the sole purpose of personal pleasure is plainly consumption. By the same token, if an individual deposits \$100 in a savings account with a financial institution, the deposit just as plainly constitutes savings. Likewise, the purchase of stock in the hope of obtaining a return offers a clear case of investment. Many individual expenditures, however, are made with mixed motives. Money is often spent at once to provide personal satisfaction and to make

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<sup>28</sup> See, e.g., B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, *A COMPREHENSIVE INCOME TAX BASE?* (1968); *COMPREHENSIVE INCOME TAXATION* (J. Pechman ed. 1977).

money; the same expenditure often has both investment and consumption aspects.

The practical problems of distinguishing between personal expenses and expenses made for business or investment purposes are familiar under the income tax. Professor Chirelstein accurately assesses the magnitude of the tax collector's task when he observes that "the notion of a sharp division between pleasure-seeking and profit-seeking is alien to human psychology and essentially unrealistic."<sup>29</sup>

In some instances, the Internal Revenue Code permits deductions for expenses without requiring the taxpayer to show any profit-seeking motive. These include the so-called itemized deductions for charitable contributions, medical expenses, interest, and state and local taxes. In other cases, the taxpayer must demonstrate a business or profit-seeking motive to obtain a deduction. Given the difficulties under the income tax of resolving these issues, there is no reason to expect that expenditure tax rules will be more satisfactory. This Part attempts to suggest practical solutions (given the likely political pressures) and, in keeping with the recommendations relating to receipts, argues for limiting deductions where expenses are induced by mixed personal and business investment motives.

### B. Business-Related Consumption

1. *Fringe Benefits.* — The existing ability of certain taxpayers to obtain fringe benefits free of income tax<sup>30</sup> violates principles of tax equity and produces allocative inefficiencies since both em-

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<sup>29</sup> M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 87 (1977). Professor Bittker has remarked on this dilemma in greater detail:

No matter how generously the Code defines business expenses in an effort to insure that all business-related expenses can be deducted, there will always be some non-deductible items beyond the line that contribute in some way to the production of income, whether it is the basic cost of living — one cannot work, after all, unless one is fed and housed — or the cost of luxuries that contribute to the taxpayer's willingness to work and to his initiative and reliability while on the job. On the other hand, no matter how severely the term "business expense" is defined, many items will continue to qualify for deduction although they confer "personal" benefits on the taxpayer. Taxpayers may be forbidden to deduct entertainment expenses because they are suspected of enjoying dinners and theater parties with their business customers, for example, but even the most puritanical definition of business expense is not likely to prevent self-employed taxpayers from deducting the cost of air-conditioning their offices, upholstering their swivel chairs, or adding gadgets to their telephones, even if they derive personal pleasure from these amenities.

Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 203-04 (1973).

<sup>30</sup> See, e.g., I.R.C. § 119 (exclusion for value of meals or lodging furnished for the convenience of the employer); 2 C.B. 90 (1920) (supper money ruling); Treas. Reg. § 1.117-4(c)(2) (1956) (tuition remission regulation).

ployees and employers find it expedient to fashion compensation in the form of excluded in-kind benefits.<sup>31</sup> Under an expenditure tax, it would be highly desirable to avoid much of the attrition of the tax base occasioned by the current exclusion of essentially compensatory in-kind benefits.<sup>32</sup> Items such as supper money, employee discounts, free admission to athletic or entertainment events, vacation facilities and country club memberships, meals and lodging, and interest-free loans would be includible in expenditure tax receipts.<sup>33</sup> Particular care would have to be exercised to prevent highly compensated individuals from structuring their remuneration so as to receive a maximum amount of compensation in the form of fringe benefits. Otherwise, the same classes of persons principally able to reduce taxes by deductions for savings would also obtain a disproportionate exemption of consumption, and the prospect of genuine progressivity would be undermined.

Taxation of fringe benefits would not be easy under an expenditure tax, either as a political or administrative matter, given the inertia of the existing exclusions and the difficulties posed by recordkeeping and withholding.<sup>34</sup> The only practical alternative,

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<sup>31</sup> See generally *Tax Treatment of Employee Fringe Benefits: Hearings of the Task Force on Employer Fringe Benefits Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. (1978); Grief, *Analysis of Treasury Proposals on Fringe Benefits: Are They Rules of the Future?*, 45 J. TAX. 96 (1976); Hickman, *The Outlook for Fringe Benefits*, 29 S. CAL. TAX INST. 459 (1977); Special Comm. on Simplification, ABA Section of Taxation, *Evaluation of the Proposed Model Comprehensive Income Tax*, 32 TAX LAW. 567 (1979) [hereinafter cited as *ABA Simplification Report*]; Wainess, *Current Trends in Executive Fringe Benefits*, 30 S. CAL. TAX INST. 319 (1978); Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141 (1976).

<sup>32</sup> See U.S. Dept. of the Treasury, Discussion Draft of Proposed Regulations on Fringe Benefits, 40 Fed. Reg. 41118 (1975). A substantial noncompensatory business purpose for providing to an employee the good or service in question should be a prerequisite for exclusion, *i.e.*, the familiar working-condition/benefit-of-the-employer doctrine should be strictly applied. The viability of any fringe benefit taxation system seems to require that employers withhold tax on amounts thus includible in employees' receipts, or at a minimum notify employees as to amounts of taxable fringe benefits. The Supreme Court's recent opinion in *Central Ill. Pub. Serv. Co. v. United States*, 435 U.S. 21, 29 (1978), however, suggests that a greater degree of certainty is required for withholding than for including amounts in income, and may undermine any scheme to tax fringe benefits via withholding.

<sup>33</sup> The alternative of disallowing business deductions to employers would not be available, since a decision to tax consumption implies the elimination of business income taxes which affect production, but it might be possible to impose a special excise tax on fringe benefits which are difficult to allocate to individual employees. Business taxation is discussed in Part V, *infra*.

<sup>34</sup> In 1978, Congress enacted Pub. L. No. 95-427, 92 Stat. 996, which precluded the IRS from issuing any new fringe benefit regulations prior to January 1, 1980. A special task force of the House Ways and Means Committee also was formed to study the fringe benefit problem. The task force's preliminary views

however, seems to be the unwarranted exclusion of such items from the consumption tax base, which seems even less acceptable than under an income tax.

2. *The Distinction Between Business and Personal Expenses.* — Similar issues are presented by the deduction for business expenses. One employee's fringe benefit may, for example, constitute a business deduction for a self-employed individual. Under the income tax the statutory standards are quite general, and the struggle to distinguish deductible business or investment expenses from nondeductible personal, family, or living expenses has been largely left to the Internal Revenue Service and the courts. Sections 162 and 212 of the Internal Revenue Code provide for the deduction of "all the ordinary and necessary expenses" incurred in carrying on any trade or business or other income-producing activities, while section 262 states that "no deduction shall be allowed for personal, living, or family expenses." Beyond these general principles, Congress has provided little guidance in distinguishing business and investment expenses from consumption expenditures.

A variety of standards have developed, depending upon the particular type of expense involved.<sup>35</sup> For some kinds of expenses, the courts ask only whether the expense is appropriate and helpful to the taxpayer's business; if it is, the taxpayer is allowed a deduction.<sup>36</sup> For other expenses, courts attempt to discern the objective motive of the taxpayer, disallowing a deduction unless the expense would not have been made "but for" the existence of the business or investment motive.<sup>37</sup> The courts ordinarily will require that a taxpayer's profit-seeking activities be undertaken in "good faith."<sup>38</sup> Some types of expenses are regarded by courts as "inherently personal,"<sup>39</sup> and nondeductible even if shown to enhance profitmaking activity.

A useful general approach to the business deduction problem

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were summarized in a discussion draft bill. HOUSE COMM. ON WAYS AND MEANS, 96TH CONG., 1ST SESS., DISCUSSION DRAFT BILL AND REPORT ON EMPLOYEE FRINGE BENEFITS (Comm. Print 1979). See also sources cited note 31 *supra*.

<sup>35</sup> See generally Halperin, *Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859 (1974).

<sup>36</sup> See *Welch v. Helvering*, 290 U.S. 111 (1933).

<sup>37</sup> See, e.g., *Fausner v. Commissioner*, 413 U.S. 838 (1973) (commuting expenses); Rev. Rul. 75-380, 1975-2 C.B. 59.

<sup>38</sup> See, e.g., *Crymes v. Commissioner*, 31 T.C.M. (CCH) 4 (1972); *Shiosaki v. Commissioner*, 30 T.C.M. (CCH) 110 (1971), *aff'd*, 475 F.2d 770 (9th Cir.), *cert. denied*, 414 U.S. 830 (1973).

<sup>39</sup> See, e.g., *Fred W. Amend Co. v. Commissioner*, 454 F.2d 399 (7th Cir. 1971) (company president's consultations with Christian Science practitioner); *Drake v. Commissioner*, 52 T.C. 842 (1969) (army enlisted man's haircuts); Rev. Rul. 70-474, 1970-2 C.B. 34 (work clothes, uniforms, and grooming).

under the expenditure tax would focus not on the taxpayer's motivation or potential business benefits, but instead on the consumption aspects of such expenditures. Deductions would be disallowed to the extent that immediate personal benefits are enjoyed,<sup>40</sup> while costs associated with deferred consumption would be deductible as saving. Deductions for travel, meals, lodging, and entertainment, for example, would be more limited than under the current income tax. On the other hand, items such as educational expenses, job-seeking expenses, and legal expenses which do not tend to provide current consumption benefits would probably be more generally deductible than under the income tax.

A review of the current treatment of legal expenses may help to illustrate how an expenditure tax might modify the courts' income tax approach to certain kinds of business expense issues.<sup>41</sup>

<sup>40</sup> See Halperin, *supra* note 35 (suggesting such an approach to business deductions for personal expenses under an income tax). Under this approach, if personal satisfaction is equal to or greater than cost, no deduction would be allowed; in other cases, a deduction would be permitted only to the extent that cost exceeds the personal benefits from the expense. Recognizing the practical difficulties of distinguishing personal consumption from profit-motivated expenses, Professor Halperin suggests the following rules of thumb which are useful as a guide to implementation decisions under an expenditure tax:

[1] *Education*: Allow amortization of the cost of professional and certain other postgraduate education and vocational training after high school.

[2] *Job seeking*: Allow a deduction for, or amortization of, job-seeking costs not involving travel or education.

[3] *Clothing*: No change in present law. [Deductible only if required as a condition of employment and not adaptable to ordinary wear.].

[4] *Office in the home*: Deny a deduction unless the principal purpose of acquiring the space is business. . . .

[5] *Travel*: [D]eduction[s] permitted would be in the ratio of time spent on business to total time on the trip. . . . Consideration should be given to whether a deduction can be fully denied for certain trips, e.g., conventions at vacation spots, which appear to result in personal satisfaction equal to cost. If so, meals and lodging on such occasions also should not be deductible.

[6] *Food*: Deny all deductions [or at a minimum] do not allow a deduction for food consumed in the home or for lunches wherever they take place [and] [p]lace a low dollar limit on deductions for breakfast and dinner. . . .

[7] *Lodging*: Deny a deduction unless lodging duplicates housing otherwise available and in all cases for days not spent on business. A dollar limit should apply.

[8] *Entertainment*: Deny any deduction.

*Id.* at 932. See also Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis*, 18 STAN. L. REV. 1099 (1966).

In addition to the issues mentioned above, expenditure tax rules would be needed to deal with so-called hobby loss investments, another area in which individuals seek to obtain personal satisfaction in the guise of profit-seeking activities. The treatment of such activities under current income tax law has generally been quite unsatisfactory and would be inadequate to ensure the inclusion of a proper amount of consumption in the expenditure tax base.

<sup>41</sup> The analysis of the appropriate expenditure tax treatment of legal expenses presented here is generally consistent with income tax arguments advanced in

The basic income tax rule is set forth in *United States v. Gilmore*,<sup>42</sup> where an individual attempted to deduct legal expenses incurred in defending a divorce action in which his wife claimed ownership of a controlling interest in the family business. The taxpayer argued that such expenses were deductible because they were incurred for the conservation of income-producing property. The Supreme Court concluded that deductibility turned not on the potential consequences of the divorce action on the defendant's property, but on "the origin and character of the claim with respect to which an expense was incurred."<sup>43</sup> The Court held that the wife's claim stemmed from the marital relationship and that the taxpayer's expenses incurred in defending the claim were therefore personal and not deductible.

In a subsequent proceeding involving the same taxpayer, however, a district court held that the attorney's fees incurred in defending the divorce action were costs of defending title to the taxpayer's property and, even though not deductible, could be added to the property's basis.<sup>44</sup> Moreover, divorced spouses are typically allowed to deduct legal expenses incurred for the collection of alimony even though these expenses originate in a personal context.<sup>45</sup> On the other hand, application of the "origin of the claim" test of *Gilmore* has led courts to conclude that legal fees incurred in preparing a will are nondeductible personal expenses, as are a legatee's expenses in contesting a will.<sup>46</sup>

In addition to the basic distinction between personal and business investment expenses, there is a significant income tax timing issue involved when expenditures are made with regard to property. For example, capitalization rather than deduction should be required of expenses incurred to perfect title to property because the benefits of successful litigation will obtain throughout the period of ownership. Under an expenditure tax, the timing issue disappears, and expenses should be deductible unless the payments can be fairly treated as consumption. If in *Gilmore* the issue were posed in terms of whether the legal expenses constituted consumption, a different answer might be forthcoming. If the expenses were costs of rearranging ownership of prop-

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Epstein, *The Consumption and Loss of Personal Property under the Internal Revenue Code*, 23 STAN. L. REV. 454, 469-71 (1971). Legal expenses are only one example of the different treatment potentially required under an expenditure tax. See also Bittker, *Reflections on Tax Reform*, 47 U. CIN. L. REV. 185, 195-200 (1978) (discussing child care expenses).

<sup>42</sup> 372 U.S. 39 (1963).

<sup>43</sup> *Id.* at 49.

<sup>44</sup> *Gilmore v. United States*, 245 F. Supp. 383 (N.D. Cal. 1965). See generally Epstein, *supra* note 41, at 457-62.

<sup>45</sup> See *Wild v. Commissioner*, 42 T.C. 706 (1964), *acq.* 1967-2 C.B. 4.

<sup>46</sup> See, e.g., *Merians v. Commissioner*, 60 T.C. 187 (1973), *acq.* 1973-2 C.B. 2.



erty within a family group — which would include the preparation or contest of wills as well as divorce settlements — this would seem not to be consumption, but rather a prelude to consumption (which will occur when the new owner sells the property). Such costs of deferring consumption are generally treated as savings and should thus be deductible under an expenditure tax. By the same token, expenses incurred in defending lawsuits might normally be deductible under an expenditure tax without inquiring, as under the income tax, whether, for example, the expenses were incurred to protect the taxpayer's reputation,<sup>47</sup> whether they were incurred in criminal rather than civil proceedings,<sup>48</sup> or whether they were incurred to acquire or to protect title to business or personal property.<sup>49</sup> In no event would such legal expenses properly be viewed as consumption.

This brief discussion of legal expenses is intended principally to illustrate that income tax precedents which distinguish personal from business or investment expenses might be reexamined under an expenditure tax. Courts faced with expenditure tax issues would likely tend to resolve them by inquiring whether a particular expenditure can fairly be characterized as an expense of immediate rather than of deferred consumption (or a loss). If this approach were adopted, many expenditures made in connection with property ownership which are not now deductible under the income tax would be deductible under an expenditure tax.

### *C. Itemized Deductions and Other Exclusions from Income*

With respect to a number of deductions and exclusions, the issues likely to arise under an expenditure tax are essentially identical to those encountered under the income tax. Although resolution of these issues would continue to depend in large part on the debate between comprehensive taxation and pursuit of extrinsic policy objectives, the shift to an expenditure tax would introduce several important differences.

*1. Charitable Contributions, Medical Expenses, and State and Local Taxes.* — The income tax deduction for contributions to educational, religious, and scientific institutions<sup>50</sup> is likely to per-

<sup>47</sup> See *Draper v. Commissioner*, 26 T.C. 201 (1956), *acq.* 1956-2 C.B. 5 (deduction allowed for litigation expenses incurred to protect professional reputation). *But see* *Lloyd v. Commissioner*, 55 F.2d 842 (7th Cir. 1932) (deduction disallowed for litigation expenses incurred to protect reputation).

<sup>48</sup> See *Commissioner v. Heininger*, 320 U.S. 467 (1943) (criminal); *Lewis v. Commissioner*, 253 F.2d 821 (2d Cir. 1958) (civil).

<sup>49</sup> See I.R.C. § 212; *United States v. Gilmore*, 372 U.S. 39 (1963); *Hochschild v. Commissioner*, 161 F.2d 817 (2d Cir. 1947).

<sup>50</sup> I.R.C. § 170.



sist under an expenditure tax, in that the policy objective of fostering the continued well-being of charities is likely to continue to overshadow the ideal of income or consumption measurement.<sup>51</sup> Similarly, the deductibility of medical expenses<sup>52</sup> can be expected to endure the shift to expenditure taxation, principally on the strength of the argument that such expenses are not voluntary consumption.<sup>53</sup> By contrast, it is essential to deny deductions for the consumption aspects of charitable contributions and medical expenses, such as season tickets on the fifty-yard line received by generous alumni<sup>54</sup> or the meals and lodging required on a therapeutic trip to Acapulco.<sup>55</sup>

<sup>51</sup> The treatment of charitable contributions under an expenditure tax has been a subject of disagreement. The Treasury argued that charitable contributions are consumption of the donor and thus no deduction should be allowed for charitable giving, BLUEPRINTS, *supra* note 3, at 95-97, 116-17, while Professors Andrews and Bittker have contended that the charitable deduction is proper because it is inappropriate to regard amounts given to charity as consumption by the donor, Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 344-75 (1972); Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37 (1972). The expenditure tax treatment of charitable contributions of appreciated property is treated in greater detail below, *see* pp. 1631-33 *infra*.

<sup>52</sup> I.R.C. § 213.

<sup>53</sup> Those who would repeal the medical deduction altogether argue that consumers exercise a high degree of choice regarding most medical expenses and that extraordinary medical expenses should be insured against, with such insurance treated like any other normal consumption expenditure. Professor Andrews, on the other hand, has argued that extraordinary medical expenses are not voluntary consumption and that an income tax deduction is necessary to reflect properly differences in individuals' abilities to pay tax. Andrews, *supra* note 51, at 336. *See also* Bittker, *supra* note 29, at 198-99. This argument has great force in an expenditure tax context. An individual hospitalized for a long period of time simply is not enjoying consumption in a manner equivalent to that of a healthy individual who spends an identical amount of money on personal satisfaction, and an expenditure tax base should reflect such differences.

<sup>54</sup> *See, e.g., Winters v. Commissioner*, 468 F.2d 778 (2d Cir. 1972) (deduction denied for contribution to education fund of church which supported schools attended by taxpayers' children); *cf. Estate of Wardwell v. Commissioner*, 301 F.2d 632 (8th Cir. 1962) (deduction allowed for elderly person's gift to nursing home into which she subsequently moved at donor's reduced rental rate); Rev. Rul. 67-246, 1967-2 C.B. 104 (membership fees in charitable organizations where benefit received in return; deductible gift reduced by value of benefit received).

<sup>55</sup> *See, e.g., Ochs v. Commissioner*, 195 F.2d 692 (2d Cir.), *cert. denied*, 344 U.S. 827 (1952) (cost of maintaining children in boarding school to alleviate mother's frail physical condition disallowed); *Rabb v. Commissioner*, 31 T.C.M. (CCH) 476 (1972) (costs of "milieu therapy," including specially tailored clothing, new furniture, and remodeling of lake cottage disallowed); *Jacobs v. Commissioner*, 62 T.C. 813 (1974) (deduction denied for psychiatrist-recommended divorce expenses); Treas. Reg. § 1.213-1(e)(iv) (meals and lodging while away from home receiving medical treatment disallowed).

If the current deductions for state and local taxes<sup>56</sup> are premised on the argument that they are a necessary aspect of fiscal federalism, such deductions will presumably be incorporated into an expenditure tax. Nevertheless, the proper treatment of state and local taxes under an expenditure tax is debatable. Professor Bittker argues that since state and local tax payments are compulsory rather than voluntary, "it strains reality to count state and local taxes as consumption expenditures."<sup>57</sup> On the other hand, the Treasury Department in *Blueprints* argues that under either a comprehensive income tax or an expenditure tax, no deduction should be allowed for state and local sales taxes, but that state income taxes should be deductible.<sup>58</sup> The rationale for this distinction is somewhat difficult to follow.<sup>59</sup>

In any event, individual taxpayers seem likely to regard both state income and sales taxes as reducing the resources available for private consumption. Perhaps there should be no state sales tax deductions on the ground that they are merely a cost of consumption, but if so, a portion of state income taxes should be denied deduction on similar grounds. As the Haig-Simons definition teaches, taxes on income are in substantial part taxes on consumption. An expenditure tax policy such as that suggested by *Blueprints*, allowing a federal deduction for state income taxes but not for sales taxes, would have the ironic result of encouraging state and local governments to shift from taxes on consumption to income taxes at the same time that the federal government is shifting from an income tax to a consumption tax.

2. *Imputed Income, Government Transfers, and Statutory Exclusions.* — Economists favor the inclusion of imputed income or consumption — the value of labor on one's own behalf or benefits derived from property ownership — in taxable receipts under both an income and expenditure tax.<sup>60</sup> For the same reasons of political

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<sup>56</sup> I.R.C. § 164.

<sup>57</sup> Bittker, *supra* note 29, at 201.

<sup>58</sup> BLUEPRINTS, *supra* note 3, at 92-94, 117.

<sup>59</sup> The Treasury apparently believes that income taxes "reduce the resources available to the payor for consumption or accumulation," *id.* at 93, but that general sales taxes do not reduce income reported by households and individuals and have "already been 'deducted' from income sources," *id.*, except to the extent that sales tax rates vary among states and localities. However, this analysis seems to assume that there is no important income effect with respect to sales taxes; that is, that such taxes do not affect work-leisure choices. If people in fact work additional hours to earn enough income to pay sales taxes on goods they wish to consume, this argument is erroneous.

<sup>60</sup> See R. GOODE, THE INDIVIDUAL INCOME TAX 117-25 (1976); MEADE REPORT, *supra* note 3, at 221-22; S. LODIN, *supra* note 3, at 83-89; R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 231-32 (1973).

reality, administrability, and taxpayer comprehension which have prevailed under the income tax, however, it is inconceivable that imputed income from housework, farming, or other forms of personal services would be included in receipts under an expenditure tax.<sup>61</sup> Under either system, little can be done to preclude the substitution of nonmarket for market consumption.

A stronger case exists for expenditure taxation of government transfer payments. Payments such as social security benefits and veterans' pensions, now excluded from gross income,<sup>62</sup> may be used to finance consumption in the same manner as wages and should therefore be included in expenditure tax receipts.<sup>63</sup> Yet where such transfers are based on a need test, the payments should probably be excluded from an expenditure tax base. For many in-kind transfers, valuation would be difficult. Moreover, since the level of government transfers is presumably determined on the assumption that they are tax free, taxation would simply necessitate an increase in their level. As a practical matter, then, expenditure tax receipts should include only transfers that are not based on need and are either in cash or are easily valued if in kind.<sup>64</sup>

Other statutory income tax exclusions such as group term life insurance,<sup>65</sup> employer-provided health insurance,<sup>66</sup> sick pay,<sup>67</sup> qualified group legal service plans,<sup>68</sup> scholarships and fellow-

<sup>61</sup> The largest amount of imputed income from services in the United States results from domestic services rendered by homemakers to their own families. Recent estimates have suggested that taxation of imputed income from this source might increase the income tax base by as much as \$200 billion dollars. R. MUSGRAVE & P. MUSGRAVE, *supra* note 60, at 232. Imputed income from the ownership of property is discussed in Part IV *infra*.

<sup>62</sup> Despite the absence of specific statutory authority, the long-standing policy of the IRS has been to exclude from income payments received under welfare legislation. See, e.g., Rev. Rul. 70-280, 1970-1 C.B. 13 (unemployment benefits); Rev. Rul. 70-217, 1970-1 C.B. 12 (social security payments); Rev. Rul. 72-605, 1972-2 C.B. 35 (veterans' benefits).

<sup>63</sup> Otherwise, advantages would result to recipients depending upon their marginal tax brackets, with higher bracket taxpayers obtaining relatively greater advantages from the exclusion. Where individuals contribute to such plans, however, deductions should be allowed.

<sup>64</sup> Likewise, transfers from charities should be excluded from receipts, if for no other reason than the administrative difficulty of taxing them, for example, food from the Salvation Army or health care from the Red Cross. In addition, consumption benefits that individuals receive from general government services, such as recreational facilities, would necessarily be excluded from the expenditure tax base.

<sup>65</sup> I.R.C. § 79.

<sup>66</sup> I.R.C. § 106.

<sup>67</sup> I.R.C. § 104(a).

<sup>68</sup> I.R.C. § 120.

ships,<sup>69</sup> and prizes and awards,<sup>70</sup> while theoretically includible in a comprehensive income tax base, reflect clear congressional policy choices in favor of certain kinds of receipts. Even though such exclusions would be difficult to justify theoretically, there is no reason to suspect that their proponents (for example, labor unions in the case of group legal services) would be less effective in persuading Congress to enact such provisions under an expenditure tax.<sup>71</sup>

#### *D. Administrative Considerations*

In general, an expenditure tax does not seem likely to produce administrative problems significantly greater than or different from those familiar under an income tax. An expenditure tax, like the income tax, would depend to a large extent upon self-assessment and voluntary compliance. Collection procedures, dispute resolution procedures, enforcement, and sanctions under an expenditure tax likely would be similar to those under the current income tax. Withholding and information reporting, however, would likely present certain additional problems under an expenditure tax.

Since more than seventy-five percent of total individual income tax liability is collected through withholding,<sup>72</sup> the need for current tax payment through a withholding system should be apparent. Collection of the bulk of taxes at the source through withholding would be essential to an expenditure tax. However, producing accurate withholding under an expenditure tax will probably prove more difficult than under the current income tax. Under an income tax, wage withholding depends only on the amount of the taxpayer's wages; credits and deductions are typically estimated on the basis of the taxpayer's wages.<sup>73</sup> Under

<sup>69</sup> I.R.C. § 117.

<sup>70</sup> *Id.* § 74.

<sup>71</sup> The income tax contains a provision, known generally as the standard deduction (now the "zero bracket amount"), which taxpayers may take in lieu of itemized deductions. *Id.* § 63(d). The amount of the standard deduction has been adjusted from time to time to ensure its use by a substantial majority of taxpayers and therefore to eliminate many taxpayers' need to keep records of expenses which qualify for itemized deductions. If itemized deductions were allowable under an expenditure tax, as seems likely, the objective of minimizing record-keeping could be achieved by a comparable standard deduction. Pressures to enact tax credits in lieu of itemized deductions and to allow deductions (for example, the charitable deduction) in addition to the standard deduction should be resisted under an expenditure tax, however.

<sup>72</sup> COMMISSIONER OF INTERNAL REVENUE, 1978 ANNUAL REPORT 9 (1978) (calculated from table of Gross Internal Revenue Collections by source).

<sup>73</sup> See I.R.C. § 3402. More individualized withholding is allowed, however, in certain cases. See *id.* § 3402(m) (special withholding option based on excess itemized deductions).

an expenditure tax, the amount of final tax liability would also depend on the taxpayer's annual savings or investment. The best withholding approximation would estimate consumption on the basis of wages and typical allocations of consumption and savings.<sup>74</sup> Achieving aggregate wage withholding under an expenditure tax generally within the current range of income tax accuracy seems feasible, but greater variations in withholding error among individuals with similar wages and different savings patterns, and for the same individual from year to year, seem likely.<sup>75</sup> The greatest variations are likely to be concentrated in the upper brackets. Withholding on expenditure tax receipts other than wages does not seem practical.<sup>76</sup>

Increased information reporting may also be necessary under an expenditure tax. For example, if, as is argued below, loans must be reported on a cash-flow basis,<sup>77</sup> lenders should be required to provide annual information statements to taxpayers informing them of both amounts borrowed and repaid. Likewise, if gifts and bequests were includible in receipts of donees,<sup>78</sup> information reporting should probably be required for gifts and bequests. Similarly, if individuals would be required to report receipts from businesses on a cash-flow basis, reporting of such payments should be required.

Likewise, expenditure tax information returns might be required for purchases and sales of investment assets and for net annual additions or reductions in savings account balances with financial institutions. Since the entire sales price of investment assets would be includible in expenditure tax receipts, incentives for underreporting sales would be greater than under the income tax, where only gain is includible in the tax base. For the typical stock market transaction, however, it would be difficult to require sellers to report social security numbers of purchasers. Absent effective enforcement, deductions for purchases of investment assets might be overstated and receipts from sales of such assets understated, therefore some aid to enforcement appears essential.<sup>79</sup>

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<sup>74</sup> There would likely be a tendency to err on the side of overwithholding to assure collection of the tax, and interest should be paid on amounts overwithheld.

<sup>75</sup> See p. 1583 *supra* (withholding error).

<sup>76</sup> Withholding on dividends and interest has been suggested from time to time under the income tax but has not been enacted principally because of difficulties in relating such withholding to taxpayers' marginal tax rates. In addition to these administrative problems, under an expenditure tax no tax would be due if these investment returns were reinvested.

<sup>77</sup> See pp. 1609-10 *infra* (cash flow treatment of loans).

<sup>78</sup> See pp. 1624-26 *infra* (gifts and bequests taxed to donees).

<sup>79</sup> Kaldor and Slitor, for example, urge the use of an expenditure tax voucher system, under which purchasers would be required to furnish vouchers to sellers,

Excessive reliance on information reporting as an enforcement device should be avoided, however. The Internal Revenue Service's ability to cross-check information reports under the present income tax system is quite inadequate,<sup>80</sup> and expansion of this capability would be desirable. As under the current income tax, expenditure tax enforcement would be largely dependent upon taxpayers' voluntary compliance.<sup>81</sup> If the so-called audit lottery were played aggressively, with tax returns serving principally as opening bids, serious enforcement problems would occur. The expenditure tax avoidance game would emphasize efforts to disguise or exclude consumption from the tax base, as contrasted with the income tax where tax avoidance efforts are often concentrated on excluding investment income from tax or deferring tax on such income through tax shelter schemes.

#### IV. TIMING ISSUES: THE TREATMENT OF INVESTMENTS, CONSUMER DURABLES, AND HOUSING

Issues of timing in income taxation, particularly with respect to when deductions are permitted and when amounts must be

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which presumably would be forwarded to the IRS to confirm transactions. N. KALDOR, *supra* note 1, at 217; Slitor, *supra* note 18, at 254-55.

<sup>80</sup> In 1978, for example, the Internal Revenue Service collected about 484 million wage, interest, and dividend information returns, but just over half were submitted on magnetic type for possible computer matching. COMMISSIONER OF INTERNAL REVENUE, *supra* note 72, at 14. When information returns are submitted on individual papers, the process of transferring such information onto magnetic tape is alone a sufficient burden to preclude cross-checking. If the number of information returns were to increase significantly because of the expansion of the category of receipts under an expenditure tax, it might be necessary to require that information be submitted in a form which is readily usable by the IRS, for example, on magnetic tape. Such a requirement would be burdensome to some taxpayers.

<sup>81</sup> Audit selection under an expenditure tax would tend to mirror the current income tax process. A mathematical technique would likely be used similar to the so-called "discriminant index function" which now identifies returns with a high potential for significant understatement of income tax. See COMMISSIONER OF INTERNAL REVENUE, *supra* note 72, at 24. Assuming that the cash-flow method of reporting investment assets recommended in Part IV were adopted, the construction of a similar expenditure tax formula would be facilitated if taxpayers were required to report beginning and ending cash balances. Otherwise, variations among individuals in the amount of cash on hand might produce variations in consumption which would not be explained by information contained in the return.

If businesses were required to shift to a cash method of accounting for the expenditure tax while continuing to use an accrual method of accounting for financial reporting, the divergence between book and tax accounting would render auditing more difficult, increase enforcement costs, and perhaps require additional training of revenue agents. If an expenditure tax were adopted as a supplement to the income tax, expenditure tax accounting and income tax accounting would have to be closely coordinated.



included in income, have received detailed consideration by tax analysts. In the expenditure tax context, analysis of timing issues is critical both for an understanding of how an expenditure tax differs from other taxes, particularly income or wage taxes, and also for guidance in resolving implementation questions. Proponents of an expenditure tax, such as Professor Andrews and the Treasury Department in *Blueprints*, have argued that the capacity of an expenditure tax to handle timing problems equitably and without economic distortion is one of its significant advantages over an income tax.<sup>82</sup>

*A. Tax Deferral in General: The Treatment  
of Financial Assets and Loans*

1. *The Immediate-Deduction/Yield-Exemption Equivalence.*— Income tax deferral is most commonly described by reference to taxpayers who reduce their income by a certain amount initially, usually by accelerating deductions or postponing income, and in a later taxable year report an income increased by that same amount. The effect of such tax deferral is most often demonstrated by two alleged equivalences: (1) the equivalence of tax deferral to an interest-free loan from the government to the taxpayer,<sup>83</sup> and (2) the equivalence of allowing an immediate deduction for the cost of an investment to imposing tax initially and exempting from tax the income from the investment. If valid, this latter equivalence (the “Immediate-Deduction/Yield-Exemption Equivalence”<sup>84</sup>) would be important under a consumption tax for two reasons. First, it would allow creation of simple and flexible rules for implementing a consumption tax. Second, since a consumption tax, unlike an income tax, is not intended to be imposed on the yield from savings per se, this equivalence seems to suggest that a consumption tax is equivalent to a wage tax.<sup>85</sup> On the other hand, it is consistent with the widely expressed notion that the difference between an income tax and an expenditure tax is solely a matter of timing.<sup>86</sup>

Professor Andrews’ example relating to deferred compensation is a helpful introduction to the basic timing difference be-

<sup>82</sup> See BLUEPRINTS, *supra* note 3, at 9, 127–28; Andrews, *supra* note 3, at 1113, 1120–28, 1150. See also Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461 (1977).

<sup>83</sup> See E. GRISWOLD & M. GRAETZ, FEDERAL INCOME TAXATION 335–38 (1976).

<sup>84</sup> See E. Cary BROWN, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSON (1948); C. SHOUP, PUBLIC FINANCE 302 (1969). See also S. SURREY, PATHWAYS TO TAX REFORM 123 (1973).

<sup>85</sup> See Warren, *supra* note 5, at 931.

<sup>86</sup> See Andrews, *supra* note 3, at 1120.



tween income and expenditure taxes.<sup>87</sup> Assuming an income tax of 33-1/3%, one dollar of wages will produce 67 cents to invest. If return on investment were 9% before tax, such a tax would reduce the return to 6%. Thus, if no tax deferral were permitted, one dollar of before-tax earnings put aside for 24 years would produce only \$2.67 for retirement. In the absence of tax (because the dollar is removed from the tax base by current deduction), the one dollar invested for 24 years until retirement will produce eight dollars for consumption. A 33% tax imposed at that time would reduce that amount to \$5.33. Deferring the tax 24 years has doubled the after-tax return. This example illustrates that tax deferral, even when an identical tax rate is subsequently imposed, is clearly inconsistent with the conceptually correct income tax treatment, which is to tax interest earnings as they occur. In contrast, such deferral is consistent with the concept of an expenditure tax; taxes on amounts invested and their return should be deferred until the proceeds are used for consumption. The deferral illustrated in this example is also consistent with the economic definition of an expenditure tax offered by the Meade Commission:

[T]he characteristic feature of an expenditure tax as contrasted with an income tax [is] that, at any given constant rate of tax, the former will make the rate of return to the saver on his reduced consumption equal to the rate of return which can be earned on the investment which his savings finances, whereas the income tax will reduce the rate of return to the saver below the rate of return which the investment will yield.<sup>88</sup>

As Professor Andrews notes,<sup>89</sup> the Immediate-Deduction/Yield-Exemption Equivalence holds in the above example; the same result would be reached by taxing 33 cents from the original dollar of earnings and allowing the remaining 67 cents to grow to \$5.33 without additional tax.

2. *The Treasury's Proposal.* — The Treasury Department in *Blueprints* relies upon the Immediate-Deduction/Yield-Exemption Equivalence not only to distinguish income from expenditure taxes, but also to develop its specific expenditure tax rules.<sup>90</sup> The Treasury recommends that an expenditure tax should allow taxpayers to elect either (1) Immediate-Deduction (cash-flow) treatment, under which purchases of financial assets would be deducted and subsequent withdrawals of principal and earnings taxed, or

<sup>87</sup> *Id.* at 1125.

<sup>88</sup> MEADE REPORT, *supra* note 3, at 37.

<sup>89</sup> See Andrews, *supra* note 3, at 1126.

<sup>90</sup> See BLUEPRINTS, *supra* note 3, at 119-27.

(2) Yield-Exemption treatment under which no deduction would be allowed for purchases of financial assets but earnings and withdrawals of principal would be exempt from tax. Borrowers would be afforded a similar choice between (1) including the amount of a loan in receipts and taking subsequent deductions for payments of interest and repayments of principal and (2) excluding loan proceeds from receipts, but foregoing later deductions. The Treasury justifies such taxpayer discretion on the ground that “[t]he consequences . . . of the two ways of taxing the purchase of assets would . . . be the same *in present value terms*.”<sup>91</sup> Assume, for example, that in year 1 the taxpayer borrows \$100 at 10% interest; in year 2, the loan plus interest — \$110 — is repaid. Taxpayers and the government should generally be indifferent whether the \$100 loan is included in receipts in year 1 and \$110 is deducted in year 2 or whether the entire transaction is omitted from expenditure tax accounts. This is because the interest deduction foregone under the omission alternative would increase tax liability in year 2 by an amount equal to interest on the amount of tax deferred by not including the loan in receipts in year 1.

(a) *Ex Ante vs. Ex Post Approach to Tax Parity*. — Even assuming the Immediate-Deduction/Yield-Exemption Equivalence were valid, the Treasury’s proposal is problematic because it apparently reflects an *ex ante* approach to tax parity. The Treasury proposal treats persons similarly whenever their tax base (consumption in this case) is the same in present value terms. Under the Yield-Exemption option, “lucky investors might become very rich and owe no additional [expenditure] tax liability on future consumption of their wealth [and] unlucky investors will have prepaid a tax on expected returns and will then obtain no deduction for the losses they incur.”<sup>92</sup> Whenever persons are in equivalent circumstances *ex ante*, the Treasury would apparently ignore differences in circumstances *ex post*.<sup>93</sup>

But an *ex ante* approach to taxation requires a major restructuring of the classic conceptions of tax equity. Horizontal equity, the most widely accepted notion of fairness in taxation, requires that persons in similar circumstances pay similar amounts of

<sup>91</sup> See *id.* at 123.

<sup>92</sup> *Id.* at 129.

<sup>93</sup> The analogous *ex ante* definition of income is “the amount which [an individual] could consume in any one year and yet be left with the resources and expectations at the end of that year which would enable him to maintain that same level of consumption indefinitely in the future.” MEADE REPORT, *supra* note 3, at 31. The Meade Commission seems to reject an *ex ante* approach to tax implementation for reasons of practicality, but accepts it as a basis for assessing various taxing schemes.

tax. Although the tax literature is replete with disputes over whether "similar" or "different" circumstances are being compared,<sup>94</sup> the notion that similar circumstances should be evaluated *ex ante* in present value terms seems quite a radical departure. Regardless of the precise contours of the definition of income or consumption, it seems clear that horizontal equity must be an *ex post* concept. Circumstances should be considered as similar only after results are known; lucky gamblers are not the same as unlucky gamblers.<sup>95</sup>

An *ex ante* approach is even more troubling with reference to the vertical equity criterion. Vertical equity is said to require differential taxation of persons in different circumstances, and is principally used with reference to the fairness of the distribution of the tax burden among persons with different amounts of income, consumption, or wealth. Certainly, if one accepts a vertical equity criterion which relates the distribution of the tax burden to "ability to pay," *ex post* rather than *ex ante* circumstances would be relevant. If progressive taxation is to be justified, even in part, as a device for the redistribution of income, consumption, or wealth, the tax base must distinguish those who are lucky from those who are unlucky, even though they might have been in the same position with respect to their expectations before the gamble. Thus, although the appropriate time period for applying a progressive rate structure and the question whether consumption is a proper base for progressive taxation may be controversial, once an expenditure tax with progressive rates is chosen the tax must be imposed with regard to actual, not expected, consumption.<sup>96</sup>

(b) *Ex Post Relationship of Immediate-Deduction and Yield-Exemption.* — Although *Blueprints* appears to follow an *ex ante* approach, the Treasury may not actually have intended to endorse such a perspective. Its recommendations are based upon the Immediate-Deduction/Yield-Exemption Equivalence, which would hold *ex post* as well as *ex ante* under a restrictive set of conditions which are present in all of the Treasury's examples and which are typically assumed (although often not explicitly) in the economic and legal literature.<sup>97</sup>

<sup>94</sup> See, e.g., Warren, *supra* note 5, at 931.

<sup>95</sup> See generally N. KALDOR, *supra* note 1, at 60-64.

<sup>96</sup> Professor Warren suggests that an *ex ante* view is implicit in the choice of a consumption tax rather than an income tax, but Professor Andrews and this Article argue that a properly designed consumption tax may be imposed on an *ex post* basis. Compare Warren, *supra* note 5, at 931 and Warren, *supra* note 6, with Andrews, *supra* note 4, at 947.

<sup>97</sup> See, e.g., BLUEPRINTS, *supra* note 3, at 123; Andrews, *supra* note 3, at 1124-25; Andrews, *supra* note 4, at 947.

Even if the Treasury's proposal is ultimately consistent with an ex post approach, however, the practical ex post validity of the Immediate-Deduction/Yield-Exemption Equivalence remains to be determined. If the equivalence holds, an expenditure tax should be equivalent to a tax on wages, under which all income from savings would be excluded from the tax base. It would then be a matter of indifference whether the base for an expenditure tax is computed by deducting amounts saved or exempting investment sales and yield. The major difficulty with the Treasury's proposal is that the ex post equivalence of Immediate-Deduction and Yield-Exemption depends upon the following set of unrealistic conditions:

- (1) Tax rates are not progressive; moreover, they do not change over time.
- (2) Taxpayers have no accumulated wealth when the system is first introduced.
- (3) The system is closed; either the taxpayer exhausts his wealth by death, the system classifies all remaining capital balances (all bequests) as being consumption in the taxpayer's final return, or an identical tax is subsequently imposed on bequests in some other manner.
- (4) There exists a perfect capital market with no uncertainty; all taxpayers can borrow and lend unlimited amounts at a risk-free interest rate.
- (5) All income can be classified as one of two types: wage income or income to capital accumulated during and after the initial period.

These conditions simply will not exist when an expenditure tax is actually implemented. As noted at the outset, any decision to shift to an expenditure tax must be premised on the retention of a progressive rate structure. Yet progressivity alone destroys the equivalence. Furthermore, tax rates are likely to vary over time, capital markets are imperfect, return on investments is uncertain, and the system is open at the beginning. The Immediate-Deduction/Yield-Exemption Equivalence therefore will not hold ex post in practice and should not serve as the basic guide to implementation decisions.

Perhaps most importantly, with uncertainty and progressive rates, the distributional consequences of the two methods would be quite different. With a progressive rate structure, the cash-flow version of the tax would narrow the after-tax differences between the lucky and unlucky investor in ways that the omission alternative would not. An expenditure tax under either the Immediate-Deduction or Yield-Exemption option would not re-

duce the before-tax rate of return on investment capital, but this does not make the options equivalent.

Under the cash-flow method, the government can be regarded as automatically becoming a joint venturer in taxpayers' investments. It, in effect, invests a percentage equal to the taxpayer's marginal tax rate in each venture — for example, with a 60% marginal rate, the taxpayer's initial tax saving is 60% of the cash investment and the government receives 60% of the gain or contributes 60% of the loss. Thus, a taxpayer would be better off under the Yield-Exemption option where the rate of return exceeds his cost of borrowing.

Consider, for example, two 60% taxpayers, *A* and *B*, each with funds available for consumption of \$40, who desire to purchase an investment for \$100. *A*, choosing Immediate-Deduction, will receive tax savings of \$60 from the \$100 deduction. On sale for \$110, tax of \$66 will be due, leaving him with \$44, a 10% return. *B* chooses Yield-Exemption and borrows \$60, as he receives no financing from a tax deduction. Assuming a cost of borrowing of 10%, *B* keeps \$44 after receiving \$110 and paying the debt of \$66. But if *B* can borrow at 5%, he can keep \$47, thereby obtaining a greater return than *A*.

The two methods of treatment produce equivalent results under certain assumptions. One such assumption is that investments of different magnitudes have the same yield. Thus, equivalence is established if *A* and *B* invest in assets costing \$100 and \$40, respectively, which each yield 10%. With borrowing in the picture, equivalence can only be established by assuming that the ratio of borrowing to investment is always the same. Thus if *B* finances an investment of \$100 by borrowing \$60 as above, *A* could invest his funds of \$40 by purchasing an investment of \$250. Tax savings would be \$60 and borrowing \$150. *B* would, as above, receive \$44 or \$47 depending on his cost of borrowing. *A* would receive the same; thus, at a 5% interest cost, *A* would receive \$275, repay \$157.50, for a net of \$117.50 or \$47 after tax. To the extent that speculative investment opportunities (or borrowing opportunities) are limited, the two methods would not be equivalent, and the cash-flow method would lessen the differences among winning and losing taxpayers. Likewise, if aggregate gains exceed aggregate losses (or if losses are not eligible for immediate refunds), government revenues would be greater under the cash-flow method, even with a constant flat rate tax.

Equivalence would also fail if, under the omission alternative for loans, a taxpayer did not subsequently pay interest or repay the loan proceeds. If such a transaction were omitted from expenditure tax accounts, taxpayers could enjoy additional con-

sumption free of tax. Although this problem is not addressed by the Treasury in *Blueprints*, if loans were not initially included in receipts, forgiveness of indebtedness or default on principal or interest should result in an expenditure tax receipt in the amount of the principal and accrued interest.<sup>98</sup>

Opportunities for manipulation to save tax would remain available, however, whenever tax accounting rules permitted departure from the assumptions underlying the Immediate-Deduction/Yield-Exemption Equivalence. The ability to shift assets within a single accounting period is illustrative. Assume that on January 1 a taxpayer receives \$1,000 which he invests in an asset under the Yield-Exemption alternative. If the asset is worth \$1,100 on December 31, the taxpayer might sell it and reinvest the proceeds under the Immediate-Deduction alternative, thereby obtaining a net deduction of \$100 (the \$1,100 investment less the \$1,000 of receipts) under circumstances where wealth has increased by \$100. The process could be repeated by immediately selling the asset on January 1 of the next year and reinvesting the proceeds until December 31 in a Yield-Exemption asset. Over time, the problem would be similar to year-end deferral, related to techniques familiar under the income tax for accelerating deductions and postponing income.

Similar results could be achieved by borrowing in January on a cash-flow basis and investing the proceeds in a Yield-Exemption asset until the loan was repaid on December 31. Assuming 10% interest on the loan and a 10% investment return, the taxpayer could obtain a net deduction of the interest payment in a transaction which produced no change in net wealth. The January 1 loan receipt of \$1,000 would be included in receipts, the December 31 \$1,100 repayment deducted, and the \$100 earnings excluded by a Yield-Exemption election. As the examples illustrate, an expenditure tax would be systematically biased in favor of tax deferral whenever the amount deferred plus an appropriate amount of interest would not subsequently appear in the tax base.<sup>99</sup>

Additional problems occur when the Treasury's assumption that there is no basis *ex ante* for a taxpayer to prefer one of the

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<sup>98</sup> This treatment would be somewhat similar to the current income tax treatment of borrowing which excludes loans from income and includes discharges of indebtedness in income. See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

<sup>99</sup> This problem seems likely to be solved, if at all, only through a general provision similar to that now contained in I.R.C. § 446 which would give the Commissioner authority to challenge tax returns where amounts reported do not "clearly reflect" expenditures. However, such a provision would be inconsistent with taxpayers' ability to elect Yield-Exemption treatment and seems unworkable.



two options is erroneous in fact. To the extent that tax rates are progressive or are expected to vary over time, taxpayers' ex ante calculations may be affected. As noted earlier, the Yield-Exemption alternative would be selected whenever the immediate deduction foregone would be expected to reduce tax at a lower rate than would apply to a subsequent gain. Under an elective system, taxpayers could likewise be expected to seek information about results before making an irrevocable election, especially for assets purchased early in the taxable year. Delays in making elections as well as efforts to revoke disadvantageous elections should also be expected. Administration of the tax laws would be simplified and tax manipulation opportunities restricted under a mandatory rather than elective system.

Moreover, even strict rules concerning the timing and irrevocability of elections would not preclude taxpayers from structuring transactions to maximize advantages from the optional forms of treatment. Common estate planning techniques would have immediate application in an expenditure tax context.<sup>100</sup> In estate planning, the goal is to "freeze the size of a client's estate at its current level and direct future growth to the natural objects of the client's bounty."<sup>101</sup> In expenditure tax planning, the goal would be to obtain deductions for investment on an Immediate-Deduction basis and direct future appreciation to taxpayers subject to Yield-Exemption treatment. One common estate planning technique is to freeze value in closely held corporations with substantial appreciation potential.<sup>102</sup> Under an expenditure tax, a parent might transfer \$2,000,000 to a corporation and elect cash-flow treatment, thereby obtaining an immediate deduction for the amount transferred. In return, the parent would receive preferred stock paying dividends of ten percent. His adult child transfers \$200,000 to the corporation for all of the common stock, and elects Yield-Exemption treatment. If the value of the corporation appreciates, say by \$2,000,000, in the next two years, the parent would receive a total of \$400,000 (\$200,000 each year) which would be includible in his expenditure tax receipts (and taxed, if consumed); the child could sell his stock for \$1,800,000 and realize a \$1,600,000 gain free of expenditure tax. Preventing avoidance through this type of transaction would require extensive and well-designed rules, and given the lack of estate tax success at inhibiting such transactions, optimism hardly seems warranted.<sup>103</sup>

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<sup>100</sup> See generally G. COOPER, *A VOLUNTARY TAX: NEW PERSPECTIVES ON SOPHISTICATED ESTATE TAX AVOIDANCE* 12-20 (1978).

<sup>101</sup> *Id.* at 12.

<sup>102</sup> See *id.* at 13-20.

<sup>103</sup> By the same token, expenditure tax planning techniques can be expected to



The Treasury proposal permits even more obvious tax avoidance possibilities by allowing inconsistent treatment of loans and assets. By electing Yield-Exemption treatment for loans and Immediate-Deduction treatment for assets, expenditure tax shelter opportunities even more advantageous than those available under the income tax would become available. This may be illustrated by considering the expenditure tax consequences of a typical motion picture tax shelter.<sup>104</sup>

Assume that a taxpayer purchases the United States rights to a foreign movie for \$2,000,000. The taxpayer's cash investment is \$200,000 and the remaining \$1,800,000 is borrowed from the foreign producer. The loan is payable first out of the proceeds of the film with the balance, if any, due and payable in 20 years. The film is unsuccessful and realizes only \$1,500,000 of income, \$1,200,000 in the first year and \$300,000 in the second year. In year 20, the taxpayer defaults on the remaining indebtedness of \$300,000.<sup>105</sup>

Under a cash-flow expenditure tax, the \$2,000,000 purchase of the film and the income (\$1,200,000 in year 1 and \$300,000 in year 2) would be taken into account on a cash-flow basis with the \$1,800,000 borrowing and the \$1,200,000 repayment taken

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shift risks of loss to taxpayers who elect cash-flow treatment, while providing appreciation for taxpayers who elect Yield-Exemption treatment. For example, a parent and his children invest \$200,000 each in an oil field, arranging their ownership like squares on a checkerboard with the parent taking the black squares, the child the red. The parent elects Immediate-Deduction treatment and the child elects the Yield-Exemption option. The parent spends \$1,500,000 on drilling to locate the oil within the field, deducts this amount, and discovers oil worth a total of \$3,000,000. The parent and child then sell their interests for \$3,000,000 (\$1,500,000 each). The parent would be required to include his proceeds in receipts, but would have obtained a net expenditure tax deduction of \$200,000. The child would have obtained \$1,300,000 free of expenditure tax.

For other estate planning techniques with potential expenditure tax application, see Miller, *Certain Aspects of Estate Planning for the Business Owner*, 33 N.Y.U. INST. FED. TAX. 81, 98-99 (1975).

<sup>104</sup> The example in the text was used by the Staff of the Joint Committee on Taxation in its June 18, 1974, presentation to the House Ways and Means Committee.

<sup>105</sup> Under the income tax, results would depend on allowable depreciation. Assuming an estimate of \$1,500,000 of total income was made in the first few weeks following release, under the income forecast method the taxpayer would be allowed depreciation deductions of \$1,600,000 the first year (80% of \$2,000,000 since the first year's income is 80% of forecast income) and \$400,000 in the second year. See Rev. Rul. 60-358, 1960-2 C.B. 68, amplified by Rev. Rul. 64-273, 1964-2 C.B. 62. The tax loss for year 1 is \$400,000 (\$1,200,000 of income and \$1,600,000 of depreciation deductions) and the tax loss in the second year is \$100,000 (\$300,000 of income and \$400,000 of depreciation deductions). In year 20, \$300,000 of income results from the default on indebtedness. The present value of the tax discounted at 6% would be \$395,186.

into account in year 1 and the \$300,000 repayment taken into account in year 2. No cash transaction occurs in year 20 so nothing would be reported. Under an election to treat the asset on an Immediate-Deduction basis but to omit borrowing, the loan transaction would not enter into the expenditure tax computation until year 20, when the default on indebtedness should produce a \$300,000 receipt. The results would be as follows:

	Cash-Flow Expenditure Tax	Borrowing Omitted Expenditure Tax
Year 1:		
Receipts:		
Income from film:	\$1,200,000	\$1,200,000
Loan	1,800,000	—0—
Total Receipts:	<u>\$3,000,000</u>	<u>\$1,200,000</u>
Deductions:		
Purchase of film:	\$2,000,000	\$2,000,000
Repayment of loan:	1,200,000	—0—
Total Deductions	<u>\$3,200,000</u>	<u>\$2,000,000</u>
Taxable Expenditure (or loss)	(\$ 200,000)	(\$ 800,000)
Year 2:		
Receipts:		
Income from film	\$ 300,000	\$ 300,000
Deductions:		
Repayment of loan	300,000	—0—
Taxable Expenditure	<u>\$ —0—</u>	<u>\$ 300,000</u>
Year 20:		
Receipts:		
Default on loan:	—0—	\$ 300,000
Taxable Expenditure	<u>—0—</u>	<u>\$ 300,000</u>
Present value of tax loss: <sup>106</sup>	(200,000)	(417,827)

Since no amount is repaid in year 20 because of the taxpayer's default on the indebtedness, that year's transaction is not included in the expenditure tax base under the cash-flow computation; under the loan omission alternative, on the other hand, a

<sup>106</sup> Discounted to the end of year 1 at a rate of 6%. The tax savings can be obtained by multiplying these figures by the taxpayer's marginal rate.

receipt of \$300,000 should be required. If the loan were in fact repaid, a loss of \$300,000 would occur in year 20 under the cash-flow method and no amount would enter under the loan omission computation. In either case, the losses under both alternatives would be the same: \$200,000, if the loan were not repaid, and \$500,000, if it were, although their timing, and therefore their present values, would be quite different.

The loan omission alternative provides an after-tax return even greater in present value than that available under the income tax prior to recent reforms,<sup>107</sup> and if the default were not required to be reported as a receipt in year 20, as seems possible under *Blueprints*, tax losses would total \$500,000 even though the taxpayer is out of pocket only \$200,000.

The disallowance of interest deductions under the loan omission alternative, however, would tend to compensate for the deferral which would be possible under such a scheme, and the example may overstate the problem because no stated interest is paid.<sup>108</sup> If an appropriate interest rate were charged, no deductions were allowed for interest, and any interest or principal forgiven or defaulted were required to be included in receipts, the tax shelter possibilities under the loan omission alternative would generally be substantially less than under the present income tax, but at the same time the ability to deduct immediately the full

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<sup>107</sup> In this case the taxpayer has, in effect, shifted \$300,000 of the loss to the foreign producer by the borrowing and subsequent default, thereby losing only \$200,000. Both the income and the expenditure tax result in total tax losses equal to the \$200,000 economic loss, and at a 60% tax rate produce a total tax savings of \$120,000. The timing of the tax savings varies dramatically, however, as would the present value effect. Under the cash-flow expenditure tax, the entire \$120,000 tax savings occurs in year 1.

The present value of the tax savings (discounted at 6%) under the income tax as of the end of year 1 equals \$237,112. One might have expected a 60% income tax to reduce the before-tax loss by only 60% but instead, by borrowing and deferring default, the taxpayer has turned a before-tax loss into an after-tax gain. (Since interest would be deductible under the income tax, the omission of interest payments from the example makes no difference to this conclusion.) That such income tax results occur is well known to high-bracket taxpayers and their advisors. The Tax Reform Acts of 1969 and 1976 and the Revenue Act of 1978 have restricted many tax shelter techniques, see, e.g., I.R.C. § 465. See generally Graetz, *The Evolution of the Tax Shelter Provisions of the Tax Reform Act of 1976: Fewer than Fifty Ways to Limit Your Losses*, 29 S. CAL. TAX INST. 1 (1977), but certain opportunities remain. Results may diverge even further from the norm in cases in which the taxpayer's income tax bracket changes over time or where the ultimate income on default or "phantom gain" is taxed at capital gains rates. Moreover, in many cases the phantom gain is never reported by taxpayers or discovered on audit.

<sup>108</sup> Indeed, if the interest on the loan is equal to the discount rate, the present value of the tax saving is the same under either scheme. A higher interest rate on the loan would make the borrowing omission option less attractive.

purchase price of an asset, including borrowed amounts, would create additional difficulties.

As the previous example illustrates, however, difficulties with the loan omission alternative would occur when the loan proceeds or interest are not repaid, either because the loan was from a related person and forgiven, or because the taxpayer defaulted. Collection of tax when indebtedness is discharged would be difficult. Underreporting of gain from such discharge is hard to detect, and even if the gain is reported or detected on audit, collection of the tax may frequently be difficult because of the absence of cash receipts in the year the tax is due.

As the foregoing example also demonstrates, the expenditure tax treatment of borrowing must be coordinated with the treatment of related assets. Treating loans on a cash-flow basis would eliminate the potential for deferral regardless of how assets were treated. Likewise, if assets were treated under the Yield-Exemption alternative, omitting related borrowing from expenditure tax accounts would not add any new problems, although the ability to leverage investments on a Yield-Exemption basis in combination with progressive rates might increase the ex post advantages to lucky winners and disadvantages to unlucky losers. If, however, assets could be treated on a cash-flow basis and loans could be omitted from expenditure tax accounting, tax shelter opportunities would continue to be available under an expenditure tax.<sup>109</sup>

3. *Recommendation.* — On balance, it is important that an expenditure tax be computed by treating assets and loans on a cash-flow basis, except in cases in which different treatment is necessary because of administrative considerations. A cash-flow approach should tend to produce less variance among ultimate winners and losers than would exemption of yield. And if individuals systematically underestimate probabilities of success

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<sup>109</sup> If enactment of cash-flow reporting of assets and loans were impossible for political reasons, the best alternative would be to limit expenditure tax deductions for investments, including asset purchases, to the taxpayer's equity in the investment (in other words, to reverse the rule of *Crane v. Commissioner*, 331 U.S. 1 (1947)). This would be equivalent to including borrowed amounts in receipts and allowing a deduction for the full cost of assets, but such an approach would encounter serious difficulties. It would be necessary, for example, to accompany such a rule with a provision that would "recapture" deductions whenever assets are refinanced. Likewise, difficulties would occur because of the need to amortize loans in order to allow deductions whenever additional principal amounts are contributed. However, if interest deductions were allowed with respect to such loans — as they should be if deductions for assets purchased were limited to equity — it would not be necessary to distinguish payments of interest and principal. It might nevertheless be necessary to trace indebtedness to various assets since in other instances interest deductions might be disallowed.

(perhaps because they are risk-averse), an immediate deduction might stimulate investment more than would an exemption of yield. A Yield-Exemption option would be confusing to taxpayers, would increase tax planning opportunities, and would tend to undermine a progressive marginal rate structure designed to distinguish among taxpayers on the basis of their actual consumption.

Cash-flow treatment of investment assets and loans would eliminate certain income tax complexities, principally those designed to mitigate the distinction between realized (and therefore taxable) gains and losses and unrealized (and therefore nontaxable) gains and losses. These would include the capital gains-ordinary income distinction,<sup>110</sup> the nonrecognition provisions,<sup>111</sup> and installment sale provisions.<sup>112</sup> Likewise, full cash-flow reporting would eliminate the need for depreciation and recapture provisions<sup>113</sup> since all purchases of investment assets would be immediately deducted and all sales proceeds included in full in receipts. Finally, any need for inflation adjustments, as have been suggested for capital gains and depreciation under the income tax, would be unnecessary under an expenditure tax.

There may be some instances, however, where the Yield-Exemption alternative would substantially simplify tax administration under circumstances in which tax planning opportunities would not be widely available. Under an income tax, individuals generally assume that deferring tax will be advantageous to them; under an expenditure tax, individuals may be indifferent to tax postponement and, in some cases, because of the progressive rate structure, may actually prefer to prepay expenditure taxes as an averaging technique. As a result, the techniques of tax deferral familiar under an income tax would not tend to cause similar systematic distortions under an expenditure tax. Obtaining a deduction in an earlier year would be of no value to taxpayers under a constant rate expenditure tax in which an annual return equivalent to the discount rate plus the amount of the original deduction would be included in the tax base in a later year.

In cases in which progressivity and changing rates are not likely to be systematically distorting factors, in which returns are generally predictable and imperfections in the capital markets may be reasonably ignored, and in which administrative considerations argue for the Yield-Exemption alternative, this method of accounting for asset purchases might be used in lieu of cash-

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<sup>110</sup> See I.R.C. § 1221.

<sup>111</sup> See *id.* §§ 1031-1040.

<sup>112</sup> *Id.* § 453.

<sup>113</sup> See, e.g., *id.* §§ 167, 1245, 1250, 1251.

flow accounting. Subsequent sections of this Part will consider applications of these principles.

### B. Life Insurance and Annuities

1. *Life Insurance.* — Life insurance is generally of two types: “term insurance” and “permanent insurance.” Term insurance represents a payment designed to protect an individual’s family against economic loss due to premature death. In effect, term insurance is a gamble that the individual will not outlive the period predicted by mortality tables. Permanent insurance provides a combination of term insurance and a significant element of savings in the form of reserves accumulated out of premium payments which earn interest for the insured’s benefit. Under the income tax, life insurance premiums are not deductible and amounts which are paid “by reason of the death of the insured” are not subject to income tax — regardless of the amount of mortality gain or loss or return of interest earnings which may actually be involved.<sup>114</sup> These rules result in preferential income tax treatment of interest earned on savings in the form of cash value life insurance.

The appropriate treatment of term insurance under an expenditure tax may be controversial since life insurance is the only generally available method by which individuals may protect their families against the economic consequences of premature death. Most commentators have recommended that term insurance be treated similarly to purchases and receipts of investment assets generally; premiums paid for life insurance would be deductible by the payor and proceeds would be taxed to the beneficiaries.<sup>115</sup> If such rules prove acceptable to Congress, they should be adopted.

On the other hand, allowing life insurance to be treated under the Yield-Exemption option would avoid imposing tax upon the death of the insured, when the family may well suffer a net economic loss even if it receives insurance proceeds. In fact, it is entirely possible that the actual economic loss to the family will be greater as mortality gains increase. If insurance proceeds are used to enable the decedent’s dependents to maintain their stand-

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<sup>114</sup> *Id.* § 101(a).

<sup>115</sup> The Treasury Department justifies this treatment on the ground that the purchase of an insurance policy lowers the lifetime consumption of the policyholder and increases “the expected lifetime consumption” of beneficiaries, BLUEPRINTS, *supra* note 3, at 132. Professor Andrews argues that allowing a deduction for premiums would enable individuals to purchase greater amounts of insurance and would therefore offset any hardships resulting from taxation of mortality gains. See Andrews, *supra* note 3, at 1164. In addition, rules that treat life insurance the same as other investment assets would have the advantage of simplicity.



ard of living during the period shortly following the insured's death, assessing expenditure tax at the time of death may be burdensome to the family. But any hardship from taxing proceeds would be offset somewhat because subsequent investments made with such proceeds would be immediately deductible. Thus, applying graduated rates to life insurance proceeds under an expenditure tax would create less severe difficulties for the deceased's family than would similar treatment under an income tax. By contrast, the arguments against taxing mortality gains from term insurance do not apply to proceeds from permanent insurance attributable to the build-up of life insurance reserves. Expenditure tax should be applied to the savings. If Yield-Exemption treatment is limited to mortality gains, premiums should be deducted and the portion of proceeds which represents interest income and return of savings should be included in the beneficiary's receipts.<sup>116</sup> Because this division would be difficult to administer, however, a simpler solution to the entire life insurance problem should be adopted. Life insurance could either be treated on a cash-flow basis, like other investment assets, or on a Yield-Exemption basis. The political pressure for exempting life insurance proceeds from receipts will likely be great, and rather than normal cash-flow treatment, the result may well prove to be both an immediate deduction for premiums and an exemption for proceeds.<sup>117</sup> Yield-Exemption treatment, which would deny deductions for term life insurance premiums but exclude such proceeds from receipts, should thus be considered an acceptable alternative, assuming that coordination of such a rule with the treatment of annuities would be feasible.<sup>118</sup>

If a Yield-Exemption treatment of life insurance were adopted, proceeds received upon surrender of cash value life insurance policies during the lifetime of the insured should also be excluded from tax receipts. Rules would have to be developed, however, to ensure that application of the Yield-Exemption option

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<sup>116</sup> Allocating taxable amounts to individual beneficiaries would create difficult information and policing problems, and if tax were not withheld by life insurance companies, collection might prove difficult. At a minimum, beneficiaries would have to be provided information by life insurance companies indicating the portion of proceeds to be included in receipts.

<sup>117</sup> See p. 1634 *infra*.

<sup>118</sup> A transaction that may cause difficulty is the joint life insurance-annuity contract. Under contracts of this type, the insurance company bears no risk with respect to the death of the insured, and favorable treatment of the proceeds of the insurance contract has been disallowed under the income tax. See *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *Kess v. United States*, 451 F.2d 1229 (6th Cir. 1971); Rev. Rul. 65-57, 1965-1 C.B. 56. Similar rules would be necessary under the expenditure tax if cash-flow treatment of annuities and Yield-Exemption for insurance were permitted.

to life insurance would not become a general opportunity to obtain exclusion of speculative gains, through "variable life insurance" policies, for example, in which premiums are invested in the stock market by life insurance companies and proceeds depend upon how well the investments perform.

2. *Annuities.* — The treatment of annuities under an expenditure tax would be much simpler than the present system of excluding a portion of each payment as a recovery of capital.<sup>119</sup> At present, the amount to be excluded is determined by the life expectancy of the person or persons whose lives measure the period of the annuity. The annuitant's income tax may be excessive if she dies prematurely and capital is not returned free of tax, but annuitants may also receive tax-free more than the amount paid for the annuity. Although considerations similar to those advanced above in connection with life insurance might seem to argue for Yield-Exemption treatment of annuities, annuity returns represent mortality gains only if the taxpayer outlives the actuarial prediction of the issuer, and similar hardships do not seem likely to occur. An annuity should be treated under an expenditure tax like any other investment; a deduction should be allowed for purchases of annuities and annuity proceeds should be included in receipts as they are paid.

### *C. Consumer Durables and Housing*

The purchase of a consumer good which provides benefits beyond the taxable year of purchase necessarily involves an element of "savings" in the form of consumption deferred to a later taxable period. Examples of such purchases are household furniture and appliances, certain types of clothing, automobiles, and yachts. In some instances, items not generally thought of as durables, season tickets to the theater or opera, for example, involve purchase in one taxable year with use extending into subsequent taxable years.

Certain goods, such as jewelry and works of art, have "investment" as well as consumption aspects. Housing is typically the most expensive and most enduring of consumer durables, and, in a time of rising housing prices, often turns out to be a family's most important investment. It is important to determine the appropriate expenditure tax treatment of purchases of such assets and of gains and losses upon disposition. The basic problems are complicated because purchases of consumer durables and housing are quite often financed by borrowing, with larger loans usually secured by the asset purchased.

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<sup>119</sup> See I.R.C. § 72.

1. *Ordinary Consumer Durables.* — Theoretically, an expenditure tax should tax consumption as it occurs and exempt amounts put aside for future consumption.<sup>120</sup> This could be accomplished by treating durables like financial assets; an immediate deduction would be allowed for the cost of the durable, and its “yield” (an imputed rent) and sales price, if any, would be taken into receipts. This would have the virtue of treating purchasers and renters of consumer goods equally, since the latter would be taxed annually on nondeductible rental payments.

In practice, however, measuring the annual rental value to be imputed to consumer durables would be extremely difficult. For many durables, rental markets do not exist; for many others, rental prices vary depending upon terms, warranties, and other conditions. The amount to be imputed as rent could only be determined by selecting an arbitrary yield on the cost of durables. Moreover, the average taxpayer would find it difficult to understand any scheme that allowed an immediate deduction for the purchase price of a good and imputed annual rent as income until disposition of the good.

In light of these administrative difficulties with the theoretically correct approach, Yield-Exemption treatment of the purchase of consumer durables (*i.e.*, denying an immediate deduction but ignoring income from the asset) should be considered instead. It is true that, as in the case of financial assets,<sup>121</sup> Yield-Exemption treatment is not equivalent to allowing an immediate deduction under the conditions that actually exist in the tax system, but the real world absence of the conditions sufficient for the equivalence between immediate imposition of tax and subsequent taxation of yield and sale price is not as troublesome in the case of consumer durables as with financial assets generally. For several reasons, the two forms of treatment would produce roughly equivalent results in the case of consumer durables. First, although speculative gains and losses from the purchase and sale of consumer durables are not unknown, they are far less common than similar gains and losses from the purchase and sale of investment assets, and can be taken into account in a

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<sup>120</sup> Although the literature is somewhat confused, there is widespread agreement among analysts as to the theoretically appropriate treatment of consumer durables. It is, nevertheless, important to repeat that analysis so that the practical rules offered here may be measured against the theoretical norm. Only then may they be properly evaluated as concessions to administrative convenience or taxpayer understanding.

<sup>121</sup> Allowing an immediate deduction for a durable's cost and including only the subsequent sales price, if any, in income would generally permit tax-free consumption to the extent of foregone interest on the initial purchase price and depreciation of the good.

limited way without undermining the basic integrity of an expenditure tax. Second, changes in tax liability due to progressive rates or legislatively altered rates will be less significant for relatively short-lived consumer durables. Third, the nature of the income from durables — imputed rent — renders incomprehensible to the average taxpayer, and makes difficult to administer, treatment such as that recommended for financial assets.

Moreover, differences in returns from consumer durables are frequently attributable to “consumer surplus” — the difference between the price and the amount the purchaser would have been willing to pay — rather than to subsequent events which, in effect, change the assets’ yield. Whether consumer surplus exists at the time of purchase is known only to the purchaser and simply cannot be taken into account for tax purposes. Expectations at the time of purchase must necessarily be measured by reference to market prices.

Accepting market prices as the touchstone, returns from typical consumer durables (such as automobiles) may be regarded as more predictable than returns from financial assets (such as a motion picture or real estate investment or the purchase of common stock). Gains on consumer durables are infrequent, and losses on consumer durables will tend to occur either because the consumer was mistaken at the time of purchase about the satisfactions that the good would yield or because the product was defective. Taking the former losses into account would require exploration into consumers’ subjective preferences. Losses from product defects are reflected to some degree in the prices of durables which vary, for example, with the availability of warranties. As under the present income tax, extraordinary casualty losses in excess of a certain amount but limited to original cost (or value, if less) might be deductible. Allowing deductions for such losses only when the casualty occurs relatively early in the asset’s expected useful life might also be appropriate. Alternatively, if the cost of insuring durables is assumed to be a general cost of use, no deductions for casualty losses should be permitted.

In sum, cash purchases of ordinary consumer durables should not be deductible, the asset’s yield (imputed rental value) should be ignored, and subsequent sales price generally should be excluded from receipts. In order to avoid problems of taxpayer manipulation, this Yield-Exemption treatment of consumer durables should be mandatory.<sup>122</sup>

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<sup>122</sup> Such rules are generally consistent with the present income tax treatment of purchases of consumer durables (omitting for the moment the deduction of interest on borrowing for consumer purchases) and are similar to those recom-

The discussion of consumer durables has thus far proceeded on the assumption that the original purchaser holds the item throughout its useful life. When durables are transferred to another, however, it becomes important to assure that an appropriate amount of total tax is paid and properly allocated among the owners. If the basic approach outlined above were followed, the purchase of used durables, like the purchase of new durables, would trigger the imposition of expenditure tax liability. If one pays tax on the entire purchase price in the year of acquisition, sale proceeds generally should not be included in the tax base for reasons set forth in detail above in the discussion of financial assets.<sup>123</sup> The value of typical consumer durables such as automobiles, furniture, and appliances, will decline over time, and the sale price will consequently be less than the purchase price. When this is the case, it seems appropriate to disregard any increase in value due to changes in market conditions since the purchase of the asset. While the actual sale price may reflect not only the decline in value resulting from use of, but also an increase in value due to changes in market conditions since the purchase of the asset, it seems appropriate to disregard the latter where the sale price is less than the purchase price. Having imposed tax initially, it is theoretically inconsistent to impose tax on sale; furthermore, it would be administratively impossible to separate losses due to depreciation from offsetting gains (or additional losses) resulting from changes in market conditions. Absent a casualty loss, it is generally reasonable to assume that at least some portion of the decline in value of consumer durables is attributable to consumption use, and separating that amount from any change in price due to market forces would be a practical impossibility.<sup>124</sup> Where the sale price exceeds the original

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mended by others who have considered this issue. See ACIR REPORT, *supra* note 3, at 21-26; MEADE REPORT, *supra* note 3, at 180; S. LODIN, *supra* note 3, at 76-82; P. MIESZKOWSKI, *supra* note 3, at 22-24; BLUEPRINTS, *supra* note 3, at 121-22; Andrews, *supra* note 3, at 1155-57. Professor Andrews and the Meade Commission, however, would limit the amount excluded on sale of the asset to the amount originally included in the tax base as consumption, generally the purchase price of the asset. See MEADE REPORT, *supra* note 3, at 180; Andrews, *supra* note 3, at 1158-59.

<sup>123</sup> See pp. 1583-86 *supra*.

<sup>124</sup> A rule including some portion of proceeds in income would also be complicated by the treatment of trade-ins. While, for example, a taxpayer would not recognize any receipt on the trade-in of a used car, analogous treatment of a taxpayer who sells his car and later purchases another would require limited deductions for purchases of consumer durables and would be difficult to administer. Proceeds from sales of used durables would have to be traced, or an aggregate limitation on the deduction based upon sales of used durables and purchases of other durables would be required.

purchase price, on the other hand, different considerations obtain. As a general matter, it seems reasonable to assume that when used goods sell for more than their original cost, market forces other than ordinary interest and depreciation have affected the price. Viewed *ex post*, if sales were not taken into account when the sale price exceeds the purchase price, either an amount of consumption or a speculative gain on the durable would be excluded from the base. Although sale price will exceed purchase price only rarely in the case of typical consumer durables (for example, when an automobile becomes a "classic car") this may occur rather frequently for certain types of durables, such as jewelry and works of art, which typically do not depreciate.

For example, assume that an individual purchases an oriental rug at the beginning of year 1 for \$1,000 and sells the rug at the beginning of year 3 for \$3,000. The theoretical analysis suggests that the individual has enjoyed some consumption in the form of imputed rent while owning the rug. If the asset were sold for an amount equal to its purchase price plus an interest return (\$1,210 in the example, assuming a 10% rate of interest) and the proceeds of sale were not included in receipts, this consumption would escape tax completely. If the asset were sold for an amount greater than its purchase price plus interest (\$3,000 in the example) and the excess over the purchase price plus interest (the speculative gain) were not taken into account for tax purposes, an additional amount of future consumption (\$3,000 minus \$1,210 in the example) could be enjoyed free of expenditure tax.<sup>125</sup>

Requiring any excess of sale price over purchase price to be included in the expenditure tax base would eliminate such possibilities of additional tax-free consumption. Taxpayers would not be able to purchase nondepreciating durables as a means of enjoying tax-free consumption due to speculative gains. Widespread availability of such an opportunity would undermine the efforts discussed in Section A above to design rules for financial assets to assure that consumption financed out of speculative gains would be included in the tax base. To the extent, however, that a portion of the excess of sale price over purchase price represents a normal interest return, taxing such amounts at the time of sale would result in overtaxation since the initial tax on the durable's purchase price includes expenditure tax prepayment with respect to normal interest returns. Nevertheless, this may generally be ignored, since for typical durables the taxpayer has chosen to forego the normal interest return in exchange for

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<sup>125</sup> Speculative gain would also be realized if the asset were sold for normal interest return on the purchase price but the asset had depreciated in the interim.



the use of the asset. In the case of nondepreciating durables, such as art or jewelry, which are enjoyed by the purchaser, an interest return has also often been foregone for using the asset, and the entire excess of the sale price over purchase price may reasonably be regarded as due to market forces, and thus an appropriate subject of tax. Theoretical purity would require distinguishing these cases in an effort to determine the portion of the sale price attributable to a normal interest return; for example, taxpayers who actually wear jewelry might be treated differently from those who merely store it. But practical considerations argue against such an approach. For most durables, sale price will be less than purchase price and the issue will not arise. For durables the sale price of which is greater than historical cost, it does not seem unreasonable simply to include the excess in receipts.

2. *Consumer Credit.*—Section A suggested that borrowing for investment in financial assets be treated on a cash-flow basis with loan proceeds included as receipts and repayments of principal and interest deducted. For much consumer borrowing, however, such treatment is impractical. Many taxpayers would find it quite difficult to determine exactly their consumer borrowing and repayments for each year, and new information reporting requirements, burdensome to lenders, would likely be necessary under an expenditure tax system that required unsecured consumer borrowing to be taken into account. It therefore seems necessary, as a practical matter, to omit typical unsecured consumer borrowing from receipts. This leaves two questions: (1) What is the appropriate scope of the omission of consumer borrowing from expenditure tax calculations? and (2) What rules will apply when borrowing is omitted?

The guidelines for the latter question have been presented in prior discussions of this Part.<sup>126</sup> In general, omitting consumer borrowing from expenditure tax calculations would entail excluding loan proceeds from the tax base and disallowing deduction of principal or interest repayments. If interest deductions were allowed when loan proceeds were included in receipts, parity would require that no deduction for interest be allowed when loan proceeds are omitted from receipts. The denial of a deduction for interest under such circumstances may be viewed as increasing an individual's tax liability by an amount which corresponds to the interest on the tax deferred by omitting loan proceeds from receipts.

When consumer durables are purchased with borrowed funds which are omitted from receipts, denying a deduction for the

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<sup>126</sup> See pp. 1599–1600 *supra*.

original purchase has an effect comparable to including in annual receipts a rental value attributable only to the taxpayer's equity in the durable, even though the taxpayer is enjoying the use of the entire durable without regard to how it was financed. Disallowing an interest deduction on funds borrowed to finance consumer durables would approximate the addition to receipts necessary to reflect the consumption value of the durable which would be taxed if its entire rental value were imputed annually. In addition, other commentators have argued for denying an interest deduction with respect to loans used to finance consumption purchases on the grounds that such interest represents additional consumption expenditure.

Excluding consumer loans from receipts and allowing no interest deduction on such loans would generally result in similar treatment of taxpayers whether or not they borrow to finance consumption purchases and would, in many common circumstances, approximate theoretically appropriate results. Including cash purchases of consumer durables in the expenditure tax base in the year of purchase and, in effect, including corresponding purchases with borrowed funds in the tax base as principal and interest on the loan are paid (since no deductions are permitted at that time), would, however, enable taxpayers using borrowed funds to spread the taxation of consumption over a number of taxable years. When durables are financed with borrowed funds, taxation would follow the schedule for loan repayments and would therefore permit self-help averaging in some cases. Finally, the simplification advantages of this approach are substantial.

Limitations on the ability to exclude borrowing from expenditure tax receipts merit attention. If a progressive expenditure tax is intended to be applied to a base which annually measures taxpayers' consumption as accurately as possible, cash-flow treatment of borrowing should be the general rule. Consumer loans would be permitted an alternative treatment of exclusion from receipts principally for reasons of administrative ease and taxpayer convenience and understanding. Because denying deductions for interest on excluded loans would significantly reduce any advantage which might occur because of the initial exclusion of the loan proceeds, however, limitations on this exclusion alternative may be quite generous so long as interest deductions are denied.

There are basically two alternative methods for limiting the scope of the exclusion of borrowing from receipts in the case of consumer credit. One method would be to allow borrowing to be omitted only up to a specified amount, say \$10,000, and require all borrowing in excess of that amount to be included in receipts

and treated under the standard method.<sup>127</sup> If the ceiling were sufficiently high, this alternative would exempt many low and moderate income families from the reporting burdens discussed above. To be sure, for the family with two heavily mortgaged cars and numerous credit card and charge account purchases, however, a higher ceiling would seem necessary to eliminate recordkeeping problems. But a ceiling set as high as \$25,000 would permit borrowing to purchase financial assets, and would tend either to complicate significantly the rules for deduction of purchases of financial assets or to permit unwarranted results such as those described in Section A.<sup>128</sup>

As an alternative to a specified dollar limit, borrowing could be exempted from tax and interest deductions denied only when indebtedness is incurred or continued to purchase or carry items for personal consumption. Such a rule would require tracing borrowing to its uses, but this is now required to some extent under section 163(d) of the Internal Revenue Code. Methods used under that provision for distinguishing borrowing for investment purposes from borrowing for personal purposes could be applied in an expenditure tax context. These rules are not completely satisfactory, however, and are of limited application under current law because dollar limitations restrict their applicability to a relatively small number of taxpayers. On balance, then, a dollar limitation, which does not require tracing loan proceeds to their use, seems preferable.

3. *Housing.* — Housing may be regarded simply as an especially expensive and enduring consumer durable. From this perspective the theoretically appropriate treatment of housing under an expenditure tax is similar to that of other consumer durables; persons who rent housing would not be allowed any deduction for rent (which would be taxed as consumption), and an imputed rental value should be taxed to owner-occupiers. If rental value were imputed to owner-occupiers, it would be appropriate to treat the purchase and sale of housing in the same manner as financial assets generally; the cost of a home and of any repairs, maintenance, or improvements would be deducted as incurred, and the sale price would be included in full as a receipt at the time of sale. Likewise, home mortgage indebtedness would be treated on a cash-flow basis.<sup>129</sup>

<sup>127</sup> This approach was suggested by both the Meade Commission and Professor Lodin's report, with limitations in the range of \$2,500 to \$7,500. MEADE REPORT, *supra* note 3, at 179 (£1000); S. LODIN, *supra* note 3, at 78 (30,000 kr.).

<sup>128</sup> See pp. 1598–1611 *supra*.

<sup>129</sup> Richard Slitor, for example, would allow a deduction for the purchase price of owner-occupied homes and include in consumption each year a ratable portion of the purchase price based upon an assumed useful life. See Slitor, *supra* note 18,

As in the case of consumer durables, however, there are serious practical obstacles to implementing this theoretically correct result. For the imputation of rent to owner-occupiers to be precise, annual appraisals for every owner-occupied home would be necessary, and account would have to be taken of capital improvements made during the period of ownership. In addition to these administrative problems, lack of understanding among taxpayers would be a drawback. Moreover, for persons whose cash incomes were low relative to their imputed rental values, taxation might well be onerous. For these reasons, as well as political ones, imputation of rents under the income tax has never received any real attention in Congress, and there is no reason to expect it would be any easier to enact under a consumption tax. It is therefore essential to explore other alternatives.

Perhaps the best solution for expenditure taxation of housing would be the treatment recommended for ordinary consumer durables. Under such a system, cash purchases of housing would not be deductible, yield (imputed rental value) would be ignored, and any excess of subsequent sale price over original cost would be included in receipts. Under such rules a provision comparable to section 1034 of the Internal Revenue Code (which excludes gain on the sale of a personal residence if the proceeds are reinvested in a home) would likely be adopted. An exclusion of a dollar amount of gain (such as a one-time \$100,000 exclusion recently enacted by Congress)<sup>130</sup> would not be necessary, however, because the general expenditure tax rules would allow offsetting deductions for the cost of investment assets purchased with the proceeds of sale. No adjustment would generally be required when houses are sold at a loss, but, as in the case of consumer durables, a limited deduction for casualty losses seems appropriate.

Home mortgages could be treated in a manner similar to other consumer credit. Amounts borrowed would not be included in receipts and no deduction would be allowed for repayments of principal or interest. To equalize treatment of renters and homeowners, it would also be appropriate to deny any deduction for property taxes.

The consumption tax base would include (1) the original cash

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at 239-40. Professor Andrews suggests allowing an owner-occupier to deduct the original purchase price (or the downpayment) of his home with income imputed to him at a specified interest rate on the amount deducted. See Andrews, *supra* note 3, at 1158 n.102. Both the Meade Commission and Professor Lodin would require a fixed annual imputation based upon a rate of return on the annual value of property (in Britain, 3% of the value and in Sweden, 5%). See MEADE REPORT, *supra* note 3, at 219-20; S. LODIN, *supra* note 3, at 83-89.

<sup>130</sup> See I.R.C. § 121.

downpayment on the purchase of housing, (2) mortgage payments of principal and interest, (3) property taxes, and (4) costs of repairs, maintenance, and improvements. To the extent that the return from housing approximates a typical rate of return on the owner's equity, including these costs in the consumer's tax base should put owner-occupiers on a tax basis approximately equal to that of renters. In the long run, rental payments can be expected to cover the owner's interest expenses, property taxes, repair and maintenance costs, and a rate of return on invested capital. Remaining disparities between homeowners and landlords would be due principally to the difference between requiring homeowners to prepay expenditure tax on their cash investment (by including cash downpayments in consumption) and requiring landlords to treat rental housing on a cash-flow basis as with other investments.

As in the case of consumer durables, this treatment implicitly assumes that when housing declines in value, the bulk of the decline is attributable to use and should be taxed. Thus when houses are sold for an amount equal to or less than their original purchase price, no amount would be entered into consumption tax receipts.

Because the rules that have been recommended would require the inclusion in receipts of the entire cash outlay for housing and other major durables in the taxable year of purchase, they would tend to overstate the amount of consumption for that year. Spreading of the tax burden over a period of years would then be necessary; without some form of averaging in a progressive tax system, such consumption would be taxed at unduly high marginal tax rates. Since general self-help averaging by taxpayer election has been rejected with respect to consumer durables, financial assets, and loans, a general averaging provision would be necessary under an expenditure tax.

There are, however, certain political obstacles to the recommended approach. For example, including mortgage interest and property taxes in the tax base can be expected to encounter serious resistance in Congress. Notwithstanding their theoretical inappropriateness under an expenditure tax, other benefits for owner-occupiers might also be enacted, given the traditional political preference afforded home ownership. If such special provisions excluded a significant portion of housing consumption by owner-occupiers from the tax base, allowing a deduction for rent might then become appropriate to ensure equal treatment. The ultimate outcome might well be to exclude from the expenditure tax base most taxpayers' housing costs. Such a scheme would have two undesirable consequences. It would misallocate resources by en-

couraging taxpayers to overconsume housing relative to other taxable forms of consumption; and it would create inequities since the deductions and exclusions that would likely be enacted would tend to be of greater value to persons in higher tax brackets. Similar inefficiencies and inequities currently exist under the income tax, however, and do not seem to engender great congressional concern. In any event, no allocative distortions would be created under an expenditure tax by the failure to include unrealized housing appreciation in income, since appreciation would not generally be included in receipts until devoted to consumption. It seems likely that even if housing were completely excluded from the expenditure tax base, distortion would be less severe than under the current income tax.

## V. GIFTS AND BEQUESTS AND THE TAXATION OF THE FAMILY

### A. *Choice of the Taxpaying Unit*

In designing any personal tax system, an important threshold issue is whether the filing unit is to be the individual or a group, such as husband and wife or the entire family, including minor children. Choice of filing unit is important in terms of tax liability when rates are progressive. The arguments relating to this choice under the income tax generally apply with similar force in the expenditure tax context,<sup>131</sup> although it seems more reasonable to regard the family as the appropriate unit for measuring consumption than for measuring the accumulation of income or wealth. In contrast to present practice, application of a progressive rate schedule to family units would have the effect of taxing the children's income or consumption at their parents' marginal rates, and seems likely to result in certain inequities. As is demonstrated below, however, the appropriate expenditure tax treatment of gifts and bequests strongly suggests the desirability of a family filing unit under an expenditure tax. A family

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<sup>131</sup> The biases produced by the current system, especially by the joint or separate filing election afforded married taxpayers, have prompted a number of analyses by lawyers and economists which have helped to elucidate the issues at stake. Unfortunately, however, recent discussions in the income tax context of whether the individual or the family is the more appropriate unit for assessment of tax have principally served to confirm that neither choice is free of difficulties. See, e.g., Rosen, *Applications of Optimal Tax Theory to Problems in Taxing Families and Individuals* (Office of Tax Analysis, U.S. Dept. of Treasury 1976); Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1975); McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977); *ABA Simplification Report*, *supra* note 31, at 665-71.



filing unit is not without difficulties, to be sure.<sup>132</sup> There is the problem of defining what is meant by a "family" in cases in which related individuals live separately or unrelated individuals live in the same household. There may also be political pressure to maintain the presently favored status of earnings of low-bracket children who are concededly part of the family.

### *B. Gifts and Bequests*

1. *Taxation of Donor or Donee.* — Some commentators have argued that gifts and bequests should be included in the incomes of both the recipient and the donor.<sup>133</sup> The better view, however, is that income or expenditure tax should be imposed only once on gifts within a family — whether on the donor or on the donee — since there is only one source of earnings and one case of spending.

Under current law, gifts and bequests are excluded from income of the donee or heir.<sup>134</sup> If an individual earns income and donates some portion to another, the income is taxed to the donor but not to the donee. It is debatable whether this treatment is theoretically consistent with the concept of an income tax. Because the selection of an income tax implies some reliance on sources rather than uses of funds, however, present rules are defensible. In addition, since donors tend to be subject to higher marginal rates than donees, present law inhibits somewhat the shifting of income among family members to take advantage of lower marginal tax rates which usually apply to children.<sup>135</sup>

Under an expenditure tax, the structural issue is basically the same — whether gifts should be taxed to the donor or the donee — but the theoretical result seems more clearly compelled by the premise that an expenditure tax is intended to impose a progressive levy on consumption. The donee, not the donor, will spend the amount of the gift or bequest. Cash gifts and bequests should thus be excluded from the donor's tax base and included in the donee's receipts. As in the case of other cash receipts, the

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<sup>132</sup> See *id.*

<sup>133</sup> See, e.g., H. SIMONS, *supra* note 16, at 125.

<sup>134</sup> See I.R.C. § 102.

<sup>135</sup> Under the income tax, in the case of inter vivos gifts of appreciated property, taxation of gain is deferred until the asset is sold by the donee and is subjected to tax at the donee's rates. I.R.C. §§ 102, 1015. This rule enables taxpayers with appreciated assets to shift income taxation of gain to family members with lower rates, notwithstanding the general rule which taxes donors on amounts transferred. Similar results can be achieved through bequests, and for most taxpayers income tax on bequests can be avoided altogether. It seems quite unlikely that Congress would respond more favorably to a proposal to tax gifts or bequests as sales under an expenditure tax.

donee should be allowed a deduction if the money is invested but not if the amount transferred is consumed. A *de minimis* provision on an annual basis should be adopted so that small gifts among family members need not be taken into account for tax purposes. When investment assets, rather than cash, are transferred, no deduction should be allowed the donor because a deduction was allowed at the time of purchase. Since the transfer does not immediately add to the donee's consumption, no amount should be included in the donee's receipts until the asset is sold. At that time, the donee would include in receipts the proceeds of sale. The problems of basis of gifts familiar under the income tax would thus generally disappear under an expenditure tax.<sup>136</sup>

The major disadvantage of taxing gifts to donees is that it would permit families to use gifts to determine who shall be subject to tax. Under a progressive rate schedule, transfers from parents to children would shift tax to lower brackets. Taxing gifts to donors would of course solve this problem, but would require treating gifts of investment assets as sales and, in addition, disallowing any deduction for the gifts. Such treatment would be undesirable because it would disadvantage gifts relative to both retention of assets and sales whose proceeds are reinvested. Moreover, in light of the current treatment of gifts and bequests under the income tax, under which gain accrued at the time of transfer is taxed only on disposition or escapes tax altogether,<sup>137</sup> it seems politically unlikely that Congress would require constructive realization of the value of a gift on transfer. This may be the case even though tax avoidance possibilities would be greater under an expenditure tax than under the income tax, since the cost of assets would be deductible at the time of purchase. Results comparable to those under current law could be achieved if amounts previously deducted were "recaptured" and included in the donor's tax base at the time of the gift.

If direct taxation of gifts to donors were regarded as an unduly complex or politically impractical means of preventing the shift of tax liability to lower bracket taxpayers, an alternative means would be taxation of shared family consumption at appropriate marginal rates. If a family unit, including husband and

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<sup>136</sup> The donee's basis in the asset would in effect be zero; all sale proceeds would be included in receipts. Thus, an expenditure tax avoids many of the complexities and recordkeeping difficulties which occur under the income tax in determining basis of donated or bequeathed property.

<sup>137</sup> See I.R.C. § 1014 (stepped-up basis for bequests); *id.* § 1015 (carryover basis for gifts). Section 1023, the limited carryover basis provision enacted in 1976 to deal with this problem, was postponed by legislation in 1978 and may well be repealed.

wife and any minor children, were selected as the unit for expenditure taxation, the most troublesome opportunities for shifting taxation to lower marginal rates would be foreclosed. Gifts would not have tax consequences until amounts were transferred out of the family unit. When such a transfer is made, imposing expenditure tax at the donee's marginal rates would be appropriate because the donee will have an amount available for consumption.

Taxing the family as a unit would not, however, inhibit intra-familial accumulation of wealth and transfer of assets. The problem of wealth transfer could be dealt with by taxing donors on gifts and bequests,<sup>138</sup> but would be better addressed by an effective and comprehensive wealth tax (perhaps in the form of an estate and gift or accessions tax and perhaps coupled with a periodic tax on trust assets) rather than by taxing gifts and bequests under an expenditure tax, which presumably would be enacted with a progressive rate schedule designed to tax periodic consumption.<sup>139</sup>

2. *Transfer of Consumer Durables.* — It has been suggested that when consumer durables with long useful lives are transferred, the recipient should be treated as if he received cash and purchased the durable in question, on the ground that inclusion of the consumption value of the durable in the tax base of the donor at an earlier period might not accurately reflect the good's consumption value at the time of the gift.<sup>140</sup> Unanticipated events subsequent to the time of purchase might have increased or decreased its value, and tax rates might have changed. Absent such a rule, donees would enjoy greater consumption than they would under the theoretically correct treatment of consumer durables, which would include an imputed annual rental value in the receipts of the individual who holds the durable.

The problem arises because of the treatment of consumer durables recommended in Part IV, but if that treatment were

<sup>138</sup> The ancillary rules for grantor and generation-skipping trusts and the taxation of unrealized gains at death would remain quite complex. See pp. 1627-28 *infra*.

<sup>139</sup> This is not to say that an effective wealth tax could be easily instituted. See MEADE REPORT, *supra* note 3, at 317-66. See also G. COOPER, *supra* note 100, at 90-III.

<sup>140</sup> See Andrews, *supra* note 3, at 1163-64. Given the congressional proclivity for enacting exceptions to estate and gift tax rules for gifts of certain types of assets or gifts to certain recipients, see, e.g., I.R.C. § 2057 (bequests to orphans); *id.* § 1023(b)(3) (stepped-up basis for household effects), such a rule would likely be burdened with exceptions. It is easy to imagine, for example, forgiveness of tax on donations of a residence or even a work of art to a spouse or orphan. If numerous exceptions were required for political reasons, special rules for gifts of consumer durables should be rejected on the grounds of complexity alone.

generally acceptable, no additional tax should be imposed at the time of a gift or bequest. The donor could hold and enjoy the asset in question without paying additional expenditure tax. Imposing tax on a donee who receives an asset, such as a work of art, that has appreciated since purchase by the donor would require the donee to pay tax to retain the asset within the family under circumstances in which no tax would be due if it were held by the donor or sold and investment assets purchased. Expenditure tax rules which would encourage a Rockefeller to sell art to buy securities at least once each generation do not seem wise. Moreover, delaying taxation until assets are sold would avoid difficulties where donees are given assets, such as grandmother's grand piano, which they do not really want, but which, for family reasons, they cannot sell. On balance, assuming a scheme which taxes gifts to donees, the treatment of gifts and bequests of consumer durables should be consistent with that of other assets; no deduction should be allowed the donor and no amount included in the donee's receipts until he sells the asset. At that time, the donee would be charged with receipts equal to the difference between the sale price and the donor's purchase price; in other words, the donee should receive a carryover basis, as he presently does under the income tax.

3. *Gifts in Trust.* — As in the case of outright gifts, taxing gifts or bequests in trust to donors rather than donees would introduce complexities under an expenditure tax. If donees and heirs were taxed, gifts of investment assets or cash in trust would pose no special problems, and the taxation of trusts, which is very complex under the income tax, would be quite simple. Since trusts do not engage in consumption, there would generally be no expenditure tax at the trust level, whether income or assets were accumulated or distributed.<sup>141</sup> A gift from a donor to a trust would be treated by the donor like any other gift. The trust would not be taxable on receipt of cash or assets, but its beneficiaries would include in receipts any distributions made from a trust, whether out of income or out of corpus. If amounts distributed by the trust were reinvested by the beneficiary, a deduction would be allowed; if the trust proceeds were consumed, the beneficiary would be taxed. It would therefore not be necessary to adopt rules similar to those under the income tax which distinguish simple trusts (which distribute all of their income) <sup>142</sup>

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<sup>141</sup> The deferral of tax which would occur as a result of investments and accumulations of income at the trust level would provide no particular expenditure tax advantage since similar deferral could be obtained through investments at the individual level.

<sup>142</sup> See I.R.C. §§ 651-652.

from complex trusts (which accumulate income).<sup>143</sup> Likewise, the income tax throwback rules<sup>144</sup> would not be necessary under an expenditure tax. Rules which distinguish grantor trusts from other trusts under the income tax could also be eliminated if the basic scheme of taxing donees on gifts were adopted. If, under the terms of the trust, property actually reverts to the grantor, for example, through the exercise of a power of revocation, distributions from the trust would be included in the grantor's receipts in the year of revocation. It would be necessary, however, to adopt rules to ensure that tax avoidance is not possible through the purchase of consumer durables, including works of art and jewelry, by trusts. On the other hand, if it were deemed desirable to tax the donor on amounts transferred by gift or bequest, the taxation of transfers to trusts would be more difficult. It would seem necessary to treat gifts of assets in trust, like outright gifts, as if the donor had sold the asset at the time of the transfer (or, at a minimum, to "recapture" amounts previously deducted with respect to the asset). In addition, if taxing gifts and bequests to donors is intended to ensure tax on appreciation at least once a generation, rules taxing generation-skipping trusts would become necessary.

4. *Gift or Compensation?* — Under the income tax, there have been considerable difficulties in determining how to treat transfers which occur in the context of a commercial relationship. Payments to widows of deceased employees have proved especially troublesome.<sup>145</sup> If a transfer is characterized as a gift, it is excludable from the recipient's income<sup>146</sup> and, to the extent over \$25, not deductible by the payor.<sup>147</sup> On the other hand, if the transfer is compensation for services, it is includible in the recipient's income and often deductible by the payor. Under the income tax, resolution of this issue depends upon the payor's donative intent or lack thereof and the Supreme Court has ruled that a trial court should determine the payor's intent by applying its "experience with the mainsprings of human conduct."<sup>148</sup>

Under an expenditure tax, taxing gifts to donees would make this elusive inquiry unnecessary. Transfers of cash, for example, should be deductible by the payor and includible in the recipient's

<sup>143</sup> See *id.* §§ 661-664.

<sup>144</sup> See *id.* § 667.

<sup>145</sup> See, e.g., *Estate of Sydney J. Carter v. Commissioner*, 453 F.2d 61 (2d Cir. 1971); *Estate of William Enyart*, 1965 T.C.M. (P-H) ¶ 65,266.

<sup>146</sup> See I.R.C. § 102(a).

<sup>147</sup> See *id.* § 274(b).

<sup>148</sup> *Commissioner v. Duberstein*, 363 U.S. 278, 289 (1960); cf. *Estate of Sydney J. Carter v. Commissioner*, 453 F.2d 61 (1971) (similar circumstances require similar findings regarding intent).

receipts regardless of the motives of the parties. Some problems would remain in the case of gifts by private persons in a non-business context. While such amounts would be taxed to the donee in any case, they should not be deductible by the donor if they are in fact payment for consumption services. Administration of this rule would not be difficult, however. For small amounts, the gifts deduction would in any case not be available to the donor. And for larger cash transfers, abuse seems more likely to take the form of not reporting the transaction at the request of the donee-independent contractor who wishes to evade the tax on his receipt.

## VI. TAX INCENTIVES AND SUBSIDIES UNDER AN EXPENDITURE TAX

The present federal income tax contains a number of provisions which afford preferential treatment to certain kinds of receipts and payments, in the form of special exemptions, deductions, credits, reduced tax rates, and deferral of tax liability.<sup>149</sup> Such so-called tax expenditures represent deviations from a net income tax structure and result in substantial revenue losses.<sup>150</sup> Nevertheless, this form of indirect federal subsidy has been increasingly popular with Congress as a means of directing investment and achieving various social policy goals, and similar congressional desire to channel investment behavior via differential tax treatment will likely persist under an expenditure tax. In the context of an expenditure tax, however, designing such incentives introduces new complexities.

Under the income tax, it is possible to favor particular investments by providing deductions or exclusions for income received from preferred sources, or by allowing accelerated deductions of capital investments and thereby permitting a higher after-tax rate of return than would be available for investments generally. Under an expenditure tax, purchases of investment assets would be immediately deductible, and when such cash-flow treatment is equivalent to an exemption of yield, the tax on investment

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<sup>149</sup> See generally STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 1ST SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1979-1984 (Comm. Print 1979) [hereinafter cited as COMMITTEE PRINT]; S. SURREY, *supra* note 84, at 6; Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

<sup>150</sup> Tax expenditures for fiscal 1978 were estimated at \$124.4 billion, constituting 26% of the federal budget. THE BROOKINGS INSTITUTION, SETTING NATIONAL PRIORITIES: THE 1979 BUDGET 315-18 (J. Pechman ed. 1978). This amount is projected to increase to \$150.6 billion for 1979 and to \$270.3 billion by 1984. COMMITTEE PRINT, *supra* note 149, at 13.



income is zero. As a result, it would not be possible under an expenditure tax, as it is under an income tax, simply to impose a lower tax to favor specific investments. Instead, a negative tax rate would be necessary to provide such inducements. This Part examines the problems associated with providing tax incentives for certain types of investments under an expenditure tax, focusing on state and local bonds, charitable contributions, accelerated depreciation for investment property, and life insurance.

### A. Interest on State and Local Bonds

Notwithstanding periodic attacks from tax reformers, the exclusion from income of interest on state and local bonds<sup>151</sup> is among the most enduring features of the income tax, having been in the law since its adoption in 1913.<sup>152</sup> The basic justification for its continuation is that it allows state and local governments to borrow at interest rates lower than those incurred by private corporations on bonds of comparable risk, thereby reducing the cost of capital outlays for projects such as schools and other public buildings, highways, water and sewage systems, and anti-pollution facilities. An ancillary effect of the exclusion is to provide windfall tax savings to individuals who would be subject to federal income tax rates higher than the rate of marginal purchasers.<sup>153</sup>

In recent years, various proposals have been advanced to tax state and local bond interest while maintaining reduced interest costs for state and local governments through a direct federal subsidy.<sup>154</sup> However, even partial replacement of the tax benefit

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<sup>151</sup> I.R.C. § 103.

<sup>152</sup> The exclusion was originally justified on grounds that federal taxation of state and local obligations would be unconstitutional. See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 583-86 (1895) (taxing income from state and municipal bonds held unconstitutional). While this rationale is of dubious validity today, it has its modern adherents. See *Tax Reform, 1969: Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. 2223-31 (1969) (statement of the National League of Cities, the U.S. Conference of Mayors, and the National Association of Counties); *id.* at 2239-42 (statement of Francis B. Burch, Attorney General of Maryland).

<sup>153</sup> The higher the ratio of yields on tax exempt to taxable bonds, the greater the windfall to individuals and institutions otherwise subject to high marginal rates of tax, and the greater the total revenue cost to the federal government relative to state and local government savings in interest charges. See E. GRISWOLD & M. GRAETZ, *supra* note 83, at 225-27; Graetz, *Assessing the Distributional Effects of Income Tax Revision: Some Lessons from Incidence Analysis*, 4 J. LEGAL STUD. 351, 359-61 (1975).

<sup>154</sup> Such a bill was passed by the House in 1969. See H.R. REP. NO. 413, 91st Cong., 1st Sess., pt. 1 at 172-74 (1969), but was deleted from the Tax Reform Act of 1969 by the Senate Finance Committee in the face of virtually unanimous opposition by state and local governments. For more recent proposals,

with a direct subsidy has been unattractive to state and local governments and has failed to muster a majority in Congress. In light of this attitude, it may be useful to inquire into the expenditure tax effect of an exclusion from receipts of interest on state and local obligations.

As outlined in Part IV, the cash-flow treatment of investment assets generally required under an expenditure tax would permit an after-tax rate of return on investments equal to the before-tax rate of return on the amount of consumption foregone by making the investment.<sup>155</sup> But if the tax system is to provide a lower interest cost for state and local debt than for corporate bonds generally, some additional benefit would be necessary. As Part IV suggests, if the yield and sale price of state and local bonds were excluded from receipts, and *no* deduction were allowed for the purchase of such bonds, there would be no reason to expect the interest on state and local bonds to be lower than that on ordinary corporate bonds. To maintain an advantage for state and local borrowing, an exclusion of at least some portion of the proceeds or some other benefit, such as a tax credit, would have to be provided in addition to the generally available deduction. Permitting both a deduction and an exclusion with respect to state and local bonds would create a *negative* tax rate with regard to income from that source which would vary directly with purchasers' marginal rates of tax. A tax credit would also produce a negative tax rate, but would be more neutral relative to individuals' marginal tax rates.

### B. Charitable Contributions

Current income tax law provides a significant incentive for gifts of appreciated property to charity. Gifts to public charities of appreciated securities or real property are deductible at fair market value even when greater than purchase price, so that the unrealized appreciation of donated property escapes taxation.<sup>156</sup> Gifts of appreciated property are most common for persons in upper income tax brackets and are an important source of private voluntary support for colleges, universities, museums, and hos-

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see H.R. REP. NO. 1016, 94th Cong., 2d Sess. (1976) (state and local government option to elect 35% federal interest subsidy upon issuance of taxable obligations); S. REP. NO. 1263, 95th Cong., 2d Sess. 143-50 (1978) (bondholder option to treat municipal bonds as taxable and receive refundable credit of 67% of interest received).

<sup>155</sup> See pp. 1609-10 *supra* (cash flow treatment of investment assets).

<sup>156</sup> I.R.C. § 170(a), (e); Treas. Reg. § 1.170A-1(c)(1) to (2). By contrast, where a sale of property (for example, inventory) would produce ordinary income or short term capital gain, the donor's deduction is limited to the asset's cost. *Id.*

pitals.<sup>157</sup> Apparently convinced that continuation of a full fair market value deduction is essential to the well-being of these institutions, Congress has rejected proposals to limit this practice.

Under an expenditure tax, a deduction would be allowed upon purchase of investment property, including securities or real estate. If an additional deduction were allowed for the fair market value of property given to charity, its cost would be deducted twice, once when purchased and again when donated. Thus, at a minimum, the deduction for charitable contributions of property should be reduced by amounts previously deducted, usually the asset's cost. If the excess of fair market value over cost were allowed as a deduction, the preferential income tax treatment of gifts of appreciated property would be retained.

There is, however, no more theoretical justification for this kind of preference under an expenditure tax than under an income tax. Taxing donors only on cost (to avoid a double deduction) would introduce considerable complexity into the tax system. Taxpayers would be required to know the basis of assets donated to charity and to retain records and make computations which would not otherwise be required. A simpler and more theoretically appropriate rule would be to limit expenditure tax charitable contribution deductions to gifts of cash. This rule, however, might seriously reduce donations to institutions of higher education since gifts of appreciated property would be denied tax advantages currently available. Likewise, split-interest gifts of property in trust, which also particularly advantage colleges and universities, would no longer be eligible for deduction.

A deduction only for cash gifts to charities also would produce lesser advantages to donors than the current income tax deduction. Allowing an expenditure tax deduction for cash gifts to charity merely equates such gifts with purchases of investment assets which are also deductible. Under the income tax, a donor faced with the choice of giving to charity or saving for his own or his family's subsequent consumption can only obtain a post-tax rate of return on savings which is a function of his tax rate times the pre-tax rate of return. Thus, for example, a taxpayer subject to a sixty percent marginal rate will only obtain four percent after tax of a ten percent pre-tax return. Under an expenditure tax, however, his post-tax return on his reduced consumption would equal the ten percent pre-tax return and the relative cost of instead donating the cash to charity would be greater than under the income tax. If recent empirical studies

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<sup>157</sup> See REPORT OF THE ASSOCIATION OF AMERICAN UNIVERSITIES, TAX REFORM AND THE CRISIS OF FINANCING HIGHER EDUCATION 7-8, 31 (1973), *reprinted in* E. GRISWOLD & M. GRAETZ, *supra* note 83, at 443.

showing a high price elasticity of charitable giving are correct,<sup>158</sup> high income individuals would likely reduce their charitable contribution substantially as giving became more costly. It is therefore quite possible that an expenditure tax would either have to permit charitable deductions for more than one hundred percent of cash gifts or be accompanied by additional tax incentives or direct subsidies for charities.

### C. Depreciable Assets

The current federal income tax in several instances permits accelerated deductions for the cost of certain capital investments, typically permitting amortization of assets before the expiration of their useful lives. Examples are accelerated depreciation for certain kinds of real property<sup>159</sup> and equipment including tangible small business personal property,<sup>160</sup> rehabilitation of low income housing,<sup>161</sup> railroad rolling stock and improvements,<sup>162</sup> certain farming expenditures,<sup>163</sup> pollution control facilities,<sup>164</sup> and expensing of research and development costs.<sup>165</sup> Like other investments, such depreciable assets would receive cash-flow treatment under an expenditure tax with an immediate deduction of the asset's entire cost and taxation of receipts upon sale. Assuming tax incentives for such classes of favored investments would continue to be desired under an expenditure tax, a negative tax rate would again have to apply. Paul McDaniel has suggested that

[r]ealistic comparison of an expenditure tax with an income tax should assume an expenditure tax that, for example, would provide a 200% deduction for equity invested in low-income housing, a 150% deduction for the equity investment in non-residential buildings and a 125% deduction for the equity

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<sup>158</sup> See Feldstein & Clotfelter, *Tax Incentives and Charitable Contributions in the United States: A Macroeconomic Analysis*; Feldstein & Taylor, *The Income Tax and Charitable Contributions: Estimates and Simulations with the Treasury Tax Files*; Boskin & Feldstein, *Effects of the Charitable Deduction on Contributions by Low-Income and Middle-Income Households: Evidence from the National Survey of Philanthropy*; Boskin, *Estate Taxation and Charitable Bequests*, all in 3 THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RESEARCH PAPERS (1977) (commonly known as the Filer Commission).

<sup>159</sup> I.R.C. § 57(a)(2).

<sup>160</sup> *Id.* § 179 (20% deduction in first year).

<sup>161</sup> *Id.* § 167(k) (60 month writeoff).

<sup>162</sup> *Id.* § 184 (60 month writeoff); *id.* § 185 (50 year writeoff).

<sup>163</sup> *Id.* § 180 (immediate deduction for fertilizer, etc.); *id.* § 182 (immediate deduction for land-clearing costs).

<sup>164</sup> *Id.* § 169 (60 month writeoff).

<sup>165</sup> *Id.* § 174 (immediate deduction).

investment in used residential buildings with a useful life of 20 years or more.<sup>166</sup>

#### *D. Life Insurance*

As noted in Part IV, the theoretically appropriate treatment of life insurance would be cash-flow, but Yield-Exemption treatment of life insurance may be politically necessary and does not seem to undermine tax administration.<sup>167</sup> Under Yield-Exemption, premiums should not be deductible, so that the yield from savings through life insurance would not receive favorable treatment vis-a-vis other investments, as it now does under the income tax. If favorable treatment were desired, it would again be necessary to raise the post-tax yield from life insurance above the pre-tax yield. But to the extent that favorable treatment of these investments is justified merely by a desire to create some opportunities for tax-free saving, such treatment would no longer be warranted under an expenditure tax.

#### *E. Summary*

Thus, while substitution of an expenditure tax for the present income tax might stimulate investment generally,<sup>168</sup> special rules would be necessary, as under the income tax, if Congress for nontax policy reasons desires to provide incentives for particular kinds of investments and direct appropriation of funds for such purposes proves politically difficult. Proponents of an expenditure tax may take solace from the elimination of unintended differentials which now often occur under the income tax and from the difficulty of providing relative advantages for particular kinds of investment which would erode the tax base. On the other hand, observers of congressional behavior may suffer apoplexy thinking about the distortions and inequities which would likely occur if Congress were to persist in its income tax ways by offering relative expenditure tax advantages to investments in particular sectors of the economy.

### VII. CORPORATE TAXATION

As a prelude to consideration of the impact on corporate taxation of a shift from an income tax to an expenditure tax, it is essential to explore briefly the role of the corporate income tax in the current system. The dominant analytical posture justifies

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<sup>166</sup> McDaniel, *Comments on Expenditure Tax Design* (by Michael Graetz), in BROOKINGS REPORT, *supra* note 4. These percentages follow the depreciation allowable under I.R.C. § 167.

<sup>167</sup> See pp. 1611-12 *supra* (treatment of life insurance).

<sup>168</sup> See p. 1576 & note 8 *supra*.

a progressive individual income tax (and likewise a progressive personal expenditure tax) by reference to individuals' "ability to pay," and based on this criterion argues that all income should be taxed equally regardless of its source. Under this view, taxation of income at the corporate level is merely a mechanism necessary to ensure that undistributed corporate income does not escape taxation.<sup>169</sup> This theoretical posture suggests a criticism of the current corporate income tax. Corporate earnings distributed to shareholders are taxed more heavily than other kinds of individual income since they are subject to the corporate income tax and taxed at shareholders' marginal rates.<sup>170</sup> Undistributed corporate earnings are, by the same token, undertaxed if the corporate tax rate is less than the shareholder's marginal rate and if the shareholder's tax can be deferred for a long period of time and/or taxed at favorable capital gains rates. In virtually all circumstances, present law creates an incentive for retention rather than distribution of corporate profits and for distribution of corporate income as deductible interest to bondholders rather than as dividends to shareholders.<sup>171</sup> The theoretically correct reform of the current corporate income tax thus becomes evident. The separate corporate income tax should be repealed and undistributed corporate income should be directly attributed to shareholders and taxed at their marginal rates.<sup>172</sup> If any tax were continued at the corporate level, it would be only a withholding tax which would be credited to shareholders as corporate income is distributed or attributed to them. Corporations would be treated merely as conduits for tax purposes and be taxed similarly to partnerships and subchapter S corporations.

From this analytical posture, the fate of a corporate income tax under an individual expenditure tax also becomes clear. Sub-

<sup>169</sup> See R. MUSGRAVE & P. MUSGRAVE, *supra* note 60, at 270-71.

<sup>170</sup> Thus, \$1,000 of corporate income is reduced to \$500 by a 50% corporate income tax, and further reduced to \$150 when distributed to a shareholder with a 70% marginal rate, or to \$400 when distributed to a shareholder with a 20% marginal rate. Although both shareholders end up with less than they would have if the \$1,000 had been earned by them individually (\$300 and \$800, respectively), it is the lower bracket shareholder who pays the greater additional tax as a result of the separate tax on corporate income. Taxes on account of his distribution are increased from 20% to 60%, while the corresponding increase for the 70% shareholder is from 70% to 85%.

<sup>171</sup> See *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 6144, 6153-55 (1978) (statement of Michael Graetz).

<sup>172</sup> See BLUEPRINTS, *supra* note 3, at 69. The practical difficulties of doing this are discussed in C. MCLURE, *MUST CORPORATE INCOME BE TAXED TWICE?* 146-84 (1979); Nolan, *Integration of Corporate and Individual Income Taxes*, 30 S. CAL. TAX INST. 899 (1978); *ABA Simplification Report*, *supra* note 31, at 595-620.



stitution of an expenditure tax for an income tax would eliminate the need to allocate undistributed corporate income to shareholders because an expenditure tax would not in any case apply until funds are devoted to consumption. To the extent that taxation of business is regarded as complementary to the taxation of individuals, a decision to move to a tax on consumption at the individual level therefore implies elimination of taxes on business income; businesses are engaged in production, not consumption. Amounts earned by businesses and retained for additional investment would be exempt from tax just like amounts invested and saved by individuals. Amounts distributed from businesses to their owners would be included in the owners' receipts and taxed unless invested or saved, but no additional tax would be imposed on the business itself, whether it is a corporation, a partnership, or a proprietorship.<sup>173</sup> Individuals would generally be allowed deductions for purchases of corporate stock, and cash receipts relating to stock ownership would be includible for expenditure tax purposes whether in the form of dividends, return of capital, or proceeds from the sale of stock.

Most proponents of expenditure taxation, however, would probably like to uncouple the case for conversion to an individual expenditure tax from any requirement that the corporate income tax be repealed. The corporate income tax is a significant<sup>174</sup> and popular source of revenue, and conditioning an expenditure tax on its repeal would undoubtedly generate significant opposition, while at the same time requiring higher rates or other sources of taxation to produce equivalent revenues. Thus, proponents must advance special reasons for imposing tax on corporations.

Since the corporate income tax predates the individual income tax, arguments for its separate existence abound. Apart from straightforward revenue considerations, these arguments do not tend to rely on any separate "ability to pay" of corporations distinct from that of their owners, but rather on special benefits—such as limited liability—available only to corporations and on nontax regulatory objectives—such as control of monopolies. The difficulty is that neither of these considerations necessarily implies corporate profits as the appropriate tax base.<sup>175</sup> A tax on corporate profits may, however, be justified solely by reference to existing law. This argument, a sophisticated variation on the old-taxes-are-good-taxes theme, contends that the

<sup>173</sup> See BLUEPRINTS, *supra* note 3, at 133-34.

<sup>174</sup> In 1978 the corporate income tax accounted for about 25% of all income tax revenue and 16% of gross revenue collections. COMMISSIONER OF INTERNAL REVENUE, *supra* note 72, at 9.

<sup>175</sup> See R. MUSGRAVE & P. MUSGRAVE, *supra* note 60, at 271-74. See generally R. GOODE, *THE CORPORATION INCOME TAX* (1951).

corporate income tax has been “capitalized” and is now reflected in share prices.<sup>176</sup> Present shareholders would enjoy windfall gains as share prices increased in response to the removal of the corporate tax. Moreover, since corporate profits distributed to shareholders are already overtaxed, a corporate tax on distributed profits would be no worse under an individual expenditure tax than under the current income tax. These arguments might be advanced to justify the continuation of a corporate tax, perhaps even the present corporate income tax.

Retention of the corporate income tax in its current form, however, is necessarily troubling to expenditure tax proponents. First, to the extent that the basic case for expenditure taxation turns on inherent difficulties of income taxation, these difficulties would be retained at the corporate level. Thus, for example, the need to distinguish realized from unrealized gains would continue, as would other timing problems of income taxation, including the need for depreciation allowances and the distinction between capital and deductible expenses. In addition, the structural difficulties of taking account of inflation under an income tax would continue at the corporate level.<sup>177</sup> Moreover, efficiency claims for expenditure taxation in terms of both neutral treatment of alternative forms of investment and increased capital formation would be lost at the corporate level. Finally, a corporate income tax would necessarily abandon the “distinguishing feature” of an expenditure tax: that the taxpayer receive a rate of return on savings equal to the before-tax yield on investments.

As a result, expenditure tax proponents have either advocated repeal of the corporate income tax<sup>178</sup> or have endeavored to describe the form of corporation tax which would best harmonize business taxation with an expenditure tax at the individual level. Taking the latter course, the Meade Commission recommends a “flow of funds” corporate tax base—essentially the excess of total receipts from the sale of goods and services over total expenditures relating to the purchase of such goods and services, including purchases of capital assets. Since earnings which were reinvested would not be taxed, the base would be equal to distributed profits—the “net amount of funds that were taken by shareholders out of the corporate sector of the economy,” generally the excess of dividends over new equity investments.<sup>179</sup>

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<sup>176</sup> See MEADE REPORT, *supra* note 3, at 227; Stiglitz, *Taxation, Corporate Financial Policy, and the Cost of Capital*, 2 J. PUB. ECON. 1 (1973).

<sup>177</sup> A principal argument in favor of the expenditure tax advanced by the Meade Commission is the difficulty of defining income in an inflationary world. See MEADE REPORT, *supra* note 3, at 112.

<sup>178</sup> See BLUEPRINTS, *supra* note 3, at 133–34.

<sup>179</sup> See MEADE REPORT, *supra* note 3, at 233–35.

Rather than repeating the Meade Commission's analysis here, I shall illustrate a flow-of-funds form of corporate tax by a simple example which should make clear the relationship between such a corporate tax and the expenditure tax treatment of investments at the individual level.

Assume an individual has a salary of \$400 and wishes to consume \$150 after tax. Assume further that an expenditure tax with a uniform rate of 50% applies to individuals and that an available investment will yield a before-tax return of 15%. If the taxpayer invests \$100 he will be entitled to deduct that amount and will pay a tax of \$150 on the remaining \$300 tax base, leaving \$150 for consumption after tax. Upon the sale of the investment a year later, the \$115 would be taxed, leaving \$57.50 for after-tax consumption, a 15% return on the \$50 of consumption foregone in order to make the investment.

The basic question is how to structure a corporate tax to produce similar results if the \$100 investment were in the form of a contribution of capital to a corporation. If the \$100 capital contribution were treated as a receipt at the corporate level, and the \$100 corporate investment, say in capital goods, were treated as an offsetting deduction, any tax at the corporate level (other than purely a withholding tax)<sup>180</sup> imposed in addition to tax at the individual level would reduce the amount of after-tax consumption available to the taxpayer below \$57.50. On the other hand, if, as under the Meade Commission's proposal, the \$100 of contributed capital were not treated as a corporate receipt, the corporation would be able to purchase a capital asset costing \$200 (assuming that it could immediately deduct the cost of capital assets, that the corporate tax rate is 50%, and that an immediate refund is available on losses or that the corporation has other income against which it may offset the \$200 deduction). Under such circumstances, the corporation would be investing \$100 and the government contributing an additional \$100 in the form of reduced tax or tax refund. If the asset produced a 15% yield, it would return \$230 after one year which, when subjected to a 50% corporate tax on distribution, would still leave \$115 to be distributed to the shareholder. This would enable the shareholder to consume \$57.50, assuming again a 50% expenditure tax on individuals.

If the funds were reinvested, no corporate tax would be imposed, but the government would continue to share in future yields and would collect tax whenever funds are taken by share-

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<sup>180</sup> Under a withholding tax, any corporate tax would be refunded (probably through tax credits) when amounts are distributed to shareholders and included in their receipts.

holders out of the corporate sector. The government would, of course, be entitled to its 50% share of corporate profits whenever funds were distributed to shareholders, and, at the latest, when the corporation terminates its existence, through a liquidation, for example. Collection would, of course, be possible in the case of a liquidation only if termination occurs when the company still controls the assets and accumulated yield. In effect, the government would have a share in the company's assets which would be realized upon distributions to shareholders, and, in general, the government would be indifferent as to the timing of distributions.

Under such a system, it would be important to ensure that shareholders could not obtain corporate earnings without imposition of the corporate tax. If, in the above example, a shareholder/employee (or lessor) were able to obtain the entire \$30 return in the form of deductible salary (or rent), greater individual consumption would be possible as a result of corporate investments.<sup>181</sup>

The appropriate treatment of debt and interest payments under a flow-of-funds type of corporate tax is not free of doubt. Some analysts recommend that payments to suppliers of finance — whether in the form of dividends or interest — should be taxed and therefore that no interest deduction should be allowed.<sup>182</sup> The Meade Commission, on the other hand, under its version of the flow-of-funds tax, would permit deductions for interest, and in general would treat corporate debt on the same cash-flow basis as individual debt under the general expenditure tax rules. Thus, difficulties in distinguishing debt from equity would remain.<sup>183</sup> Since post-enactment loans would be includible in receipts, however, while equity contributions would not, it would seem possible simply to correlate the imposition of tax on distributions to suppliers of capital with the treatment of that capital when initially supplied. If no inclusion in receipts were required when capital was received by the corporation, the government would have a contingent tax claim when returns on such capital are

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<sup>181</sup> In addition, if such a tax system were adopted at the corporate level, it would be inappropriate to allow any tax credits or other relief on amounts distributed to shareholders as dividends, for allowing such relief would, in effect, reduce the tax on corporate investments below that applicable to other investments. See MEADE REPORT, *supra* note 3, at 248-49.

<sup>182</sup> See J. KAY & M. KING, *THE BRITISH TAX SYSTEM* 200 (1978).

<sup>183</sup> The Meade Commission notes that "it would be necessary to prevent companies from issuing debt to their shareholders at abnormally high interest rates, so that the return on capital which had in fact been financed by share issues . . . would be paid out as [deductible] interest on debt." MEADE REPORT, *supra* note 3, at 241. In this connection, the Meade Commission regards it as necessary to treat interest in excess of a specified rate as a dividend distribution. *Id.*

distributed; if capital were originally included in receipts, returns would be regarded as deductible interest.

The Meade Commission argues that imposing a corporate tax in this manner would produce revenue even though it would not reduce the rate of return on corporate investment. With regard to future transactions, this revenue allegedly would be produced because "the government would receive a tax revenue from any profits made by companies on their real transactions in excess of the rate of interest on government debt."<sup>184</sup> This would occur because the government becomes, in effect, a joint venturer with the corporation, contributing one-half of the original cost of the asset (\$100 in the above example) and receiving one-half of any returns distributed to shareholders. Revenue would also be derived from gain relating to corporate assets on hand at the inception of the tax. Distributed income from such assets would be fully taxed even though the full cost of the asset might not have been deducted in prior years.

Putting aside for the moment the question of "windfall gains" for existing shareholders who presumably invested with the expectation of a continuing tax on corporate income, unless the Meade Commission's argument depends upon expected increases in the aggregate level of investment, it is difficult to understand why its proposed corporate tax would be preferable to elimination of any separate corporate tax (or conversion of the corporate tax to a withholding tax). Returning to the prior example, if the individual had invested in an unincorporated business, only \$100 of assets could be purchased, whereas under the Meade Commission's corporate tax system, if he invested in a corporation, he could obtain an additional deduction at the corporate level and thereby purchase \$200 of assets. To reach equivalent results at the individual level, a deduction would have to be allowed for an amount double the amount of the investment. It is difficult to understand why \$50 of foregone consumption at the individual level should produce \$200 for investment if contributed as capital to a corporation, but only \$100 if otherwise saved or invested. The government would, in effect, be participating as a joint venturer in investments made by corporations in a manner different from investments made directly by individuals.

If only the appearance of a corporate tax were desired (presumably for political reasons), a corporate tax could be designed which would include contributions of capital in corporate receipts, but would be offset by a system of imputation and tax credits at the shareholder level. Such a corporate tax would serve simply as a withholding tax to be refunded to shareholders

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<sup>184</sup> See *id.* at 230.

whenever amounts were distributed and included in the shareholder's receipts. Distortion would result, however, from lags between collection of the tax at the corporate level and refund at the shareholder level. In addition, an entire corporate tax system might be necessary, even though no additional revenue were intended to be collected from corporations. Conversion of all or a portion of the corporate income tax to a withholding tax on dividends might involve difficult practical problems which have been discussed in connection with recent proposals to integrate the individual and corporate income taxes through a system of imputation and tax credits.<sup>185</sup> Alternatively a straightforward withholding tax on distributions by corporations to shareholders could be enacted to apply at a flat rate without any calculation of corporate income or profits. Such a tax would be available as a credit against shareholders' expenditure tax liability.

The distinguishing feature of the Meade Commission's proposed flow-of-funds tax is that it provides a mechanism for collecting some corporate taxes on existing investments made under an income tax regime without distorting new corporate investment decisions made in the environment of an individual expenditure tax. In so doing, it would eliminate any need to distinguish dividends from returns of capital, to determine a taxpayer's basis in corporate stock, to distinguish capital purchases and improvements from deductible expenses, or to adjust corporate taxes for inflation.

The Meade Commission estimates that the revenue yield from a flow-of-funds corporate tax would be no less and might perhaps be more than that now produced from income taxes on the corporate sector.<sup>186</sup> Certain differences between the American and British tax systems are noteworthy, however. First, many British companies currently pay little or no corporate income tax because of a system of "stock-relief" enacted in 1974 which has had the effect of eliminating the corporate tax liability of British manufacturing companies.<sup>187</sup> In addition, since 1973, payment of a certain amount of corporate tax has been imputed to shareholders in the form of a credit against their individual income tax liability on dividends. This means that a significant amount of total British corporate tax revenues are, in effect, withholding taxes. Finally, the Meade Commission bases its revenue estimates on the obviously unrealistic assumption that corporations' behavior would remain the same under the new tax system. While a similar effort at estimating the effects on revenue of a change to a flow-

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<sup>185</sup> See authorities cited note 172 *supra*.

<sup>186</sup> MEADE REPORT, *supra* note 3, at 245. See also *id.* at 61-65.

<sup>187</sup> J. KAY & M. KING, *supra* note 182, at 176.



of-funds corporate tax in the United States is beyond the scope of this Article, it seems quite likely that revenue consequences would be substantial, since no tax would be immediately due with respect to retained earnings. A reduction in corporate tax receipts on the order of fifty-percent or more would not be surprising.

Repealing the corporate tax or converting it to a withholding tax has serious additional implications. Elimination of the corporate tax might, for example, require enactment of direct subsidies to induce corporate investments which now receive tax-preferred treatment or regulations or excise taxes to discourage corporate expenses, such as those for grassroots lobbying, which are now disallowed under the income tax. Moreover, concern with "windfall gains" from repealing the corporate income tax might produce long-delayed effective dates or a phase-out so gradual as to interfere with the fundamental economic justifications for converting to an expenditure tax. If this appears likely, the Meade Commission's proposal for a flow-of-funds corporate tax would merit serious consideration. (Other possibilities, such as a lump-sum tax on assets payable over a number of years, should also be analyzed.) If, on the other hand, retention of a separate corporate tax is predicated on considerations of revenue alone or of corporate privileges (such as political power or limited liability), various possibilities for corporate excise taxes (on total assets or gross sales, for example) should be given attention.<sup>188</sup>

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<sup>188</sup> Another issue that should be mentioned is methods of accounting. Commentators seem to agree that only the cash method of accounting for receipts and expenditures would be appropriate under an expenditure tax. See, e.g., BLUEPRINTS, *supra* note 3, at 135. In the case of a proprietorship, any excess of net receipts over business expenditures would be added to the owner's receipts, and the owner would be allowed a deduction if expenditures exceeded receipts. Likewise, cash distributions from partnerships would be included in partners' receipts and contributions to a partnership or amounts paid to purchase partnership interests would be deductible by the individual partner.

The cash method of accounting is considered appropriate because an accrual accounting system would often tax individuals on amounts not currently available for consumption and would allow deductions for amounts not yet paid and therefore currently available for consumption. Certain cash method accounting problems which have occurred under the income tax would continue under an expenditure tax. The constructive receipt doctrine, for example, would still be applied. See *Hornung v. Commissioner*, 47 T.C. 428 (1967). On the other hand, the cash equivalency doctrine, which has produced considerable litigation under the income tax, would likely not produce significant expenditure tax problems because such issues tend to arise most frequently with regard to notes or other investment assets for which offsetting deductions would be available under an expenditure tax. By the same token, as Part IV indicates, prepayments of expenses other than year-end prepayments would not cause problems under an expenditure tax to the same extent as under an income tax. Requiring businesses to keep

## VIII. INTERNATIONAL ISSUES

A shift by the United States from income to expenditure taxation would have major implications for international transactions.<sup>189</sup> The industrialized countries have tended to assert rights to tax residents and citizens on all income, regardless of where earned, and to tax all income earned in their jurisdiction, regardless of the residence of the person who earns it. The United States taxes its citizens, resident aliens, and domestic corporations on their worldwide income.<sup>190</sup> Nonresident alien individuals and foreign corporations are taxed on income "effectively connected with" the conduct of a United States trade or business and on other items of United States source income through withholding taxes, although the latter are in many cases reduced or forgiven.<sup>191</sup> United States citizens and residents are allowed tax credits for foreign income taxes on foreign-source income, subject to rules limiting such credits to an amount not greater than that determined by applying United States income tax rates to foreign-source net income.<sup>192</sup> In addition, United States shareholders of foreign corporations are generally not taxed on foreign corporate earnings until such earnings are distributed to them. The United States also provides tax relief to its citizens residing abroad in the form of an exclusion from income of a specified amount of earnings.<sup>193</sup> In addition, preferential treatment is granted to domestic corporations on income derived from the active conduct of business in a United States possession and to "domestic international sales corporations" engaged in the ex-

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books and records on a cash basis might, however, produce some additional costs for companies which now maintain their books on the accrual method.

It is interesting to observe that methods of accounting under the expenditure tax differ significantly not only from income taxes but also from value-added taxes, under which accrual accounting is generally the preferred method for businesses. In Europe, for example, the value-added tax generally attaches at the time products are delivered or services rendered and when the recipient becomes obligated to pay, whether or not a cash payment is actually made. Similar results occur under manufacturers' excise taxes in the United States.

If a separate corporate tax were continued in an expenditure tax regime, there is no compelling reason to base such a tax on the cash method of accounting. Accrual accounting should probably be allowed for purposes of the corporate tax, but this should be regarded as a concession to taxpayer convenience rather than a result required by theoretical considerations.

<sup>189</sup> See generally MEADE REPORT, *supra* note 3, at 411-30, 433-42; S. LODIN, *supra* note 3, at 108-14; P. MIEZKOWSKI, *supra* note 3, at 48-57.

<sup>190</sup> See generally W. GIFFORD, TAXATION OF FOREIGN SOURCE INCOME (1977); D. TILLINGHAST, TAX ASPECTS OF INTERNATIONAL TRANSACTIONS (1978).

<sup>191</sup> See I.R.C. §§ 871-896, 1441-1443.

<sup>192</sup> See *id.* §§ 901-904.

<sup>193</sup> See *id.* § 911.

port of goods manufactured in the United States.<sup>194</sup> Precise relations among various industrialized countries' income tax rules are typically governed by treaties. It should be clear from this brief summary of United States income taxation of international transactions that no single principle has governed congressional policy. Although current policy tends in the direction of establishing neutrality among the industrialized countries with regard to the taxation of income, there are important divergencies from this principle.

It has been urged in an income tax context that countries tax the worldwide incomes of their residents.<sup>195</sup> Although the definition of residence is difficult, the residence principle, if accepted internationally, would also seem an appropriate basis for assessing a progressive consumption tax. Receipts would be includible without regard to their source; investments or savings, whether in the United States or abroad, would be deductible; and consumption would be taxed without regard to where it occurs. The need for foreign tax credits would be eliminated and the progressive rate structure would be applied only once to all consumption.<sup>196</sup> A graduated expenditure tax imposed on the basis of residence would differ from other taxes on consumption, such as the value-added tax, which are generally applied only to consumption within the boundaries of the taxing jurisdiction.

The practical barrier to an expenditure tax system based upon the residence principle is that international harmonization would come slowly, if at all. Some industrialized countries would probably retain income taxes, and taxing income based upon its source (rather than its owner's residence) would remain attractive to countries which are net importers of capital. Rather than indulging the unrealistic assumption that with patience international harmonization would occur and expenditure taxation on a residence principle would be adopted throughout the industrialized world, this Part briefly explores the problems that would arise if the United States were to shift to expenditure taxation while taxation in the rest of the world remained unchanged.

#### *A. Consumption Abroad; Nonresident Aliens*

The decision to individualize the tax on consumption through a progressive rate structure clearly implies that United States

<sup>194</sup> See *id.* §§ 931, 991-997.

<sup>195</sup> See BLUEPRINTS, *supra* note 3, at 98-101.

<sup>196</sup> Likewise, if source were adopted internationally as the exclusive basis for taxation, a foreign tax credit would not be needed. In addition, if the United States were to cease taxing on the basis of citizenship, there would be no problems in taxing foreign earnings of nonresidents. None of these possibilities, however, seems likely in the near future.

residents (and perhaps nonresident citizens) should be taxed on their consumption whether the consumption takes place here or abroad; the expenditure tax is designed to tax individuals on the basis of the amounts they consume, and it should not matter where consumption takes place. Notwithstanding a general shift from income to expenditure taxation of United States citizens and residents, it does not seem appropriate for the United States to eliminate its income taxes on nonresident aliens or foreign corporations or its withholding taxes on United States source income earned by foreign residents until it obtains concessions from other countries with regard to foreign-source income earned by United States residents. Thus, for a substantial period of time — at least until treaties can be renegotiated — the basic income tax provisions (or at least withholding taxes) applicable to foreign residents would have to be retained. Even though this state of affairs would produce complexity and run counter to United States tax treaty undertakings to treat investors from treaty countries and domestic investors equally, limiting United States taxation of nonresidents to their expenditures on consumption in the United States does not seem immediately feasible or desirable.

### *B. Foreign Investments*

The treatment of foreign portfolio investments by individuals should create few problems under an expenditure tax. Returns from such investment receive a foreign tax credit for foreign withholding taxes that are “grossed up,” *i.e.*, included in income and credited against United States tax liability.<sup>197</sup> Typically, such taxes are reduced or eliminated by treaties. If cash-flow treatment were adopted for foreign investments under an expenditure tax, similar treatment would be appropriate.<sup>198</sup>

Investment by corporations in ten percent or more of the stock of a foreign company would, however, present more serious problems. Under present law, credits are allowed for foreign taxes attributable to dividends paid.<sup>199</sup> Since there would likely be no determination of “dividends” as under present law and no computation of “earnings and profits,” a major rethinking and restructuring of the foreign tax credit would seem to be required.

If adopting an expenditure tax at the individual level were

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<sup>197</sup> I.R.C. § 901. Corporate portfolio investment of less than 10% of the stock of foreign companies is treated similarly.

<sup>198</sup> If Yield-Exemption treatment were permitted foreign investments, all foreign taxes would be ignored since all returns are excluded from the expenditure tax base.

<sup>199</sup> I.R.C. §§ 901, 902.

accompanied by repeal of the corporate income tax, the most important harmonization question would be whether foreign tax credits relating to income of foreign subsidiaries of United States corporations should be allowed as credits to United States shareholders. Allowing such credits could become quite complex; it would be particularly difficult to determine the applicable individual tax rate to serve as a limitation on allowable credits.<sup>200</sup> Since income which is reinvested would be subject to a zero rate of United States tax, no credits should be allowed with regard to undistributed income. Since income earned domestically would be taxed on a cash-flow basis, similar treatment should apply to income earned abroad. Foreign taxes paid with respect to distributed income would be included in shareholder's receipts. The shareholder would then compute his tax on the basis of the "grossed up" dividend, and take a credit for the amount of foreign tax paid.<sup>201</sup> Including foreign taxes in income and crediting such taxes should achieve equal treatment of domestic and foreign investment regardless of the tax rate of the foreign country or of the individual investor, assuming that the pre-tax returns on investment in the two countries are identical.<sup>202</sup>

On the other hand, it might be argued that allowing imputation and credit would, in effect, treat foreign corporate income taxes as if they were withheld expenditure taxes of the individual, and that foreign taxes should not be imputed and credited with

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<sup>200</sup> See *ABA Simplification Report*, *supra* note 32, at 617-20, for a discussion of some of these problems.

<sup>201</sup> If grossing up were not required and if individuals were allowed both an immediate deduction for the purchase of investment or business assets and foreign tax credits with respect to such investments, the post-tax rate of return on reduced consumption would exceed the pre-tax rate of return on foreign investments while the post-tax rate of return would equal the pre-tax rate of return on domestic investments. Assume, for example, that an individual subject to a 50% expenditure tax rate wishes to reduce his consumption by \$500 and invest \$1,000. He is considering choosing between two investments in similar companies. Company A will earn \$100 domestically which will be distributed as dividends. Company B will earn \$100 through foreign subsidiaries abroad, will pay foreign income taxes on that income of \$20, and will distribute the remaining \$80 as dividends. If the taxpayer invests in Company A he will receive \$100 which would be included in his receipts and subjected to a 50% tax unless saved or reinvested. The \$50 after-tax return on the \$500 of reduced consumption would equal the before-tax return of 10%. If he invests in Company B, he will receive an \$80 dividend that, if a \$20 foreign tax credit were allowed, would produce a \$60 after-tax return — or 12% on reduced consumption under circumstances in which the company earned 10% before tax. In fact, the higher the foreign tax rate, the higher the post-tax rate of return. See *American Chicle Co. v. United States*, 316 U.S. 450 (1942).

<sup>202</sup> If the foreign tax were a tax on consumption, there would be no need for a tax credit or imputation to preserve equal treatment of foreign and domestic investment.

respect to the foreign investment because any lesser return from the investment abroad is due to the foreign country's decision to impose an income tax rather than an expenditure tax. This argument suggests denying credits for foreign income tax altogether. Denying foreign tax credits would simply require inclusion of cash receipts from foreign investments in the United States expenditure tax base, but would result in an advantage for domestic investments, whose returns would not be reduced by income taxes.

Limiting either imputation and crediting of foreign taxes or denial of foreign tax credits to instances in which investments have been subject to United States expenditure tax treatment would require distinguishing pre-enactment from post-enactment investments, an extremely difficult rule to administer. This might be necessary, however, if continuing present treatment of foreign investments made under the current income tax rules were considered necessary by the Congress. If such a "grandfather" provision proves necessary, it would be simpler to continue to allow the foreign tax credit with respect to all foreign-source income, but to deny immediate deduction for investments abroad. While such a distinction might create controversy under the General Agreement on Taxes and Tariffs, there are precedents; the investment credit, for example, does not apply to foreign investments by United States corporations or individuals.<sup>203</sup> Such a rule, however, would require retention of income tax treatment for foreign-source income. It would then be necessary, for example, to distinguish depreciable from nondepreciable assets and to provide depreciation allowances with respect to the former as under the current income tax. The prospect of an expenditure tax system for domestic investments coupled with an income tax system for foreign investments is not appealing.

A far simpler solution would be to treat all foreign-source investment and income on a cash-flow basis, and either impute and credit foreign income taxes to shareholders or disallow foreign tax credits altogether. The impact of such rules on the international flows of capital and labor merits further study. The issue of deferral of taxation of income earned abroad, which has engendered great controversy under the income tax, should disappear under an expenditure tax.<sup>204</sup> Foreign-source receipts would be includible in expenditure tax accounts on the same cash-flow basis as other investments.

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<sup>203</sup> See I.R.C. § 48(a)(7).

<sup>204</sup> There are special provisions of the code to eliminate or limit deferral by taxing U.S. shareholders of controlled foreign corporations on certain types of distributed earnings of such corporations. See I.R.C. §§ 951-964 (Subpart F); *id.* § 553 (foreign personal holding companies).



*C. Emigration and Immigration*

The Meade Commission and Professor Lodin argue that there will be a substantial incentive for persons to leave an expenditure tax country when they intend to dissave by living on previously accumulated capital. To deal with this problem the Meade Commission proposes a special tax on emigrants that is intended to recapture relief initially granted when taxpayers were allowed deductions for savings.<sup>205</sup> It would require taxpayers to know the total value on the date of emigration of all assets previously deducted in calculating expenditure taxes; the value, adjusted for inflation, of assets as of the date the expenditure tax was introduced; and the value, adjusted for inflation, of gifts and bequests subjected to transfer tax. Additional adjustments would be required if the taxpayer were previously an immigrant. As an alternative, the Meade Commission suggests a special tax on the entire value of an emigrant's assets. Professor Lodin's proposals are substantially similar.<sup>206</sup>

Lengthy discussion of these proposals does not seem necessary; they are unworkable and probably impossible to enforce in the United States—certainly impossible without restrictions on the movement of capital to foreign countries. Although the predictions by the Meade Commission and Professor Lodin of widespread avoidance of British and Swedish expenditure taxes through emigration are troubling, the problem may be more significant for European countries than for the United States. It is simply impossible to know in advance whether the shift from an income tax to an expenditure tax will induce United States citizens to emigrate in any significant numbers.<sup>207</sup> In one sense at least, the tax avoidance problem seems likely to be less significant under an expenditure tax than under an income tax. Under an income tax, persons need only move capital to another country to avoid tax; under an expenditure tax, an individual would have to move himself. Moreover, if nonresident United States citizens were subject to expenditure tax on worldwide consumption, they could avoid tax only by abandoning citizenship. Elaborate mechanisms to deal with emigrants should be avoided unless and until expenditure tax experience demonstrates that they are essential.

New problems of enforcement and collection, however, do

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<sup>205</sup> See MEADE REPORT, *supra* note 3, at 438–42.

<sup>206</sup> See S. LODIN, *supra* note 3, at 108–10. Professor Lodin's proposals would be easier to adopt in Sweden because that country already has a net wealth tax.

<sup>207</sup> In any event, any such tendency of United States citizens and residents to emigrate should be offset by the countervailing tendency of persons to immigrate to the United States to avoid income taxes abroad.

seem likely to arise under an expenditure tax when individuals obtain a deduction upon purchase of an asset and attempt to exclude the asset's sale price from receipts, perhaps by selling it abroad. Under an income tax, all that is at stake when assets are sold is the tax on the gain from the asset; under an expenditure tax, the asset's entire sale price would be included in the base, and, if not included, tax-free consumption in an amount equal to the entire sale price could be achieved. Thus, greater policing of foreign sales, including those of foreign trusts, may prove necessary.

Because expenditure tax deductions would be allowed for the purchase of investment assets, it would seem necessary to include in receipts for the year of immigration the amount of cash (or consumption goods) imported by immigrants or otherwise to limit the amount an immigrant can deduct against subsequent receipts. If such rules were not adopted, immigrants would consume imported cash free of expenditure tax. The treatment of cash brought to this country by immigrants is related to the general treatment of cash balances upon enactment of an expenditure tax, a problem which is discussed in Part IX.

#### IX. TRANSITIONAL PROBLEMS

The change from income to expenditure taxation would constitute a major revision of the tax system and would require careful consideration of transitional problems. The expenditure tax base of those low income taxpayers who spend more than their income would be greater than an income base, but rates and exemptions could be adjusted to eliminate any increase in tax. For many low and moderate income taxpayers whose income and consumption are approximately equal, the change would not significantly affect tax liability and should cause no special problems. By contrast, the situation of taxpayers who have accumulated wealth under an income tax that would be spent under an expenditure tax has brought forth special transitional proposals.<sup>208</sup> For example, a retiree who had saved his earnings under the income tax to consume during retirement would be liable for expenditure tax on this amount. Such taxation of income which has been taxed in the past has been denominated a "carryover problem."<sup>209</sup> A second problem — a "price change"<sup>210</sup> — would arise for persons whose investments received preferential treat-

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<sup>208</sup> MEADE REPORT, *supra* note 3, at 187-92, 198-200; S. LODIN, *supra* note 3, at 123-27; see BLUEPRINTS, *supra* note 3, at 181-215.

<sup>209</sup> BLUEPRINTS, *supra* note 3, at 182.

<sup>210</sup> *Id.* at 183.

ment under the income tax but would not under an expenditure tax. The price of such assets would decline as investors sold them to buyers no longer attracted by a tax-favored yield. Here the alleged inequity would not be due to prior income tax burdens, but rather to the frustration of expectations that the investments would continue to receive favored treatment.

There are two basic attitudes which might inform recommendations for transition. The politically dominant approach to significant changes in the tax law has been to protect the expectations of taxpayers who have "relied" on existing law; protection typically takes the form of "grandfathered" effective dates.<sup>211</sup> The Treasury argues in *Blueprints* for grandfathering whether "price changes" or "carryover problems" are involved. An alternative perspective about tax law transitions, which I have advanced in greater detail elsewhere,<sup>212</sup> is that neither fairness nor efficiency demands grandfathered effective dates, but that when the magnitude of change is large, its impact should be reduced through delayed or phased-in effective dates rather than grandfathering.

It may be possible to distinguish some effects described by the Treasury as "carryover problems" from "price changes," because the wealth effects of the former would not necessarily be reflected in the market price of individual assets, but the two kinds of problems are generally similar in effect. In the case of a retiree who had accumulated wealth to consume during retirement, funds available for consumption would necessarily be less than was anticipated. Likewise, when an asset declines in value because its yield is no longer treated advantageously under the new law, the owner's ability to consume is also decreased. Assuming the decrease in consumption in each case were similar in magnitude, I would treat the problems analytically as one — as a wealth reduction due to a change in law.

Assuming that the relevant criterion is the magnitude of the loss of wealth due to frustration of expectations, the question remains under what circumstances expectations should be protected. The argument that reliance on existing law should be protected as a matter of fairness is problematic and suffers from circularity. This argument, in effect, would treat the recipient of a tax benefit as if he had entered into a contract with the government which precluded the government from changing the law. Tastes and social conditions change, however, and such

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<sup>211</sup> See sources cited note 208 *supra*.

<sup>212</sup> See Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977); *ABA Simplification Report*, *supra* note 31, at 676-86.

changes are often reflected through the political process as changes in law. To be reasonable, expectations in the tax law context should be tempered by the subjective probability that the law will be altered. Individual reliance on the status quo simply does not suffice as a basis for compensation or grandfathered effective dates.

Fairness arguments grounded upon individuals' reliance have tended to concentrate on protecting only those individuals who are nominally affected by a change in the law. For example, in the case of an exemption for state and local bond interest, advocates of compensation to losers would compensate only the holders of tax-exempt bonds. It has not been suggested, however, that issuers of tax-exempt bonds, who may well have structured their financing plans on the expectation that exempt status would continue into the future, are entitled to continuation of the tax exemption because of their "reliance" interest. Nor has it been argued that those who demanded or supplied substitutes, on the assumption that the exemption would continue, should also be protected. If the fairness of change depends upon individual reliance, all persons who might be expected to have altered behavior because of a particular tax rule must be protected.

If fairness demands protection of all whose expectations are upset by a change in law, grandfathered effective date rules will typically be inadequate to the task. Nothing short of perfect stability of legal rules seems likely to suffice. Uncertainty necessarily will produce winners and losers. But a requirement that once a law is enacted it must remain unchanged raises fairness problems itself, particularly in the context of law produced by representative democratic political institutions subject to periodic changes in representation and political leadership.<sup>213</sup>

#### *A. The Problem of Income Tax-Favored Investments*

Upon the introduction of an expenditure tax, holders of assets whose proceeds now receive favored treatment would tend to suffer a decline in value as favorable tax treatment is extended to investments generally.<sup>214</sup> This effect will be explored with reference to state and local bonds, on the assumption that interest on such bonds would be included in receipts under an expenditure tax and therefore treated similarly to return on other investment assets.

<sup>213</sup> See Graetz, *supra* note 212, at 65.

<sup>214</sup> Analogous issues regarding changes in the law arise in an income tax context. See, e.g., *id.*; BLUEPRINTS, *supra* note 3, at 181-215; Committee on Tax Policy, New York State Bar Association, *Retroactivity of Tax Legislation*, 29 TAX LAW. 21 (1975); Note, *Setting Effective Dates for Tax Legislation: A Rule of Prospectivity*, 84 HARV. L. REV. 436 (1970).

If owners of state and local bonds were not protected through a grandfathered effective date rule, the value of their bonds would decline relative to other investment assets and there would be no difference in the value of state and local bonds and, for example, corporate bonds of similar risk. Protecting holders of tax-favored assets by a grandfathered effective date, however, may result in an increase in the value of the asset. For example, under the income tax, if the exclusion of interest on municipal bonds were repealed only for bonds issued after the date of enactment, interest on previously issued bonds would remain exempt from tax. Since the bonds are not perpetual obligations, once all of the bonds outstanding as of the enactment date reach maturity, all interest would be subject to tax. The maximum supply of tax-exempt bonds would be fixed as of the date of enactment, and with varying maturity dates for the bonds outstanding at that time, the supply of tax-exempt bonds would subsequently shrink until all of the bonds had matured. With a grandfathered effective date, the value of outstanding municipal bonds would rise as higher bracket taxpayers purchased these bonds from lower bracket taxpayers.<sup>215</sup>

In order to protect the position of those who enjoy favored treatment under the income tax, special rules would be needed to distinguish the expenditure tax treatment of municipal bonds from that of other assets. If other pre-enactment assets were generally included in initial expenditure tax receipts, exemption of yield or deduction for basis (or value) of income tax-favored assets would protect the owners of such assets. If, on the other hand, pre-enactment assets were generally provided a special transitional expenditure tax deduction or exclusion, an additional benefit would have to be provided to maintain the relative advantage of the tax-favored investment. For example, if pre-enactment corporate bonds were treated as expenditure tax prepaid (either through the Yield-Exemption option which would exclude the interest and sale price of such bonds from tax receipts, or through an immediate deduction for the assets' basis or value), it would be necessary to provide *both* an expenditure tax

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<sup>215</sup> See Graetz, *supra* note 212, at 60-63. Subsidizing production of specified goods, through favored tax treatment or otherwise, will typically result in a decrease in the price of the subsidized goods and an increase in their output. The precise effects of the subsidy on price and quantity would depend upon the elasticities of supply and demand of the good. If the subsidy were repealed, *ceteris paribus*, the output and price would be expected to return to the equilibrium in effect before the subsidy was introduced. But if certain firms were grandfathered so that their subsidies would be continued, those firms would enjoy economic rents (in this case, increased relative value).

exclusion and a deduction for state and local bonds issued before the date of enactment.

The problem of special transitional treatment of income tax-favored assets is further complicated by arguments that certain assets which have received preferential income tax treatment should be treated *less* favorably under an expenditure tax. The Meade Commission, for example, argues that pension benefits which have received expenditure tax treatment under the income tax (*i.e.*, were not taxed when earned) should not be eligible for the transitional exclusion treatment proposed for assets which have previously been accumulated out of after-tax income. In fact, the Meade Commission would reduce the amount of assets otherwise eligible for transitional relief by the amount of accumulated pension benefits.<sup>216</sup> State and local bonds might also be characterized as having approximately received expenditure tax treatment under the income tax (although they are advantaged through Yield-Exemption rather than Immediate-Deduction). This fact, however, would be of little comfort to persons concerned with the adverse wealth effects (due to the decline in value of such bonds) which would occur if no special treatment were provided.

In general, grandfathered effective dates should not be enacted to protect assets that have received favored treatment under the income tax. Grandfather rules should typically be rejected in favor of delayed or phased-in effective dates.<sup>217</sup> The owners of assets that received preferential treatment under the income tax law would suffer a decrease in wealth which would, in effect, be attributable to the termination of the income tax on *other* investments. Under such circumstances, the arguments for protecting those who hold tax-favored investments seem even less compelling than in the context of income tax repeal of tax-favored treatment, even though their disappointment (and the decline in the value of their assets) would be identical.

### *B. The Problem of Wealth Accumulated After Payment of Income Taxes*

Commentators who have considered transition to an expenditure tax have been principally concerned with persons who have accumulated wealth out of taxed income and would spend it after enactment of an expenditure tax. Taxation of such expenditures is considered inequitable if such an individual is compared with one whose income, savings, and consumption all occur after or before enactment of an expenditure tax. The combined income

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<sup>216</sup> See MEADE REPORT, *supra* note 3, at 190.

<sup>217</sup> See Graetz, *supra* note 212.



and expenditure taxes on an individual caught in the transition might be greater than the total taxes which would be imposed if all his income, savings, and consumption had taken place under either an income tax or an expenditure tax.

To prevent this putative inequity, *Blueprints*<sup>218</sup> and Professor Lodin<sup>219</sup> recommend that at the inception of an expenditure tax all existing assets should be treated as tax prepaid; in other words, pre-enactment assets would not be taxed on a cash-flow basis but rather would be excluded from expenditure tax computations. To minimize "inequitable distribution effects" of such treatment, the Treasury recommends that taxpayers be required for a ten-year period to compute both income and expenditure tax liability and pay the greater amount.<sup>220</sup> All unrealized capital gains would be subjected to income taxation at the end of the ten-year transition period. The Meade Commission also raised the possibility of phasing-in the expenditure tax by substituting an additional one-tenth of the expenditure tax base for an equal share of the income tax base each year for ten years.<sup>221</sup> Because of reservations about this approach, however, the Commission alternatively recommended that individuals who hold assets on the date of enactment be given tax relief. Such relief would be limited to an amount which would vary directly with the taxpayer's age.<sup>222</sup> This limitation is presumably intended to ensure that wealthy individuals would not avoid all payment of expenditure taxes into the indefinite future simply because they have paid income taxes in the past. If, for example, relief were not subject to such a dollar limitation, a person with \$1,000,000 of assets treated as expenditure tax prepaid on the date of enactment could consume \$100,000 a year tax-free for ten years, even if she earned no additional income. If additional income were earned and saved, the imposition of expenditure tax might be delayed indefinitely.

Assuming that the alleged inequity due to a shift from income to expenditure taxation for persons with pre-enactment wealth should be addressed, the principal objection to the Treasury and Meade Commission recommendations is that they are unduly complex. Each involves a ten-year phase-in during which individuals are required either to compute both income and expenditure tax or to make fractional "expenditure tax adjustments" to income tax calculations; the Meade Commission re-

<sup>218</sup> See *BLUEPRINTS*, *supra* note 3, at 209.

<sup>219</sup> See S. LODIN, *supra* note 3, at 123.

<sup>220</sup> See *BLUEPRINTS*, *supra* note 3, at 205, 209-11. The Treasury suggests that this requirement might be limited to wealthier taxpayers. See *id.* at 214 n.12.

<sup>221</sup> See *MEADE REPORT*, *supra* note 3, at 188.

<sup>222</sup> See *id.* at 189-91.

quires full valuation of assets at the date of enactment,<sup>223</sup> and both the Meade Commission and the Treasury require realization of all unrealized gains prior to making the expenditure tax fully effective.<sup>224</sup> In addition, the Treasury's transitional proposals are complicated by the decision to permit the expenditure tax Yield-Exemption option for financial assets, discussed in Part IV.

If relief is to be granted with respect to assets acquired before enactment, it should take the form of an immediate deduction of the basis of assets held on the date of enactment (perhaps limited to a maximum dollar amount with a carryover or required spread over a period of years). This would eliminate the need for a realization date for unrealized capital gains and also would eliminate any need for taxpayers to sell pre-enactment assets to obtain expenditure tax deductions. In addition, it would avoid any subsequent increase in tax-free consumption from post-enactment appreciation which would be possible under the Treasury's proposal to exempt pre-enactment assets from expenditure tax computations.

Because of the variety of fully and partly exempt sources of income under current law, limiting relief to assets that have been purchased with taxed income would add complexity to the transition. For example, pension benefits have not been taxed, and realized capital gains have been only partly taxed. Inherited wealth has been taxed only to the extent that unrealized gains have not escaped income taxation through stepped-up basis provisions. Investments in state and local bonds, real estate, oil and gas, motion pictures, farming, etc., might have been untaxed, partly taxed, or subsidized. Although one might argue for special rules either to deny transitional relief or to preserve tax-favored treatment in such cases, unacceptable complexity would necessarily result from either choice. On balance, I would deny special transitional relief to all assets without attempting to determine whether they were accumulated from taxed or untaxed income. Providing transitional relief limited to cases in which income was previously taxed (since the equity case seems somewhat stronger here) would necessarily require higher tax rates on consumption (and therefore a greater tax burden on wages) and would cause undue complexity in compliance and administration.<sup>225</sup>

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<sup>223</sup> See *id.*

<sup>224</sup> See *id.*; BLUEPRINTS, *supra* note 3, at 205, 209-11.

<sup>225</sup> To avoid the most difficult problems of transition described in the previous Sections of this Part, Professor Andrews, following Kaldor, has recommended that the transition to an expenditure tax should be approached by first phasing in a "supplemental personal expenditure tax." Andrews, *A Supplemental Expenditure Tax*, in BROOKINGS REPORT, *supra* note 4; N. KALDOR, *supra* note 1, at 224.

In the short run at least, the change from an income tax to an expenditure tax should increase the after-tax return from savings and investments and would thus benefit those who are able to save, whether from wages or accumulated wealth. The principal difficulties of transition would occur for persons who

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This tax would basically be a graduated cash-flow expenditure tax designed to replace that portion of the income tax with marginal rates in excess of 40%. An exemption of \$20,000-\$30,000 would be allowed to exempt from the tax all taxpayers below the 40% marginal income bracket. Professor Andrews argues that such a tax would maintain the progressivity of current income tax law and would, at the same time, eliminate "the worst distortions and inequities in the existing [income] tax [which] result from the application of very high marginal rates to a base in which there are [wide] disparities in the treatment of investment returns." Andrews, *supra*. Existing disparities in the treatment of such returns would be maintained in the basic income tax but the supplemental expenditure tax would be imposed on a comprehensive tax base which would not provide tax incentives for particular kinds of investments. Whether this is politically possible, even in the context of a supplemental expenditure tax, is doubtful. Professor Andrews apparently believes that retention of a basic income tax with rates up to 40% would enable a supplemental expenditure tax to be enacted without any of the restructuring of the corporate income tax or international taxation which this Article considers essential to enactment of a general expenditure tax. Such issues deserve careful attention. Problems of coordinating the supplemental expenditure tax with the income tax also appear inevitable. Difficulties might occur, for example, if gifts were taxed to donors under the income tax and to donees under the expenditure tax.

Professor Andrews' proposal is related to a suggestion advanced by the Meade Commission. MEADE REPORT, *supra* note 3, at 204-15, 442-46. The Meade Commission also considered a graduated expenditure tax limited in application to higher bracket taxpayers, to ease the transitional problems of moving to a generally applicable expenditure tax. *Id.* at 213. It would, however, have combined a graduated expenditure tax with a single basic rate of tax on consumption (probably in the form of a value-added tax) rather than with an income tax.

Each of these approaches to transition merits detailed consideration. I have argued elsewhere that a graduated expenditure tax may be desirable as a replacement for the minimum tax provisions of current law. Graetz, *supra* note 107. However, for this purpose an expenditure tax should be an *alternative* to the income tax—payable by taxpayers with substantial incomes (say over \$50,000) whenever it exceeds the individuals' regular income tax liabilities—not an additional tax as recommended by Professor Andrews.

The most troubling aspect of the Andrews proposal is its treatment of savings. Professor Andrews argues that adopting a supplemental personal expenditure tax in place of income tax rates over 40% would provide "relief for savers" on a much more "coherent and uniform basis" than the many special provisions of the current income tax, concluding that "[t]he structure of the change assures that it would give the most relief to those whose savings are now most severely taxed." Andrews, *supra*. While this is certainly true, the fact that the proposal provides a tax advantage only for the savings of persons with taxable incomes of about \$30,000 or more raises serious questions about its fairness. The Meade Commission would avoid this difficulty by advantaging the savings of all taxpayers, and its combination of a value-added tax and a supplemental graduated expenditure tax seems preferable to Andrews' income-expenditure tax combination.

consume a large portion of their wealth in the early years following enactment and would thus be unable to enjoy the increased after-tax returns from savings which would likely accrue in the short run under an expenditure tax.<sup>226</sup> This circumstance is likely to occur most frequently for retired elderly taxpayers.

The income tax contains three principal benefits available to taxpayers aged sixty-five or over. The first of these benefits is the exclusion from income of social security benefits (which have been recommended for taxation under an expenditure tax).<sup>227</sup> The second is an extra personal exemption of \$1000 available to every person aged sixty-five or over.<sup>228</sup> The third is the retirement income credit, which is designed to reduce tax on elderly persons' income (including a certain amount of earnings) so long as total income is limited,<sup>229</sup> principally benefiting low and moderate income taxpayers. These income tax provisions have been adopted over the past forty years without any comprehensive rationale. Although some form of reduced income taxation for the elderly can be supported on the grounds that the income tax penalizes deferred consumption relative to present consumption, the precise benefits of current law are quite difficult to justify theoretically. Under an expenditure tax, the main argument for special benefits for the elderly generally disappears. Taxpayers who defer consumption until retirement would not face any relative tax disadvantage.

The current generation of elderly persons, however, has been subject to income tax during its working years and would be subject to expenditure tax after retirement without the offsetting benefit of being able to save for a substantial period of time under advantageous expenditure tax conditions. It would therefore seem appropriate to continue some special benefit for the elderly during the early years of expenditure taxation. This could take the form of a special dollar exclusion which could be a large amount when the tax is first introduced and gradually phased down.<sup>230</sup> It should be recognized, however, that there will be tremendous political pressure to maintain a special benefit for the elderly at a high level. Thus, while such a special exclusion is considerably simpler (and, as this Section has argued, preferable on other

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<sup>226</sup> The question whether any increase in after-tax return would occur under an expenditure tax in the long run, or whether increases in the supply of capital would result in a reduction of pre-tax and therefore after-tax returns, is beyond the scope of this Article.

<sup>227</sup> See p. 1594 *supra*.

<sup>228</sup> See I.R.C. § 151(c).

<sup>229</sup> See *id.* § 37.

<sup>230</sup> To avoid an abrupt difference in tax burdens due to age at enactment, the special benefit would also probably have to be phased in for taxpayers between ages 60 and 65.

grounds) than other forms of transitional relief, its attendant political risks are serious.

For taxpayers other than the elderly, a delayed effective date would provide an opportunity to make adjustments to the new system and would reduce the impact of the change. A phase-in of the expenditure tax seems less feasible than a delayed effective date because it would be necessary to retain all or part of the income tax during the phase-in period to maintain aggregate revenues. A phase-in would therefore require computation of both income and expenditure tax liabilities during the transition. A delayed effective date would enable individuals who had received more favorable treatment under an income tax to realize gains or losses while the income tax was still in effect. Transactions subsequent to the effective date would result in taxation if proceeds were consumed, but if proceeds were reinvested, no expenditure tax would be due. It would seem appropriate, however, to provide greater ability during the transition period than under current law to obtain income tax deductions for capital losses. If further relief is considered essential, a deduction for a limited amount of pre-enactment assets' bases could be provided, but no such rule is recommended.

### *C. The Problem of Initial Cash Hoarding*

Because financial assets would be taxed on a cash-flow basis and gain on consumer durables would be included in receipts,<sup>231</sup> the widespread pre-enactment shifting to "tax-prepaid" assets feared by the Meade Commission and the Treasury would have to take the form of pre-enactment hoarding of cash or pre-enactment purchases of consumption for post-enactment use. If, for example, taxpayers were to stuff their mattresses with currency before the tax were implemented, these amounts could then be consumed without being taken into receipts and therefore without incurring any expenditure tax liability. Cash hoarding would be a problem only preceding enactment of the expenditure tax. Subsequent to enactment it would be to taxpayers' advantage to put cash into savings or investments which would produce an immediate deduction. If, as has been recommended in this Part, no transitional relief were to be provided for assets generally, initial cash balances should be included in receipts. To detect such cash, it would probably be necessary as a practical matter to rely on information reports of large withdrawals from savings accounts and of substantial sales of investment assets. Such detection would nevertheless be quite difficult.

As an aid to enforcement, it would probably be desirable to

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<sup>231</sup> See pp. 1598-620 *supra*.

require individuals to file an initial report listing all assets on hand at the inception of an expenditure tax. If willful misstatements were subject to punishment as fraud, truthful information would likely be forthcoming. In addition, if an expenditure tax were implemented with a delayed effective date and a statement of assets were required immediately following enactment, converting assets to cash prior to the effective date would result in a loss of earnings. This might have some further impact in deterring cash hoarding. A report of initial wealth could also be required if, as a transitional matter, tax-free expenditures out of savings accumulated before enactment of the expenditure tax were permitted. Conversion of assets to cash would not be a problem with such a transition, but such statements would burden both the Internal Revenue Service and taxpayers and should not be required unless potential cash hoarding is expected to be substantial.

#### X. CONCLUSION

The foregoing analysis suggests that the obstacles to implementing a progressive personal tax on consumption would be substantial, but not absolutely prohibitive. An administratively feasible expenditure tax is possible in the United States today, but it is impossible to know whether a consumption tax which would emerge from the political process would in fact achieve the efficiency and fairness advantages that its proponents claim are theoretically possible. Moreover, the problems of implementation which have been identified in this Article suggest the need for great caution in going forward with expenditure tax proposals.

The following problems will likely prove particularly burdensome:

First, an expenditure tax seems to require a tax-exclusive base and thus extremely high nominal marginal rates — well in excess of 100% — if an approximation of the distributional burden of the current income tax is to be maintained. The impact of such a rate structure both in terms of acceptance of the tax by the populace and its impact in producing distorted behavior require careful attention.

Second, expenditure taxation at the personal level implies no separate tax on income of corporations. Repeal of the corporate income tax would result in the loss of a significant source of revenue and would be quite unpopular politically. On the other hand, retention of the corporate income tax in its current form would eliminate many of the advantages asserted on behalf of an expenditure tax. In particular, the problems of deprecia-



tion, taxing inflationary gains, and distinguishing realized from unrealized gains are extremely important at the corporate level. A compromise that would restructure the corporate tax to conform more closely to the existence of an expenditure tax at the personal level seems likely to reduce revenues substantially, and at the same time to produce a subsidy, rather than a tax, for new corporate investments.

Third, coordination of expenditure taxation in the United States with income taxation and value-added taxation by the other industrial nations will be quite difficult as a practical matter, and may well have significant effects on international flows of capital and labor.

Fourth, the transitional problems of moving from income to expenditure taxation are likely to prove enormously troublesome. While this Article has argued for a relatively simple transition with transitional relief generally limited to elderly taxpayers, these proposals are contrary to the prevailing view which requires grandfathering of prior transactions and are thus unlikely to prove politically acceptable. Other transitions — the Treasury's proposal for a ten-year period of joint income and expenditure taxation, for example — would be very burdensome to both taxpayers and the Internal Revenue Service.

Fifth, if gifts are taxed to donees (which this Article has suggested as the appropriate expenditure tax rule), new taxes on wealth or significantly increased transfer (estate and gift) taxes appear essential to maintain the distributional pattern of existing taxes. New wealth taxes will create important questions of design and implementation themselves, and increased transfer taxes run directly counter to recent legislation reducing the estate tax base by about one-third. In addition, to the extent that a move from income to expenditure taxation requires new or increased taxes on savings, many of the efficiency advantages claimed for the expenditure tax will be reduced.

Sixth, if the congressional practice of subsidizing particular investments or other transactions through income tax deductions and exclusions were to be incorporated into a personal expenditure tax, many of the simplification advantages claimed for the tax would disappear. Records of basis, for example, would be required if the present favored treatment of charitable contributions of property were to be retained and negative taxes would be necessary to advantage special kinds of investments, such as state and local municipal bonds.

Seventh, if a broadly available Yield-Exemption option such as that proposed by the Treasury in *Blueprints* were essential to adoption of the tax, tax gamesmanship would be well-rewarded,

tax shelters would likely abound, and considerable complexity in tax practice relating to investment advice would remain.

Eighth, expenditure taxation increases the need to include in the personal tax base fringe benefits and expenditures which now qualify as business deductions.

In sum, the practical problems of implementing a graduated tax on consumption are indeed great—far greater than has been previously suggested by its recent proponents. Given these practical difficulties, proponents of such a tax should be required to demonstrate that its claimed advantages in terms of equity and economic efficiency are real and cannot be achieved in a simpler fashion—either through changes in the income tax, such as new deductions for some amount of individual savings and increased opportunities to rollover and defer taxation of investment gains or, more dramatically, through a value-added or national sales tax for the majority of taxpayers with an income tax for upper income individuals. Unless and until this burden is met, replacing the income tax with a progressive personal tax on consumption should remain low on the list of political priorities, and the principal utility of expenditure tax analysis should continue to lie in illuminating issues of income taxation and increasing our understanding of tax policy.