Progressive Consumption Taxes

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Progressive Consumption Taxes

MITCHELL L. ENGLER*

INTRODUCTION

Consumption taxation recently has taken center stage as an enticing, and realistic, possibility at the federal level. After years of debate, an academic consensus has emerged that favors the consumption tax, especially as it would close significant loopholes under the income tax. The consumption tax’s political prospects have increased along with its burgeoning intellectual appeal. The Bush Administration, armed with enhanced Republican Congressional control, has made fundamental tax reform a second-term priority, and the Administration has a known affinity for the consumption tax.

As intellectual and political forces move the consumption tax to the forefront, critical issues remain. A conventional retail sales or value-added tax (VAT) eliminates the current progressive rate structure, raising persistent distributional objections. In hopes of achieving the

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* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. I am grateful to Reuven Avi-Yonah, David Carlson, Arthur Jacobson, Kyle Logue, Ed Zelinsky, and all the participants at the University of Michigan Law School Tax Policy Workshop for their helpful comments. I would also like to thank Michael Giusto, Julia Rubin and Mark Schwed for their valuable research assistance.


2. This involves unintended structural loopholes, not intended special preferences such as deductions for home mortgage interest. As discussed infra note 82 and accompanying text, such intended preferences could be maintained under a consumption tax.


5. The first change—shifting the tax base from income to consumption—has also raised distributional objections due to a perceived elimination of the tax on investment returns. This
consumption tax benefits without sacrificing individualized progressivity, scholars have increasingly responded with innovative proposals. Two such proposals—the “X-tax” and the “Hybrid Approach”—were separately analyzed in an important “fundamental tax reform” symposium of distinguished tax policy experts. Unlike traditional consumption tax models, both proposals would tax individuals on their wages, even if saved. In recognition that wages deviate from actual consumption, both “dual” consumption taxes would supplement the wage tax with a second tax. The Hybrid Approach, which I originally proposed, would also tax individuals on the excess of (i) savings withdrawals for consumption over (ii) previously-saved wages plus the risk-free interest return thereon. The X-tax, originally proposed by Professor Bradford, would impose a VAT-like tax on businesses, modified to allow a wage deduction.

By further analyzing and showcasing these two inventive ways to tax consumption with individualized progressivity, the recent symposium significantly furthered the progressive consumption tax cause. Yet, the separate analyses of these two independent proposals missed an opportunity for even greater advancement. The proposals’ striking overlap amidst their obvious differences cries out for further comparative analysis. On the one hand, the shared characteristics of the two proposals highlight the merits of breaking the consumption tax into multiple parts, with a progressive wage tax as the first part. Beyond such considerable overlap, however, a critical comparative issue arises regarding the best supplementary tax for the wage tax. Should it be a VAT-like tax on businesses, like the X-tax suggests, or should individuals be taxed on savings withdrawals less previously-saved wages, like the Hybrid Approach proposes?

This Article undertakes the much needed comparative analysis and identifies the significant advantages of each approach. By limiting individual reporting to wages, the X-tax has certain administrative advantages over the Hybrid Approach. On the other hand, the X-tax objection has decreased in importance, though, as recent scholarship demonstrates flaws in such perception. See infra Part I.A.


would change current law significantly more than the Hybrid Approach, changes which are unnecessary in the move to a consumption tax. For instance, the X-tax would move the tax on “pass-through” tax partnerships from the partners to the partnership itself; more generally, individuals would pay tax only on “wages.” These and other X-tax changes exacerbate transition concerns and are more likely to trigger the related “status-quo bias” against substantial changes. In favorable contrast, the Hybrid Approach largely preserves the current framework while shifting to a tax on consumption.

Is it possible, then, to harmonize the respective strengths of the two proposals and craft a progressive consumption tax which minimizes both administrative concerns and ancillary changes? Refining my original Hybrid Approach, I now propose a new consumption tax which supplements the wage tax with (1) a corporate business tax and (2) a narrowed individual tax on investments which exempts the following from individual reporting: most corporate stock, bank deposits, treasury securities, and comparable low-rate interest investments.

Part I evaluates the recent trends underlying the consumption tax’s growing support, including loophole proliferation under our current income tax system and a better understanding of how income and consumption taxes comparatively burden investment returns. Part II highlights the shortcomings of the traditional VAT and other “single-element” consumption taxes. Part III demonstrates how the shared dual elements of the X-tax and Hybrid Approach respond to these shortcomings. Part IV identifies key differences between the X-tax and Hybrid Approach. Part V develops the new proposal, demonstrating its superiority over the other leading options and current law.

I. THE EMERGING CONSUMPTION TAX CASE

The income versus consumption tax debate has long centered on the merits of taxing investment returns, following the traditional belief that a consumption tax exempts all investment return relative to an income tax. Consumption tax proponents typically argued that the income tax burden on investments resulted in too little savings. Income tax proponents typically countered on fairness grounds: i.e., the wealthy would disproportionately benefit from the consumption tax’s exemption of investment income.

Two recent trends have shifted the analysis, though, and drive the consumption tax’s accelerating support. First, commentators have exposed serious flaws in the traditional belief that the consumption tax exempts all investment returns relative to a loophole-free income tax. Recent commentary shows instead that a consumption tax comparatively

9. This includes not only state law partnerships but also many limited liability companies.
exempts only the low risk-free return. Part I.A provides a new demonstration supporting these claims. Second, income tax shelters continue to proliferate despite complicated anti-avoidance rules, thereby exposing intractable structural problems with the income tax. The consumption tax effectively, and simply, corrects the core income tax defect, as shown in Part I.B. A consumption tax therefore appeals independent of the national savings concern because it would close income tax loopholes while yielding relatively little of the tax base.

A. LIMITED RISK-FREE EXEMPTION UNDER THE CONSUMPTION TAX

What explains the long-standing misconception that the consumption tax exempts all investment return compared to an income tax? A subtle, but flawed, assumption regarding investment decisions provides the answer. The misconception implicitly assumes that savers would increase their risky investments with the additional funds available to them prior to consumption under a consumption tax. As evidenced by the first example below, savers appear to "avoid" tax on their profitable investments under this assumption, because the extra pretax return from the increased investments equals the tax on all the investment returns. By focusing solely on the upside, the traditional view disregards the greater downside risk of loss from increased risky investments, as evidenced by the second and third examples.

Assume taxpayer (T) earns a $100,000 salary in 2004; payable on 12/31/04. T saves the entire salary for consumption one year later on 12/31/05. T invests all after-tax wages in X Corporation stock. The X

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11. Some have labeled the current system a hybrid income/consumption tax because it has some consumption elements (e.g., the treatment of qualified retirement savings). E.g., Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 TEX. L. REV. 1145, 1146 (1992). This discussion nonetheless refers to the current system as an "income tax," consistent with its historical label and underlying core structure.

12. This concern over savings might, of course, lend additional support to the consumption tax. See Joseph Bankman & Barbara H. Fried, Winners and Losers in the Shift to a Consumption Tax, 86 GEO. L.J. 539, 541 (1998) ("[M]ost legal commentators have traditionally assumed that shifting from an income to a consumption tax would affect all returns [by] moving them in each case from a positive to zero rate of tax. Over the last 15 years, commentators have chipped away at the standard analysis of a consumption tax as repealing the existing (positive) tax on all [investment returns].").

13. Additional funds are available because a conventional consumption tax defers the tax on saved wages until consumption.

14. Such extreme savings of 100% is considered for ease of exposition. The demonstrated
stock doubles in value over the one-year investment period. A flat 40% tax rate applies under either the income tax or the consumption tax.\textsuperscript{16} Example 1 begins by highlighting the source of the misconception regarding taxation of risky returns.

**Example 1A (Income Tax Results):** Under a 40% income tax rate, T owes $40,000 tax in 2004 on $100,000 of wages.\textsuperscript{17} T invests the remaining $60,000 in X Corporation stock. The stock investment is sold on December 31, 2005 for $120,000. T reports a $60,000 stock gain, resulting in a $24,000 tax liability. This leaves $96,000 of after-tax funds available for consumption.

**Example 1B (Consumption Tax Results):** To facilitate the comparison to the income tax, consider the cash flow version of the consumption tax. The cash flow tax converts the current income tax into a consumption tax through two primary adjustments:\textsuperscript{18} (i) an unlimited deduction of new savings,\textsuperscript{19} and (ii) the inclusion of savings withdrawals for consumption. Under such a cash flow (consumption) tax, T owes no tax in 2004. T invests $100,000 of wages in X Corporation stock, which is sold one year later for $200,000.\textsuperscript{20} T owes total tax of $80,000 on the $200,000 "savings withdrawals," leaving $120,000 of after-tax funds available for consumption.\textsuperscript{21}

The old view that a consumption tax comparatively exempts all investment return appears in three different ways from the Example 1 results, tabulated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>Consumption Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/04 Investment</td>
<td>$60,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>2005 Profits</td>
<td>$60,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>12/31/05 Pretax Funds</td>
<td>$120,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>2005 Total Tax</td>
<td>$24,000\textsuperscript{22}</td>
<td>$80,000\textsuperscript{23}</td>
</tr>
<tr>
<td>12/31/05 After-Tax Funds</td>
<td>$96,000</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

\textsuperscript{16} A flat tax rate is assumed for ease of exposition in developing the initial key principles.

\textsuperscript{17} Under an income tax, even "saved wages" generally are taxed in the current year. There is a limited exception for qualified retirement savings that does not apply on these facts. See infra note 163 and accompanying text for a discussion of qualified retirement savings under a consumption tax.

\textsuperscript{18} In addition, subject to possible exceptions, loan proceeds would increase the tax base while loan repayments would reduce the tax base. For a more detailed discussion of loans, see Engler, supra note 7.

\textsuperscript{19} Under the current income tax, limited amounts of qualified savings are deductible. See discussion of retirement savings, infra note 163 and accompanying text.

\textsuperscript{20} This assumes T earns the same pretax return regardless of the investment amount. See infra note 35.

\textsuperscript{21} \$200,000 - (40\% \times \$200,000).

\textsuperscript{22} 40\% \times \$60,000.

\textsuperscript{23} 40\% \times \$200,000.
First, the 2005 after-tax funds under the consumption tax ($120,000) match the 2005 pretax funds under the income tax, suggesting an implicit consumption tax exemption for the stock gains.\(^2\) Similarly, T has $24,000 of additional after-tax funds in 2005 under the consumption tax ($120,000 – $96,000), equal to the full tax on the investment profit under the income tax. Finally, compare the different pretax stock gains: $60,000 under the income tax versus $100,000 under the consumption tax. The extra $40,000 pretax profit under the consumption tax equals the total consumption tax collections on T’s $100,000 aggregate investment profit ($100,000 x 40%).\(^3\)

Example 1 masks the real reason for the full “exemption” of the risky stock gain by considering only a profitable stock investment. Increasing the risky stock investment from $60,000 to $100,000 exposes T to greater risk of loss if X stock declines in value.

Example 2 demonstrates this greater loss exposure by assuming that the X stock experiences a 50% decline in value during 2005.

**Example 2A (Income Tax Results):** Under the income tax, T’s $60,000 X stock investment is sold for $30,000 on December 31, 2005. T reports a $30,000 loss on the sale. Such tax loss saves T $12,000 tax ($30,000 x 40%), assuming that tax losses are deductible against other taxable income.\(^4\) The stock investment therefore increases T’s after-tax funds available for consumption in 2005 by $42,000: $30,000 stock sale proceeds plus a $12,000 reduction in otherwise payable income taxes.

**Example 2B (Consumption Tax Results):** Under the cash flow tax, T sells the $100,000 X stock investment for $50,000 on December 31, 2005. T owes $20,000 tax on the $50,000 savings withdrawal ($50,000 x 40%). This leaves T with $30,000 after-tax funds available for consumption in 2005.

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24. It is an implicit exemption because that tax actually is collected under the cash flow tax on the full investment return.

25. T’s total tax bill of $80,000 can be divided into a $40,000 deferred payment on the $100,000 in wages plus a $40,000 payment on the $100,000 stock gain. Another way to see the apparent exemption is that this $40,000 tax on the stock gain equals the $16,000 tax on the additional $40,000 pretax return plus the $24,000 tax on the investment profits under the income tax.

26. This is appropriate under the income tax as the original investment was already subject to tax. The particular form of a real-world income tax might deny the taxpayer the full value from the loss (a “full loss offset”). A smaller decline in loss exposure results, e.g., to the extent losses do not generate (i) current tax savings (i.e., a deduction against other taxable income for the year or a government refund if the loss exceeds other net income for the year), or (ii) future tax savings through a loss carryforward, increased by interest as compensation for deferral. This can arise where limitations are placed on loss deductibility. See, for example, the current rule limiting capital loss deductions to the capital gain income plus $3,000. I.R.C. § 1211(b) (2000). While unused capital losses carry forward, the taxpayer does not receive full value from the loss because the carryover loss amount is not increased by an interest factor. In theory, however, an income tax arguably should allow full loss compensation. In fact, the current restrictions must be analyzed in the context of the current income tax which has practical shortcomings, such as the selective loss realization problem discussed infra notes 58–60 and accompanying text.
The additional loss exposure under the consumption tax can be seen in several ways from the Example 2 results, tabulated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>Consumption Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2004 Investment</strong></td>
<td>$60,000</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>2005 Pretax Return</strong></td>
<td>($30,000 loss)</td>
<td>($50,000 loss)</td>
</tr>
<tr>
<td><strong>2005 Pretax Funds</strong></td>
<td>$30,000</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>2005 Tax or Savings</strong></td>
<td>$12,000 savings$27</td>
<td>$20,000$28</td>
</tr>
<tr>
<td><strong>2005 After-Tax Funds</strong></td>
<td>$42,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Once again, T's 2005 after-tax funds under the consumption tax match the 2005 pretax funds under the income tax. In this case, however, T is $12,000 better off under the income tax due to the $30,000 income tax loss and the 40% tax rate. The $12,000 difference also can be determined by focusing on the extra $20,000 investment loss under the consumption tax. T bears 60% of this additional pretax loss because the government bears a percentage of T's losses equal to the tax rate under either the consumption or income tax.$29

So how much of the full investment return "exemption" in Example 1 was attributable to the additional risk of loss, rather than the shift to a consumption tax? After equating T's risk of loss under the income and consumption taxes, Example 3 below demonstrates the new view that the consumption tax exempts only the risk-free return.

Assume now that T invests the additional $40,000 available to him on December 31, 2004 under the consumption tax in a risk-free Treasury note, which pays interest at an assumed 10% risk-free rate. T invests the other $60,000 in the risky X stock. Tracking Examples 1 and 2, assume, in the alternative, that the X stock either doubles in value or declines by 50%.

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27. 40% x $30,000. This assumes the $30,000 tax loss (i) offsets other taxable income for the current year, (ii) losses carry forward with an interest adjustment, or (iii) the government provides a current refund for net losses in the current year. See supra note 26.
28. 40% x $50,000.
29. Loss sharing results under the cash flow tax because pretax losses reduce savings available for withdrawal, which are subject to tax. Loss sharing results under the income tax because taxpayers report gain or loss based on the difference between purchase and sales prices. The following proof shows the equivalency of the two textual explanations of the $12,000 difference. The first way—simply the loss under the income tax times the tax rate—can be expressed as L x TR. The second explanation takes the product of (1) one minus the tax rate and (2) the additional pretax loss, which equals the excess of (i) the product of the income tax loss, and one divided by one minus the tax rate (because that equals the amount by which T increased the stock investment) over (ii) the income tax loss. This can be expressed as (1 - TR) x ([L x 1/(1 - TR)] - L). This expression becomes (1 - TR) x ([L/(1 - TR)] - L), then L - [L x (1 - TR)], then L - L + (L x TR), and finally the same L x TR.
Example 3A (X Stock Doubles): The Treasury note pays $44,000 one year later ($40,000 plus $4,000 interest). Assuming the X stock doubles in value, T sells it for $120,000 on December 31, 2005. T has total funds of $164,000 before taxes. After paying the 40% cash flow tax, T has $98,400 available for consumption on December 31, 2005.30

Example 3B (X Stock Declines by 50%): Assuming the X stock declines by 50%, T sells it for $30,000 on December 31, 2005. T has total funds of $74,000 before taxes ($30,000 stock sale proceeds plus the $44,000 treasury note proceeds above). After paying the 40% cash flow tax, T has $44,400 available for consumption on December 31, 2005.31

The 2005 after-tax funds from all three examples, tabulated below, support the new view that a consumption tax comparatively exempts only the risk-free return.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>100% stock increase</strong></td>
<td>$96,000</td>
<td>$98,400</td>
<td>$120,000</td>
</tr>
<tr>
<td><strong>50% decline in stock</strong></td>
<td>$42,000</td>
<td>$44,400</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Under the new view, the consumption tax increases T's after-tax funds by a narrow, and constant, amount of $2,400 (compare the second and third columns). This contrasts favorably to the old view, which leaves T with significantly more or less after-tax funds depending on the stock's performance (compare the second and fourth columns). The new view's superiority is based on its sounder assumption of equal tolerance for stock market losses under the alternate tax structures.32 The steady $2,400 difference under the new view also quantifies the consumption tax's limited risk-free exemption. The $2,400 excess under the

30. 40% x $164,000 = $65,600. $164,000 - $65,600 = $98,400.
31. 40% x $74,000 = $29,600. $74,000 - $29,600 = $44,400.
32. This is suggested by the fact that T is $54,000 worse off under both the second and third columns if X stock declines by 50% rather than doubling in value. This does not properly quantify the true risk of loss, of course, because this compares one loss scenario to one positive return possibility. A better comparison would contrast the 50% stock decline scenario to an alternative under which T invested all funds in risk-free treasury notes yielding 10%. If so, T would have had (1) $66,000 under the consumption tax ($110,000 Treasury Note proceeds less $44,000 tax thereon) and (2) $63,600 under the income tax ($66,000 Treasury Note proceeds less 40% tax times the $6,000 interest return). Thus, T loses a steady $21,600 under either the income tax or the consumption tax if T invests $60,000 in the stock under both taxes ($63,600 - $42,000 under the income tax; $66,000 - $44,400 under the consumption tax). In contrast, T loses $36,000 if T increases his risky stock investment to $100,000 under the consumption tax ($66,000 - $30,000).

One difference between the income and consumption taxes should be noted: T receives an additional risk-free return under the consumption tax, which might have an impact on T's investment decisions. Nonetheless, the new view does seem to make a sounder assumption than the old view, even taking into account such difference.
consumption tax equals the tax rate times only the risk-free return on the saved wages under the income tax \( (40\% \times 10\% \times \$60,000) \). Accordingly, risky investment returns would not become exempt by virtue of a shift to the consumption tax.\(^{34}\)

Finally, the above analysis generally holds true even if T invested the full $100,000 wages in the risky stock under the consumption tax. If so, T similarly should, and could, increase the riskiness of his portfolio under the income tax given this higher risk tolerance.\(^{35}\) This could be done by,

\(^{33}\) A conceptual explanation for the consumption tax's limited risk-free exemption follows. The cash flow tax differs from the income tax in that taxpayers retain until consumption the tax on saved wages; this equals the tax rate times the pretax saved wages \( (\text{"TR x SW"}) \). Taxpayers should make similar risky investments under the income and consumption taxes because, in either case, they share gains and losses with the government. This assumes the same, constant tax rate under the income and consumption taxes and, as discussed \textit{infra} note 26, a theoretically-sound full loss offset under the income tax. The cash flow benefit from tax deferral on saved wages therefore equals the risk-free return \( (\text{"RFR"}) \) on the deferred tax because taxpayers generally should invest it in risk-free assets: \( \text{RFR x TR x SW} \). As suggested \textit{infra} note 35 and accompanying text, taxpayers should use the extra cash to purchase risky assets in certain cases, but this does not change the general analysis. The \( \text{RFR x TR x SW} \) pretax return must be reduced because such return will be taxed when withdrawn for consumption, leaving: \( \text{RFR x TR x SW x (1 - TR)} \). Reordered as \( \text{TR x RFR x (1 - TR) x SW} \), taxpayers "avoid" tax on the risk-free return generated by the after-tax saved wages. This assumes the same rate applies to wages and the risky returns. The calculation changes if a lower rate applies to the risky returns under the income tax (e.g., a lower capital gains tax). If so, the difference between the income and the consumption tax narrows because the taxpayer should invest less in the risky asset under the income tax than under the consumption tax. This results because the taxpayer has to share less of the risky profits with the government under the income tax's lower risky rate. See David A. Weisbach, \textit{Taxation and Risk-Taking with Multiple Tax Rates}, 57 Nat'l Tax J. 229 (2004) (providing formula for calculating such reduction).

\(^{34}\) This is not to say that a consumption tax necessarily burdens risky investment returns. As discussed below, investors might be able to avoid the burden by increasing their investment amounts. This would not be a new or relative exemption under the consumption tax as a similar possibility exists under the income tax. See \textit{infra} note 35.

\(^{35}\) This possibility of increased risky investments under either the consumption or income tax explains the recent commentary that both income and consumption taxes exempt certain risky returns. See, e.g., Cunningham, \textit{supra} note 10. The argument follows from the concept that the government shares both gains and losses with taxpayers in a percentage equal to the tax rate. If so, taxpayers arguably can negate the risky investment return by increasing the risky investments by a factor equal to one divided by one minus the tax rate. Consider again the basic facts of Example 1 but now assume a stand-alone wage tax which expressly exempts investment returns. T owes $40,000 tax on 12/31/04, leaving $60,000 to invest in X stock. If the stock doubles in value, T is left with $120,000 for consumption. As evidenced by Example 1B, T achieves the same result if he makes a $100,000 stock investment with the $100,000 available funds. While T formally paid tax on both the $100,000 wages and the $100,000 investment return, a comparison to the stand-alone wage tax evidences the lack of any burden on the risky return. Restated, T should be comfortable making such increased investment under the consumption tax—relative to the wage tax with the investment return exemption—because the government bears 40% of T's loss under the consumption, but not the stand-alone wage tax. On the positive side, increasing the investment amount by \( 1/(1 - t) \) "avoids" the tax because T keeps \( (1 - t) \times P \) after taxes where \( t \) equals the tax rate and \( P \) equals the pretax profits. This argument requires certain assumptions such as constant tax rates and the lack of market pricing changes if investors increase their investment amounts in this fashion. The merits of the assumptions, and hence the argument regarding the risky return exemption, need not be resolved for purposes of the consumption/income tax debate. This results because the income and consumption taxes generally
e.g., (1) liquidating risk-free assets, if any, to purchase more X stock; (2) purchasing even riskier investments with the $60,000 after-tax saved wages; or (3) using leverage to acquire more X stock (either options or regular loans). And the difference between the income and consumption taxes generally remains limited to the risk-free return even under such changed facts.\textsuperscript{36}

B. CONSUMPTION TAX CORRECTS CORE INCOME TAX DEFECT

The prior demonstration assumed away some long-standing practical problems under the income tax. This section now considers the real-world shortcomings of the income tax, which solidify the consumption tax case. This section demonstrates how the consumption tax simply corrects the income tax’s structural problem.

1. Realization Defects Under the Income Tax

The income tax problems stem from the “realization” requirement under which income is reported only when “realized” through a market transaction like the sale of an asset or payment of a salary.\textsuperscript{37} The realization requirement raises a number of income tax avoidance opportunities, which fall into three broad categories.\textsuperscript{38} First, taxpayers

\begin{itemize}
\item[36.] Recall for example the consumption tax results of Example 1B where T invested the full $100,000 in the risky X stock which doubled in value. T ended up with $120,000 after-tax funds for consumption. Now assume T similarly purchased $100,000 worth of X stock under the income tax by, e.g., borrowing $40,000 at the 10% risk-free rate. If so, T’s after-tax consumption would be $117,600 ($200,000 sales proceeds – [$4,000 debt repayment + $38,400 tax bill (40% x $96,000 profit: $100,000 stock gain less $4,000 interest expense)]. This once again is $2,400 less than the consumption tax results. The difference between the income and cash flow (consumption) tax would increase somewhat if T incurred borrowing costs in excess of the risk-free rate. The general analysis nonetheless holds for the following reasons: First, as suggested in the text, taxpayers might be able to increase their risky investments without incurring borrowing costs in excess of the risk-free rate (through options, liquidation of risk-free assets, purchase of riskier stocks, etc.). Second, certain unconventional consumption tax forms—such as the dual Hybrid Approach analyzed infra Part III.A.1—also collect tax on saved wages at the wage date, leaving taxpayers in the same position as under the income tax regarding available investment funds. Finally, even in the limited cases where T would have to incur excess borrowing costs under the income tax, the basic point regarding T’s ability to increase his portfolio’s riskiness under the income tax significantly undercuts the old view that the consumption tax comparatively exempts the \textit{full} risky return. For a deeper discussion of these issues, see Engler, supra note 7; Daniel N. Shaviro, \textit{Replacing the Income Tax with a Progressive Consumption Tax}, TAX NOTES, Apr. 5, 2004, at 91, available at LEXIS 2004 TNT 66-48.

\item[37.] E.g., I.R.C. § 1001 (2000) (“T[he] gain from the sale or other disposition of property shall be the amount realized therefrom over the adjusted basis”) (emphasis added). There are some limited exceptions under the current structure which apply only in specific designated areas. See, e.g., I.R.C. § 475 (requiring securities dealers to report market appreciation even on retained securities).

\item[38.] For a discussion of difficulties with an alternate accretion-based income tax, see infra notes 62–63 and accompanying text (legitimate valuation and administrative reasons underlie the realization
can defer their taxes without interest by delaying realization. As evidenced by Example 4, this reduces the tax burden under time value of money principles.\textsuperscript{39}

Assume T purchased Z stock for $100,000 on 1/1/04 and it appreciates in value to $200,000 as of 12/31/04.\textsuperscript{40} T contemplates selling the stock on 12/31/04 and reinvesting the $200,000 in Y Corp. stock. T will consume all after-tax proceeds one year later on 12/31/05. The Z and Y stocks both double in value during 2005.\textsuperscript{41} Assume the income tax applies a flat 40% rate to all income, including capital gains.\textsuperscript{42} T holds $40,000 of cash which will be used to pay the tax if the Z stock is sold on 12/31/04; if T retains the Z stock until 2005, the $40,000 will be invested in a 10% one-year Treasury note.\textsuperscript{43} How much after-tax consumption will T have, first if he sells the Z stock for reinvestment on 12/31/04, and second if he holds the Z stock until consumption on 12/31/05?

\textbf{Example 4A (Sells for Reinvestment):} T owes $40,000 tax in 2004 if he sells the Z stock for a profit of $100,000. If T sells the Y stock for $400,000 on 12/31/05, T owes $80,000 tax on the $200,000 Y stock gain. This leaves $320,000 for consumption.

\textbf{Example 4B (Holds Until Consumption):} T receives pretax proceeds of $444,000 on 12/31/05: $400,000 from the Z stock and $44,000 from the Treasury Note. T reports $304,000 of income: $300,000 from the Z stock and $4,000 from the Treasury Note. After paying the tax of $121,600, T has $322,400 for consumption.

What should we make of the $2,400 difference? At the outset, consider two conceptual explanations for the different results. As evidenced by the same $2,400 difference seen above in Section A, T effectively converted the income tax into a consumption tax by deferring realization until consumption. As such, T avoided the tax on the risk-free

\textsuperscript{39} Deferral of taxes without interest lowers the true cost because a lesser figure can be set aside today to meet the (future) tax liability; i.e., the lesser figure can be invested and earn interest. The tax system imposes a deferral charge only in very limited circumstances. A more comprehensive interest charge regime has proven elusive despite the efforts of many commentators. See Edward A. Zelinsky, \textit{For Realization: Income Taxation, Sectoral Accretionism and the Virtue of Attainable Virtues}, 19 Cardozo L. Rev. 861 (1997). Compare the discussion infra notes 62-63 and accompanying text regarding the elusiveness of a comprehensive regime to eliminate the underlying realization requirement itself.

\textsuperscript{40} This simplifying assumption establishes the entire $100,000 proceeds as taxable amounts, easing the calculations.

\textsuperscript{41} Any assumed change in value would demonstrate the principles so long as the Z and Y stocks experience the same value change. This is required to preserve the pretax equivalency.

\textsuperscript{42} Accordingly, ignore a possible lower capital gains rate, which is considered infra notes 54-57 and accompanying text.

\textsuperscript{43} This leaves T with the same amount of risky investments regardless of the timing of the tax payment on the appreciation. This is required in order to maintain pretax equivalency. See supra Part I.A.
investment return. A more traditional explanation emphasizes T's ability to defer the tax on the 2004 accrued stock gain without any interest charge.

Given that the basic stock example above might suggest equal deferral potential for all, why is interest-free deferral until consumption so problematic? Consider fairness concerns first. Taxpayers in fact do not have equal deferral opportunities; such opportunities depend on the nature and amount of their income. Employees, for instance, typically must pay current tax on their wages even if saved for future consumption. In contrast, self-employed business owners might achieve interest-free deferral on their earned income by paying themselves a below-market salary. And as evidenced by Example 4 above, taxpayers generally have greater opportunities to defer investment income than earned income. The end result is that some taxpayers are subject to the income tax's burden on risk-free savings returns—e.g., the ordinary wage saver—while others receive the more favorable consumption tax treatment.

Beyond fairness, interest-free deferral raises deep efficiency concerns that would exist even if deferral was equally available to all taxpayers. The realization income tax distorts owners' selling decisions. Interest-free deferral might induce an owner to retain an otherwise unwanted asset until consumption, as evidenced by Example 4 above. In addition, some sophisticated taxpayers transfer the ownership rights without actual title in hopes of avoiding the tough choice between higher taxes and unwanted assets. A classic example which worked until recently is the "short against the box" technique, under which taxpayers retain their own appreciated shares of stock while selling comparable shares borrowed from another stockholder.

44. Once again, the $2,400 equals the 40% tax rate times the 10% risk-free return on the $60,000 of after-tax proceeds.
45. E.g., Cynthia Blum, New Role for the Treasury: Charging Interest on Tax Deferral Loans, 25 HARV. J. ON LEGIS. 1 (1988). Under this alternate explanation, T benefits in an amount equal to the product of the deferred $40,000 liability and the 6% (after-tax) interest rate. $40,000 x 6% = $2,400.
46. In other words, all taxpayers have the ability to defer their taxes by avoiding realization until consumption.
47. In particular, the wealthy have greater avoidance opportunities. See infra note 61 and accompanying text. Separately, the disparate tax results can distort behavior, thereby implicating efficiency concerns.
48. This can be done without any economic loss to the owner/employee because the below-market salary increases the value of the stock. For a more detailed example, see Engler, supra note 7, at 1211–12. Sophisticated taxpayers also might defer taxes on wages through a two-step approach: (1) first convert wages to capital gains through leveraged investments, and then (2) use capital losses to offset the capital gains. See Reed Shuldiner, Indexing the Tax Code, 48 TAX L. REV. 537, 646 (1993).
49. Similar to the wage context, deferring realization of investment income provides a benefit equal to the tax rate times the risk-free return on the after-tax investment income.
50. The shareholder effectively locks in the stock gain through this technique because any subsequent losses on the retained shares will be matched by a gain on the short sale.
involving the prominent Lauder family, Congress finally responded with section 1259 of the Internal Revenue Code which requires gain recognition upon a “constructive sale of an appreciated financial position.” While section 1259 clearly shut down the short against the box by specifying it as a “constructive sale,” the underlying problem remains as more sophisticated approaches are taken in response to the statute and the provision’s limited scope.

Distorted selling decisions also contribute to the second category of realization problems, relating to the lower tax rate for gains on the sale of a capital asset. Such capital gains preference appeals under the income tax to reduce “tax lock-in”: i.e., the tax bias favoring retention of appreciated assets. Similar to the deferral analysis above, however, a different rate for such gains raises equity and efficiency concerns. The problems go beyond the lower tax paid by those who realize true capital gains. First, the tax system has difficulty separating the earned income component from true investment gain in certain areas such as a patent development. Accordingly, ordinary wages generally will be subject to ordinary rates while other labor returns will qualify for the capital gains rate. The broader problem, however, tracks the above deferral analysis. The significant tax rate difference encourages sophisticated taxpayers to “convert” ordinary-rate income into long-term capital gains. Once again, the government has responded with a complicated anti-avoidance provision that leaves intact the underlying problem.

Tax losses are the third area of vulnerability under the realization


53. More sophisticated techniques on appreciated stock involve puts and calls. In such cases, the application of section 1259 turns on whether the taxpayer transferred substantially all the benefits and burdens of ownership. See David Schizer, Hedging Under Section 1259, TAX NOTES, July 20, 1998, available at LEXIS 1998 TNT 138-91.

54. Taxes might encourage individuals to retain assets they would otherwise sell (i.e., in the absence of any tax liability upon sale). Such tax-distorted retention deprives the government of any current tax collections on the gain and also leads to efficiency concerns as transfers to more efficient users might not materialize. For literature analyzing the potential benefits of a reduced rate for gains, see, e.g., Noel Cunningham & Deborah Schenk, The Case for a Capital Gains Preference, 48 TAX L. REV. 319 (1993).

55. See I.R.C. § 1235 (“A transfer of ... all substantial rights to a patent ... by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year ...”).

56. This involves converting wages to investment return. See, e.g., David Cay Johnston, Big Accounting Firm’s Tax Plans Help the Wealthy Conceal Income, N.Y. TIMES, June 20, 2002, at A1 (noting wage conversion); Shuldiner, supra note 48. While the tax code has anti-avoidance provisions, they are under-inclusive and add complexity. See infra note 60.

57. For remaining avoidance possibilities, see, e.g., Shuldiner, supra note 48. For attempted statutory protections, see, e.g., I.R.C. §§ 1258 (recharacterizing gain from certain financial transactions as ordinary income), 163 (limits on interest deductions).
income tax. Investment losses generally should be deductible under an income tax because they reduce overall net income. The problem under a realization income tax is that taxpayers control which assets they sell each year. Taxpayers therefore can "realize" a tax loss absent a true economic loss by selling loss assets while retaining appreciated assets. This allows further interest-free deferral, possibly even beyond the consumption date. Congress again attempts to police the area with anti-avoidance provisions, which add complexity without solving the problem.

In sum, the realization income tax's interest-free deferral and preferential capital gains rate raise serious equity concerns given the lack of equal availability to all taxpayers. The wealthy in particular have greater access to such beneficial aspects of current law. Efficiency concerns similarly abound given the interest-free deferral distortions. As an aside, an income tax in theory could correct these shortcomings by dropping the realization doctrine and taxing economic income as it accrues each year. A number of practical issues block such an "accretion" income tax, however, most notably administrative and

58. See supra note 26.

59. Consider again Example 4. T deferred the tax on the appreciated Z stock under the realization income tax until consumption by holding the stock until 2005. T might benefit from even longer interest-free deferral under the realization income tax if T held other investments, at least one of which has gone down in value. By selectively selling the loss asset(s) in addition to the Z stock (and reinvesting the proceeds), further interest-free deferral results if such losses can offset the taxable Z stock gain. While government has provided anti-avoidance provisions, sophisticated taxpayers often dodge such obstacles. See infra note 60.

60. Consider first the more straightforward I.R.C. § 1211(b). This section attempts to protect the earned income tax base from the selective loss problem by allowing capital losses to offset only capital gains plus a de minimis amount of ordinary income ($3,000). Sophisticated taxpayers skirt the limitation by converting earned income to capital gain. See supra note 56. The provision also does not block deductibility against capital gain proceeds which fund consumption. In the other direction, the provision is over-inclusive. Consider for example a taxpayer with $100,000 of earned income who sells his one investment for a $100,000 loss. The taxpayer must pay tax on virtually all the earned income despite the lack of any true net income. See, e.g., Robert H. Scarborough, Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax, 48 TAX L. REV. 677 (1993).


61. See David Schizer, Frictions as a Constraint on Tax Planning, 101 COLUM. L. REV. 1312, 1315 (2001) (government's narrow avoidance provisions have not increased the burden on wealthy taxpayers, who "sidestep" the provisions); Stephen Joyce, TIGTA Applauds IRS Compliance Scheme, Urges Better Measurement of Case Closures, DAILY TAX REPORT (BNA), Nov. 29, 2004, at G-4 (A government audit stated that the "increase in taxpayers earning more than $100,000 annually introduced possibilities of non-compliance because those taxpayers possess the means to engage in tax-avoidance strategies.").

62. This approach would increase (decrease) the tax base by the net increase (decrease) in value of the taxpayer's assets each year.
Accordingly, the realization problems continue to fester after all these years, reinforcing a leading commentator’s characterization years ago of the realization requirement as the “Achilles heel of the whole comprehensive income tax ideal.”

2. **Consumption Tax Addresses Realization Problems**

The consumption tax corrects all three problematic areas under the realization income tax. First, the consumption tax eliminates the tax incentive to retain appreciated assets until consumption because asset sales for reinvestment generally would not trigger tax. Thus, T would have the same after-tax consumption in Example 4 supra regardless of whether he sold or held the Z stock on December 31, 2004. As a related matter, because tax lock-in would no longer justify the capital gains preference, the complicated capital gains regime could, and should, be eliminated under the consumption tax. Finally, the consumption tax eliminates the tax loss problem because asset sales, even at a loss, would not reduce the consumption tax base.

C. **SUMMATION OF CONSUMPTION TAXATION CASE**

The consumption tax corrects the interest-free deferral difficulties under the realization income tax. A consumption tax would raise potentially significant offsets if, as is sometimes assumed, the consumption tax exempted all investment return relative to a loophole-free income tax. The consumption tax comparatively exempts only the low risk-free return, however, thereby significantly minimizing potential

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63. See Zelinsky, supra note 39, at 893–901 (describing elusiveness of accretion system and adding public acceptance as another stumbling block).


66. A limited exception exists for purchases of consumer durables (e.g., cars or homes). Such purchases likely would face current tax, notwithstanding an investment element. For a deeper discussion of consumer durables, see Engler & Knoll, supra note 6.

67. T’s after-tax consumption would equal $322,400 regardless of whether T sold the Z stock for reinvestment on December 31, 2004. Even if T sold in 2004, T could retain his $40,000 Treasury Note investment because he would owe no tax in 2004. This ignores non-tax transaction costs, e.g., broker fees, which are independent of the tax regime.

68. The lock-in justification is generally regarded as the leading justification for the preference. E.g., Cunningham & Schenk, supra note 54. Note how the new view calls into question another purported rationale in favor of the preference—reducing the tax burden on risky returns. The new view suggests that an income tax does not burden most risky returns. See supra note 35; infra note 109.

69. As discussed supra note 29 and accompanying text, the government shares true economic losses under the consumption tax. Importantly, though, selective sales of loss assets do not reduce the consumption tax base. See Engler & Knoll, supra note 6, at 76 n.107 (discussing an alternate escape possibility under the consumption tax involving borrowed funds). As discussed therein, however, the consumption tax significantly narrows the exposed areas, and the consumption tax, unlike the income tax, automatically corrects for time value of money differences.
tradeoffs to the critical correction of the problematic interest-free deferral. Finally, the consumption tax provides sorely-needed simplification by eliminating the need for the current complicated provisions related to interest-free deferral, including the capital gains regime.

II. PROBLEMS WITH “SINGULAR” CONSUMPTION TAXES

The preceding Part demonstrated the significant advantages of replacing the income tax with a consumption tax. As with any tax law change, the resulting advantages must be balanced against offsetting detriments, including transition issues. This Part highlights the significant offsets under the single-element VAT and the cash flow consumption tax, which obstruct the shift to a consumption tax.

A. THE TRADITIONAL VAT (AND RETAIL SALES TAX)

The comparable retail sales tax and VAT tax businesses rather than individual consumers. Accordingly, tax rates would not vary based on the consumer’s overall consumption level because the tax is based on the business’s operations. Therefore, a VAT would eliminate the current progressive rate structure, under which individual tax rates increase as overall income rises. A VAT could impose varying rates on different goods, e.g., high rates on “luxury” items and low rates on “necessities.” This fails to achieve reliable progressivity, however, as many goods are consumed by individuals at different wealth levels. In sum, the lack of individualized progressive rates has raised serious and persistent distributional objections. Other issues raised by the VAT’s business-

70. As discussed supra note 12 and accompanying text, exempting the risk-free return might have substantive appeal as a way to boost national savings. That is, in addition to yielding a relatively minor component of the tax base, such relinquishment might even be desirable in its own right.

71. As discussed supra note 54 and accompanying text, the capital gains relates to interest-free deferral because tax lock-in provides the primary support for the preference. Administrative issues will be discussed in greater detail infra Parts IV.B.1 and V.

72. The key difference between the two taxes regards the manner of collection. The VAT collects the tax on the value added at each level of production. The retail sales tax is imposed on the full retail sales price. The multi-stage VAT is generally viewed as a better check against noncompliance. See Alan Schenk, The Plethora of Consumption Tax Proposals, 33 SAN DIEGO L. REV. 1281 (1996).

73. Varying rates also distort consumer choices by providing a tax incentive to consume more “necessities” and fewer “luxury” goods.

74. For instance, even leading proponents of a “flat-rate” tax modified the stand-alone VAT to allow some individualized rate variance. See Robert E. Hall & Alvin Rabushka, The Flat Tax: A Simple Progressive Consumption Tax, in FRONTIERS OF TAX REFORM 27 (Michael J. Boskin ed., 1995) (separating out compensation in order to exempt salary of low wage earners); see also Allison Bennet, Bush Soon to Appoint Tax Reform Panel, Committed to Real Change, Bodman Says, DAILY TAX REPORT (BNA), Nov. 19, 2004, at G-8 (Deputy Treasury Secretary Samuel Bodman says the “president wants the tax system to be fair, stressing that ‘progressivist is one attribute that is fundamental to fairness in taxation’”); Brett Ferguson, Social Security-Related Tax Reforms “Off the Table,” Panel Chairman Mack Says, DAILY TAX REPORT (BNA), Jan. 31, 2005, at G-8 (Chairman Mack of the Whitehouse-appointed tax reform panel says the panel “will be sensitive to progressivity”); Nancy
level tax will be reserved for later Parts.75

B. CASH FLOW CONSUMPTION TAX

As discussed above, the cash flow tax would convert the current system to a consumption tax by making two primary changes: (1) an unlimited deduction for savings, and (2) the inclusion of all savings withdrawals for consumption. In marked contrast to current law, taxpayers would not pay any tax on saved wages until withdrawn for consumption.76 This delayed tax collection on all saved wages implicates several contentious issues which hinder acceptance of the cash flow tax.

Consider first two interrelated transition issues. Absent special rules, savings held at transition could be taxed twice. Assume T earns $100,000 under a 40% income tax. T pays $40,000 tax on receipt, saving the other $60,000 for future consumption. T withdraws the $60,000 for consumption after adoption of a 40% cash flow tax. Under the normal cash flow rules, T would owe another $24,000 tax upon such withdrawal. A special cash flow exemption for previously-taxed savings withdrawals would address the double taxation. Such transition relief would cause a significant revenue loss in the early years after the shift, however, because both newly-saved wages and significant savings withdrawals would be tax exempt.77

Ognanovich, Bush Says He Will Begin Difficult Effort To Change Tax, Social Security Structures, DAILY TAX REPORT (BNA), Nov. 5, 2004, at GG-1 (Bush acknowledges the need for Democratic support for his tax reform agenda); Katherine Stimmel, House Democrats Say They Back Tax Reform But Not Efforts Toward National Sales Tax, DAILY TAX REPORT (BNA), Nov. 10, 2004, at G-5 (Democratic representative James Clyburn favors tax reform but not the “establishment of regressive tax programs,” like a national sales tax). A VAT also could achieve progressivity through rebates to less wealthy taxpayers, but this requires a separate determination of every taxpayer’s wealth. Cf. Laurence Seidman, A Progressive Value Added Tax: Has its Time Finally Come?, TAX NOTES, June 7, 2004, at 1255, available at LEXIS 2004 TNT 110-33 (proposing a low-rate VAT as a supplement to the current income tax, with rebates based on levels of reported income).

75. See infra Part IV.B. Analyzing such other issues is not necessary at this point because lack of progressivity is enough by itself to reject the stand-alone VAT.

76. Under current law’s qualified retirement plan treatment, taxpayers can avoid some tax on saved wages. This treatment has significant limitations, however, including (1) ceilings on the amount of saved wages, and (2) prohibitions on use of the savings.

77. The problem is that either the income tax or the cash flow tax by itself generally provides a relatively steady tax flow from savers and dissavers, i.e., those who consume from their savings. The income tax collects from savers while the cash flow tax collects from dissavers. In response to the double tax problem discussed above, assume that after the shift dissavers may consume previously-taxed savings without the usual cash flow tax. The cash flow tax would not collect tax on any new savings—under its regular rules for savings—or any dissavers owning wealth at transition—under the special transition relief. While the problem dissipates over time as dissavers consume their transition wealth, there could be a real decline in tax revenues for some time period. Politics impedes enhanced government borrowing in the interim period as a possible solution. See, e.g. Louis Kaplow, Recovery of Pre-enactment Basis Under a Consumption Tax, TAX NOTES, Aug. 28, 1995, available at LEXIS 1995 TNT 171-47. For a more detailed discussion of these issues, see Engler & Knoll, supra note 6; Engler, supra note 7.
The cash flow tax also raises more permanent concerns that taxpayers might not pay the delayed tax on saved wages.\textsuperscript{78} Tax currently is imposed on saved wages as paid, reinforced by a withholding obligation on the employer. The cash flow tax relinquishes tax at the original payment source, creating uncertainty as to whether savers ultimately will pay the tax due on consumption. Commentators have voiced concerns that some individuals would never pay the delayed tax due to expatriation or other tax evasion and avoidance mechanisms.\textsuperscript{79}

The cash flow tax also would shift significantly the imposition of the progressive rate structure. The amount of wages for the year largely determines the degree of progressivity under current law. Progressivity under the cash flow tax would be based instead on the yearly consumption level, thereby introducing significant new imprecision.\textsuperscript{80}

To summarize, the cash flow tax changes go well beyond the risk-free exemption demonstrated in Part I above. These additional changes are unfortunate because they trigger serious objections—yet they are unrelated to the consumption tax’s loophole-closing virtue, which stems from the risk-free exemption. Is it possible, then, to develop a different consumption tax form which maintains the loophole-closing virtue without raising the cash flow tax objections? As demonstrated in the next Part, two innovative “dual” consumption taxes provide an affirmative response.

III. SIMILAR APPEAL OF THE TWO DUAL CONSUMPTION TAXES

The preceding Part highlighted the objectionable tradeoffs of the singular VAT and cash flow consumption taxes. This Part demonstrates how the Hybrid Approach and the X-tax similarly avoid these unacceptable offsets while preserving the consumption tax’s loophole-closing virtue. As shown below, the trick is to decompose the consumption tax into multiple parts, consisting of a progressive wage tax and a supplementary tax on consumption less wages. Neither the X-tax nor the Hybrid Approach taxes consumption per se, as evidenced by

\textsuperscript{78} The prior problem recedes over time as transition savings are consumed.

\textsuperscript{79} \textit{E.g.}, Michael J. McIntyre, \textit{The Design of Tax Rules for the North American Free Trade Alliance}, 49 Tax L. Rev. 769, 769 n.14 (1994). The expatriation concern arises, for instance, because an expatriate would be outside the United States at the time of consumption. For a more detailed discussion of these issues, see Engler & Knoll, supra note 6, at 64–65; Engler, supra note 7.

\textsuperscript{80} This follows from the fact that the tax collection date on saved wages would shift from the wage date to the consumption date. Setting aside the delay in the tax collection, the concern involves the possible change in tax rates on the two dates. Even in the absence of legislative change to the rate structure, a different tax rate could result due to the progressive rate structure. For instance, a higher tax rate could apply under the cash flow tax if consumption is bunched together into a heavy consumption year (e.g., the purchase of a home or transfers upon death to the extent wealth transfers were treated as consumption). See Alvin C. Warren, Jr., \textit{Fairness and a Consumption-Type or Cash Flow Personal Income Tax}, 88 Harv. L. Rev. 931 (1975). For a more detailed discussion of these issues, see Engler & Knoll, supra note 6; Engler, supra note 7.
their similar taxation of saved wages. Nonetheless, both approaches end up with the equivalent of a consumption tax via the workings of their supplementary tax on consumption less wages. Part III.A describes in greater detail the workings of the Hybrid Approach and the X-tax. Part III.B then highlights why the shared characteristics of these dual taxes avoid the problems of singular consumption taxes.

A. THE TWO DUAL CONSUMPTION TAXES

1. The Hybrid Approach

As demonstrated above, the consumption tax implicitly exempts from tax the risk-free return on previously-taxed wealth. Drawing upon this insight, the Hybrid Approach minimizes ancillary changes to current law by working an explicit risk-free exemption into the existing structure. The Hybrid Approach would continue to tax individuals' wages, even if saved, subject to current law's limited exception for qualified retirement savings (the wage tax component). Individuals also would be taxed on the excess of (1) savings withdrawals for consumption over (2) saved wages plus the risk-free return thereon (an adjusted cash flow component). Thus, similar to current law, individuals would be taxed on wages and investment return, and the system could maintain current deductions for home mortgage interest and charitable donations. Unlike current law, the investment return tax would explicitly exempt the risk-free return and would be imposed only at consumption, and at the regular tax rate.

As a practical matter, new investments would be deductible against savings withdrawals, but not wages. Unusable new investment deductions—due to the wage limitation—would carry forward indefinitely with interest at the risk-free rate. The basic facts of Examples

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81. Under current law, individuals do not face current tax on saved wages if invested in qualified retirement plans such as 401(k) or 403(b) plans. For a more detailed discussion of qualified retirement accounts, see infra note 163 and accompanying text.

82. See Kurt Ritterpusch, Bush-Appointed Tax Reform Panel's Heads Meet with Treasury Staff; Experts Optimistic, DAILY TAX REPORT (BNA), Jan. 12, 2005, at G-11, G-12 ("Bush directed the [tax reform] panel to ... recognize 'the importance of homeownership and charity.' In previous statements, Bush has spoken in favor of preserving tax deductions for mortgage payments and charitable contributions.")

83. The hybrid approach therefore maintains the consumption tax's response to the income tax's realization-based concerns. Compare discussion of the cash flow tax at Part I.B. The combination of the risk-free return exemption and a possible home mortgage deduction could present tax arbitrage concerns if taxpayers purchased investment assets with qualified home mortgage indebtedness (this would result if taxpayers could deduct the full nominal interest amount while excluding a portion of the corresponding asset return). As discussed infra note 87, however, such concerns could be addressed through several possible adjustments.

84. Home mortgage interest and charitable donations could be deducted against both wages and investment returns, as per current law. New investments would be deductible against both savings withdrawals and wages under the traditional cash flow tax. See supra note 19 and accompanying text.
1A and 3A in Part I will illustrate these practical workings and the Hybrid Approach's consumption tax equivalency. Recall that T earns a $100,000 salary in 2004, payable on 12/31/04. T saves the entire after-tax salary for consumption one year later, investing $60,000 in X stock which doubles in value. A flat 40% tax rate applies and the risk-free rate is 10%. T would pay $40,000 tax in 2004, just like under the income tax. When T sells the $60,000 X investment for $120,000 on 12/31/05, T will owe tax because the proceeds will be used for consumption. The 40% tax applies to the excess of (1) the $120,000 proceeds less (2) the $60,000 saved wages plus a $6,000 risk-free interest adjustment. After paying $21,600 tax on such $54,000 excess, T can consume $98,400.

This $98,400 figure matches the Example 3A results for the cash flow tax. These identical results demonstrate the consumption tax equivalency of the Hybrid Approach. Also consider a second key identity between the cash flow tax and the Hybrid Approach: asset sales for reinvestment would not impact the tax base. Thus, the Hybrid Approach similarly corrects the realization problems under the income tax. Retention of appreciated assets would no longer provide interest-free deferral benefits, nor would the selective sale of loss assets. Once again, the capital gains preference could, and should, be eliminated.

Finally, note how the Hybrid Approach would aggregate an individual's investments. For example, assume that T splits the $60,000 after-tax wages on 12/31/04 into two $30,000 investments and that T sells only the first investment for consumption on 12/31/05 at an assumed $60,000 price. Despite the $30,000 investment profit, T would not yet pay tax because aggregate savings withdrawals for consumption ($60,000) would not yet exceed aggregate saved wages plus interest (the same $66,000 as under the original example). Assuming no other savings, when T sells the second investment for consumption, T would owe tax on the sales proceeds less the $6,000 unused offset as of 12/31/05 ($66,000 - $60,000) plus subsequent interest thereon.

85. Like the cash flow tax, there would be a limited exception for purchases of consumer durables. See supra note 66.

86. Once again, there would be a limited exception for consumer durable assets. In addition, separate tracking for property transferred by gift might be desirable. As a check on intra-family transfers to reduce the tax rate, the top tax rate could be applied to gift recipients upon consumption of the gifted property. This could be achieved by a separate "basket" for gifted property. For use of the basketing approach under the income tax, see William Klein, Joseph Bankman & Daniel Shaviro, Federal Income Taxation (13th ed. 2003).

87. As discussed supra note 83, the combination of a home mortgage deduction and interest adjustments on the unused offset amounts could raise tax arbitrage concerns. There are several possible responses to the tax arbitrage concern. First, the unused offset account could be reduced by some or all of the taxpayer's qualifying home mortgage indebtedness. Alternatively, the interest deductions on (some) home mortgage indebtedness could be reduced by the risk-free interest rate. For a similar suggestion in the business context, see infra note 143.
2. The X-tax

The X-tax would also tax individuals on wages. In addition, businesses would pay a VAT-like tax, modified to allow a wage deduction. The X-tax therefore differs from the Hybrid Approach, most obviously in that the non-wage tax is imposed on businesses, not individuals. Nonetheless, like the Hybrid Approach, the X-tax decomposes the consumption tax into (1) an individual wage tax, and (2) an additional tax on consumption less wages. Another key similarity is that the X-tax uses risk-free interest adjustments to achieve timing neutrality when business deductions are deferred to later years.

An illustration of the X-tax is complicated by the uncertainty over who ultimately bears its burden—i.e., its economic incidence. Consider first the business portion of the X-tax. Individuals bear taxes, not businesses. Well, then, which individuals would bear the X-tax paid by businesses? Several possible alternatives highlight the uncertain incidence. Business owners would bear the tax to the extent it reduces after-tax profits. But business owners might be able to pass on the tax to others, such as consumers through higher prices. A tax on wages also raises uncertainty over its economic incidence. While the legal obligation falls on the employee, the tax also could be passed on to consumers if pretax wages increase in response to the separate wage tax, and such higher business costs lead to higher consumer prices.

Assume first that the X-tax is borne by consumers. The X-tax results would then track the cash flow tax examples above because the X-

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88. See infra Part IV for other differences in the supplemental taxes under the X-tax and Hybrid Approach.

89. This could result where the business’s investments in a given year exceed its taxable receipts. See discussion infra note 98 and accompanying text. Accordingly, like the Hybrid Approach, the X-tax makes more explicit the individual cash flow tax’s implicit risk-free exemption.

90. It is generally assumed that consumers bear a VAT as they consume. The X-tax might call into question such assumption due to its decomposition of the consumption tax into a fixed-rate business tax on consumption less wages and a progressive wage tax. In addition, some commentators question whether consumers bear the full conventional VAT. See infra notes 94, 96.

91. But see infra note 109 (regarding taxes as the government’s co-investment share).

92. This is true even where employers have a withholding obligation on wages, as under current law. See I.R.C. § 3402. Employers withhold on behalf of their employees, who retain the primary tax liability.

93. The appropriate comparison is to a system which does not tax individuals on their wages, such as a conventional VAT.

94. This is consistent with the classic assumption for broad-based consumption taxes. See, e.g., Henry Aaron, The Differential Price Effects of a Value-Added Tax, 21 Nat’l Tax J. 162, 167 (under classic assumptions, the consumption tax is fully shifted to consumers); Michael Graetz, International Aspects of Fundamental Tax Restructuring: Practice or Principle, 51 U. Miami L. Rev. 1093 (1997) (GATT rules effectively assume VATs are borne by consumers). But see infra note 96. If consumers bear the business tax under the X-tax, consistent with the classic assumption for the traditional VAT which does not separate out the wage component, consumers presumably also bear the X-tax’s wage portion.
tax would then fall on the act of consumption. As such, the X-tax corrects the realization problems, much like the cash flow tax.

Given the significant uncertainty over the economic incidence, an alternate assumption would assume that laborers bear the wage portion and business owners bear the business portion. Assume again that T receives a $100,000 wage on 12/31/04. In order to emphasize certain X-tax provisions, however, now assume that T invests his after-tax salary in a new wholly-owned business. Like the Hybrid Approach, T owes $40,000 tax on the $100,000 wages in 2004, leaving $60,000 for investment in the business on 12/31/04. The business purchases $60,000 inputs on 12/31/04. While such inputs generate deductions under the X-tax, the deductions here must be carried forward to 2005 because the business has no taxable receipts to offset in 2004. As mentioned above, the deduction carryforwards get increased by the risk-free interest rate. Assume the business sells all its assets/products for $120,000 one year later. Like the Hybrid Approach calculations above, the business would owe 40% multiplied by $54,000 (the excess of the $120,000 receipts over the $66,000 interest-adjusted deduction). After paying $21,600 tax, T once again has $98,400 available for consumption.

95. Recall Example 3A, where T invested $60,000 of his wages in the risky stock and $40,000 in the Treasury Note. Although T must pay tax on his wages under the X-tax, his pretax wages would be grossed up to $166,667 under the assumption that economic incidence falls on the consumption act. If so, T still has $100,000 to invest after paying the 40% wage tax. Once again, T invests $60,000 in the risky stock and $40,000 in the Treasury Note, generating $164,000 before he consumes. This amount allows T to purchase only $98,400 of goods; that amount of goods must be sold for $164,000 to cover the tax ($164,000 x 40% equals $65,600 of tax).

96. Some commentators question whether consumers in fact bear the entire VAT. E.g., Cliff Massa & David Raboy, The Canadian Value-Added Tax: Does Anybody Care?, TAX NOTES INT'L, Oct. 25, 1989, available at LEXIS 1989 TNI 43-58. Beyond the traditional VAT, the X-tax might introduce additional uncertainty due to its separation of the wage component, taxed at an individualized progressive rate. Other permutations for the ultimate incidence are possible as well, of course.

97. As an aside, T's employer would not owe business tax on this salary payment even if it is funded from taxable receipts (e.g., product sales) because T's salary is deductible by the employer. This is in contrast to the traditional VAT, under which the compensation tax would be paid at the business level. See supra note 87 and accompanying text.

98. Business deductions could also be carried forward, with interest, under Professor Bradford's suggestion that new expenditures should be spread out over time even where the business has otherwise taxable receipts. See Shaviro, supra note 36. For an alternate path to same result if the deductions can be currently used, see infra note 99.

99. For ease of exposition, the example assumed the business could not currently use the deduction from its new purchase funded by T's contribution. Relaxing this assumption would leave T in the same general place, although the explanation is more complicated. If the business in which T invests saves current tax from T's investment, T need invest only $36,000. This results because a $60,000 business investment requires only $36,000 of outside capital if the new investment currently saves $24,000 of tax (40% x $60,000). Therefore assume that T invests $36,000 in the business with the remaining $24,000 of after-tax wages in Treasury notes. The business would owe $48,000 tax upon the sale of all assets for $120,000 the next year. There would be no offsetting deduction now because it was already utilized in earlier year. This leaves a $72,000 distribution to T. Because T receives $26,400 from the Treasury notes ($24,000 plus $2,400 interest), T consumes the same $98,400 as under the
B. DUAL TAXES ADDRESS SINGULAR CONSUMPTION TAX PROBLEMS

Part III.A showed how the Hybrid Approach and X-tax correct the income tax's realization problems, similar to the conventional VAT and cash flow tax. This Part III.B highlights why the dual taxes' shared characteristics also address objections to the singular VAT and cash flow tax. Recall first the serious distributional objections to the business-level VAT. In favorable contrast, both the X-tax and the Hybrid Approach tax wages at progressive individualized rates. 101

Consider next the cash flow tax concerns stemming from its relinquishment of current tax on all saved wages. The dual taxes respond by maintaining an individual wage tax on saved wages. 102 First, an exemption for transition savings withdrawals would not trigger the same interim revenue concerns because tax still would be collected on new savings. Second, the up-front tax collections at the wage date and source address concerns that wage savers ultimately would avoid the deferred tax due at consumption. Finally, progressivity on saved wages would be based on yearly wages rather than yearly consumption, like current law. 103

Finally, compare another possible consumption tax equivalent to emphasize the merits of the dual taxes' supplementary tax on consumption less wages. The basic facts of Examples 1A and 3A illustrate the possible consumption tax equivalence of a single-element wage tax, with an explicit exemption for all investment return. 104 Under a flat 40% wage tax, T again would pay $40,000 tax on the $100,000 wages in 2004. In this case, however, T should limit his risky X stock investment to $36,000 (60% of $60,000) because the government no longer shares 40% of the profits and losses. 105 If T invested the other $24,000 in a 10% Treasury Note, T again could consume $98,400 after one year: $26,400

other consumption taxes.
100. See, e.g., supra note 83.
101. As discussed infra Part IV, the Hybrid Approach also could impose progressive rates through its supplemental individual tax on consumption less wages.
102. As discussed infra note 103 and accompanying text, the current rules providing special treatment for qualified retirement plans could be maintained under the Hybrid Approach.
103. As discussed infra Part IV, the two dual consumption tax forms differ in some regards as to their response to the cash flow tax concerns. Consider progressivity, for example. The investment return component of the Hybrid Approach takes an individualized approach, based on the individual's consumption level when savings are withdrawn. The X-tax's investment return component would also be imposed at the highest individual rate. Nonetheless, viewed generally, the first shared feature of the two dual consumption tax forms—the current tax on saved wages—addresses the cash flow tax concerns.
104. See Warren, supra note 80, at 936–41 (discussing the possible equivalency of the wage and consumption taxes, and the shortcomings of a stand-alone wage tax).
105. T invested $60,000 in the risky stock under the income and cash flow taxes only because the government's 40% tax on investment returns in effect limited T to a 60% partnership share.
Treasury Note proceeds plus $72,000 X stock proceeds.\textsuperscript{106}

Although the singular wage tax addresses the VAT and cash flow concerns like the X-tax and Hybrid Approach, it places tremendous pressure on distinguishing “wages” from “investment return.”\textsuperscript{107} In favorable contrast, both dual consumption taxes provide back-stop protection against such conversions through their supplemental tax on consumption less wages.\textsuperscript{108} The stand-alone wage tax raises other issues even if one assumes, as suggested by the core example analysis above, that tax collections on typical risky investment returns do not ultimately burden taxpayers.\textsuperscript{109} Limiting tax collections to wages might raise offsetting revenue concerns or a perception problem that the wealthy pay no tax on their primary revenue source.\textsuperscript{110} In addition, tax collections might actually burden risky returns for a number of reasons.\textsuperscript{111} Once

\textsuperscript{106.} The $98,400 matches the results under the cash flow tax in Example 3A and the Hybrid Approach discussed supra Part III.A.1.

\textsuperscript{107.} While provisions like the capital gains rate make this distinction important under current law, see supra notes 55–56 and accompanying text, the singular wage tax would raise the stakes even higher through its complete exemption for investment return.

Consider the following example. T invests $100,000 of capital in a new business and performs $100,000 of services for such business. T sells the business for $300,000 to fund consumption. Half of the $200,000 increased value reflects the services and should be taxed under a wage tax. T might avoid such wage tax unless the business pays T the full $100,000 in salary, however. At the extreme, the business might not pay T any compensation (from a non-tax perspective, T qua laborer does not need to receive a salary because any unpaid salary redounds to him qua business owner). T might treat the entire $200,000 gain as exempt investment return. While the government could challenge the lack of salary, this requires enforcement resources and the ability to determine the true labor component in the absence of a market transaction. This difficulty in separating out the true labor amount arises in other contexts, such as patents. See David A. Weisbach, Ironing Out the Flat Tax, 52 STAN. L. REV. 599, 608–09 (2000).

\textsuperscript{108.} Recall the example supra note 107. As discussed in that note, T might avoid all tax by treating the $100,000 earned income value as exempt investment return. If T treated the earned income value as investment return under either of the dual consumption taxes, the tax would not be avoided. If the wages were paid, T would pay tax on $100,000 of wages under either dual tax; the true investment return in excess of the risk-free rate (e.g., $90,000, assuming a 10% risk-free rate) also would be taxed. While treating the earned income value as investment return would avoid the wage tax component, the taxable investment return under either dual tax would increase from $90,000 to $190,000.

\textsuperscript{109.} The possible wage tax equivalency suggests that the consumption tax, in particular, fails to burden all investment return, including the risky portion. If this is correct, Part I.A indicates that the income tax also exempts risky returns. This can be seen in two ways. First, as shown supra Part I.A, the primary difference between the income and consumption taxes concerns the risk-free rate. Second, the reason for the apparent lack of burden under the consumption tax is that taxpayers can offset the government’s forced partnership on risky returns by increasing their risky investments. Under certain assumptions, this negates the tax burden, despite the formal tax payment. As discussed supra Part I.A, taxpayers similarly can increase their investments under the income tax. See supra note 35.

\textsuperscript{110.} This also could raise concerns over the lack of U.S. taxation on foreign investment in the U.S. See infra note 148 and accompanying text.

\textsuperscript{111.} One such reason concerns special, limited inframarginal opportunities, which provide above-market returns after adjustment for risk. Taxpayers cannot avoid the tax burden on inframarginal returns by increasing their investment amounts (the inframarginal investment, by definition, is limited). A change in tax rates provides a second possible reason; the wage tax equivalency above assumed constant tax rates.
again, the dual consumption tax equivalents favorably contrast as they collect tax on risky investment returns, much like current law.

IV. DIFFERENCES BETWEEN THE X-TAX AND HYBRID APPROACH

Part III demonstrated the significant overlap between the X-tax and the Hybrid Approach and how their shared characteristics correct key difficulties with the income and singular consumption taxes. The two dual consumption taxes contain important differences, however, amidst their significant overlap. This Part explores the key areas of divergence, identifying the relative advantages of each. Part IV.A highlights the X-tax's administrative advantages over the Hybrid Approach, while Part IV.B identifies a number of ancillary X-tax changes that significantly increase transition and related costs.

A. FURTHER X-TAX SIMPLIFICATION FROM THE BUSINESS TAX

As discussed above, a consumption tax closes income tax loopholes and simplifies the law.\(^\text{112}\) The X-tax provides even greater simplification, at least in one regard. Individuals would report only wages under the X-tax; all other reporting aggregates at the business level. In contrast, individuals would be required to account for all investments under the original Hybrid Approach.

In one sense, this distinction between business and individual reporting can be misleading. Similar accounting would be required of a small business owner under both the X-tax and the Hybrid Approach.\(^\text{113}\) A meaningful distinction nonetheless exists when considering, e.g., an "ordinary" individual who owns some stocks, bank deposits, and money-market accounts. Such individual would need to track these investments, and apply the risk-free interest adjustment, under the original Hybrid Approach. In favorable contrast, the comparable interest adjustments under the X-tax would be aggregated and applied at the business level. Pushing such calculations to the business level might lessen administrative, or related public perception, objections to the new interest adjustments.\(^\text{114}\)

\(^{112}\) See supra Part II.B. Consumption taxes eliminate significant areas of income tax complexity by neutralizing time value of money differences. This includes, but is not limited to, the elimination of the need for the capital gains preference. See also, e.g., supra notes 52-53 and accompanying text (discussing I.R.C. § 1259, regarding constructive sales).

\(^{113}\) This assumes that the X-tax lacks a small business exemption. A small business exemption raises possible tax avoidance and other concerns. See Weisbach, supra note 107, at 645-47.

\(^{114}\) See Bankman, supra note 1, at 87 (taxpayers might have difficulty understanding the interest adjustments). Moving the interest adjustments to the entity level might address such concerns, at least in part. Individual taxpayers would not have to make such adjustments although they still would be part of the tax system. Offsetting elimination of complexity under the consumption tax should more than outweigh complexity concerns over the new interest deductions.
B. ADDITIONAL X-TAX TRANSITION COSTS

Transition costs generally favor narrow over broad legal changes, ceteris paribus, as briefly evidenced above by the cash flow tax difficulties. And the second key difference between the X-tax and the Hybrid Approach concerns the degree of change to current law. While both taxes provide the desired realization correction through a limited risk-free exemption, the X-tax also would make a number of ancillary fundamental changes to current law. This section first identifies such X-tax changes, and then explores transition costs in greater detail.

I. Additional Fundamental Changes Under the X-tax

Consider first the “corporate tax integration” under the X-tax. Under current law, corporate stock investments are taxed both at the corporate and shareholder levels.115 The X-tax would “integrate” this current double tax regime into a single fixed-rate business tax. Next, and somewhat related, the X-tax would shift the current single tax on non-corporate businesses from the individual owner level to the business level.116 This significant shift would apply to all “tax partnerships,” including many limited liability companies. In a third significant shift, the X-tax would exempt most “financial” transactions such as loans, earning its moniker as an “R-tax,” imposed only on “real” transactions.117

The last two fundamental changes interrelate. Broadly, the X-tax shifts from a “receipts” focus to an “expenditure” focus. That is, the current system must police appropriate inclusions of taxable receipts (e.g., wages, investment returns, etc.). In contrast, the X-tax base relies on the proper reporting of taxable expenditures by individuals (e.g., purchases of goods and services).118 Finally, significant international changes would result regardless of whether the X-tax was imposed on an “origin” or “destination” basis. Consider first an “origin-basis” X-tax which would tax U.S. production rather than U.S. sales. In a significant change, there would not be any direct U.S. tax collections on imports consumed by U.S. individuals.119 Contrast a “destination-basis” X-tax,

115. Currently, shareholders are subject to tax on dividends and gains on sale, I.R.C. §§ 61(a)(3), 116. In addition, the X-tax would apply regardless of whether the business’s interests are publicly traded. But compare I.R.C. § 7704(a), which generally forces double taxation on non-corporate entities only if they are publicly traded.

117. Avoidance concerns are at least partially responsible for making the tax “R-based.”

118. The current system must monitor expenditures in determining allowable deductions. Nonetheless, the change is potentially important because the rule on inclusions differs. While the current system must regulate expenditures, the “default rule” is that expenditures are consumption (i.e., taxpayers must claim deductions, which are subject to challenge). Under the expenditure focus of the X-tax, the system must specifically target inclusion of those expenditures that constitute taxable “consumption.” Compare infra note 127 (discussing the new gap on deferred payment sales).

119. In contrast, U.S. individuals generally are subject to U.S. tax on consumption of foreign goods under the current (income) tax structure. This results because U.S. individuals generally must include
which would be imposed on U.S. sales rather than U.S. production. While imports would be subject to a direct U.S. tax, U.S. exports would receive a blanket U.S. tax exemption in an alternate shift.  

2. Difficulties with X-tax’s Ancillary Changes

The additional X-tax changes would significantly increase transition costs. Consider first X-tax changes over the legal responsibility for the tax. As described above, partnerships would assume responsibility for federal taxes from the partners. Tax payments on loans similarly would shift from lenders to borrowers as the X-tax would eliminate interest deductions for borrowers and interest inclusions for lenders. Changing the legal responsibility for the tax could create undesirable wealth shifts as existing partnership and loan agreements reflect the current tax treatment. For instance, the current tax treatment of loans—inclusion (deduction) of interest by lenders (borrowers)—results in higher interest rates, ceteris paribus. This reflects the parties’ understanding that the after-tax interest rate is lower than the pretax interest rate. Lenders therefore could benefit at borrowers’ expense on existing loans under the X-tax as the higher pretax rate would become the after-tax rate as well.  

their worldwide tax receipts as income. U.S. individuals arguably would bear an implicit tax on their consumption of foreign goods even under an origin-basis U.S. VAT. This argument relies on exchange rate adjustments to equalize origin and destination based taxes, at least in the long run. For example, if the United States exempted imports under an origin VAT, increased demand for foreign goods would weaken the dollar, thereby making foreign goods more expensive. See, e.g., Graetz, supra note 94, at 1101–03. The import exemption nonetheless is likely to raise objections. See id. at 1103 (“U.S. ‘manufacturers’ that compete with products from abroad will not readily accept economists’ assurances that exchange rates will adjust quickly and effectively.”). In any event, the origin-basis VAT would be a significant change to current law, implicating the general concerns discussed infra Part IV.B.2.

120. Current law is not typically contemplated in terms of an origin or destination basis because it is an income tax. The income tax nonetheless encompasses an origin-basis. Shaviro, supra note 36, at 92.

121. Currently, borrowers generally can deduct interest while creditors generally must report an offsetting inclusion. An R-based system would eliminate the borrower’s deduction and the lender’s inclusion.

122. This is not a concern for new loans, because interest rates would adjust on a going-forward basis. There could be similar wealth shifts between partners. Consider, for instance, how the ancillary move to entity taxation might undercut desired transition relief for the more general shift from an income tax to a consumption tax. As discussed supra text accompanying notes 76–77, transition relief generally appeals in connection with the move to a consumption tax as a way to avoid an undesired double tax on transition savings. Suggested transition relief generally takes the form of allowing deductions for asset basis at the time of transition. Consistent with its entity approach, X-tax transition relief contemplates business transition deductions based on the business’s basis. David Bradford, Consumption Taxes: Some Fundamental Transition Issues, in FRONTIERS OF TAX REFORM 123, 143 (Michael J. Boskin ed., 1996). This might significantly distort the desired relief for non-corporate businesses, however. The X-tax approach would aggregate the relief at the entity level, allowing all entity participants to share in such relief on a pro rata basis. Yet, the participants generally should receive varying relief based on their basis in their ownership interests. Because shareholders also are taxed under current law, it might appear that the same is true in the corporate context. A distinguishing feature in the corporate context, though, is that there currently is an entity tax. In
Possible transition relief would add complexity without eliminating the concerns. Private drafting costs also would increase as parties would have to renegotiate arrangements in response to these significant changes. A recent study by Professors Yin and Shakow neatly summarizes the collective transition concerns. After analyzing the related issue of possible improvements to partnership taxation under the income tax, Yin and Shakow recommended a modified individual-level tax over a new entity tax, citing “greater transitional costs” as “perhaps the deciding factor.”

The substantial X-tax changes also raise the level of uncertainty regarding the shift to a consumption tax. Possible exploitation after enactment is one aspect of the uncertainty difficulties. As an example, overstating the interest element on a deferred payment sale would allow tax-free consumption under the X-tax. Uncertainty difficulties from extensive changes may also impede enactment as policy makers must reach comfort on a wider range of issues. The X-tax requires

theory then, there should be both entity and individual relief. Because the corporate tax is the more prominent tax, entity tax relief might be a good compromise in the corporate context.

As with any tax law change, the propriety of transition relief is open to some debate. For a general discussion of transition relief, compare, for example, Kyle D. Logue, Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment, 94 Mich. L. Rev. 1129 (1996), with Michael J. Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47 (1977). As to the specific issue regarding debt, Professor Bradford, the X-tax originator, concluded that it was a real concern worthy of possible transition relief. Bradford, supra note 122, at 143. While any consumption tax form raises a transition shift on debt due to the new risk-free exemption, an R-type consumption tax exacerbates matters by extending the shift to the full interest return.


George K. Yin & David J. Shakow, Federal Income Tax Project, Taxation of Private Business Enterprises, Reporters’ Study 100–01 (American Law Institute 1999). Specifically, they go on to explain that the individual “approach is already in effect for [tax partnerships]. In contrast, an entity tax approach imposing only a single level of taxation on business income would represent a new system for all firms.” Id. at 101.

See Van Alstine, supra note 124, at 834–35 ("[U]ncertainty spawned by legal change . . . will increase the likelihood of opportunistic argumentation at the margins of the law.").

This stems from the shift to an R-tax with expenditure focus. There would be a corresponding understatement of the real (taxable) purchase price. The problem arises from the loan exclusion under the R-based tax. While the government can challenge the interest component, this is an imperfect response. Manipulating the interest and purchase price components also presents issues under current law for certain taxpayers due to the capital gains rate and time value of money concerns. Nonetheless, this would add a significant new element: no tax collection to the extent of the disguised purchase price on consumption expenditures by all individual consumers. See Charles E. McLure Jr. & George R. Zodrow, A Hybrid Approach to the Direct Taxation of Consumption, in Frontiers of Tax Reform 70, 76–77, 84 (Michael J. Boskin ed., 1996).

See Nathaniel O. Keohane, Richard L. Revesz & Robert N. Stavins, The Choice of Regulatory Instruments in Environmental Policy, 22 Harv. Envtl. L. Rev. 313, 358 (1998) ("[L]egislators may need to spend time learning about unfamiliar policy instruments before they can provide substantial support, thereby giving rise to a status quo bias in favor of the current regime . . . ").
consideration of complex issues including corporate integration, complete elimination of an individual investment return tax, the partnership and loan tax collections shifts, and the U.S. exemption of either imports or exports. Related thereto, recall the consumption tax’s initial attraction as a simple correction to realization problems under the income tax.

To summarize, then, this is not a policy argument against any particular X-tax change. Rather, the enormity of the X-tax changes can overwhelm the process and trigger the status quo bias against substantial changes. In favorable contrast, the Hybrid Approach minimizes

129. Corporate integration through a single corporate-level tax precludes the ability to vary the rate on corporate investors based on their particular profile. For one potential problem related to this standardization, see infra Part V.A.2, regarding foreign investors and treaty negotiations. In addition to the issues mentioned in the text, consider the possible shift in tax incidence from investors to consumers, as is commonly assumed under the X-tax. See supra notes 94, 96 (discussing tax incidence under the X-tax).

130. Whether imagined or real, there might be discomfort in completely releasing the individual tax. Consider, for example, the following questions which might come to mind. Would there be a small business exception? Would an exemption for real estate businesses be problematic? See Weisbach, supra note 107, at 614 (noting such exemption for the structurally comparable flat tax). Back to the expenditure focus, would the tax encompass all consumption of goods/services? Furthermore, even if the substantive issues are adequately addressed, there might be a public perception problem. It might appear that the wealthy do not pay any tax on investment returns.

131. See supra notes 119–20 and accompanying text.

132. Current arguments for the consumption tax’s superiority often emphasize the limited risk-free differential between the consumption and income taxes. See, e.g., supra Part I.A; Bradford, supra note 122, at 128–33; Shaviro, supra note 36. An income tax proponent might be swayed by this intellectually challenging, yet concentrated, argument. The X-tax consumption form, however, then forces the income tax proponent to navigate through a number of other significant changes, calling into question the limited nature of the differences between an income and a consumption tax. See, e.g., Julie Roin, The Consequences of Undoing the Federal Income Tax, 70 U. CHI. L. REV. 319, 334 (2003) (“This essay just begins to identify and evaluate the myriad dislocations and changes that would be brought about by [the] repeal” of the federal income tax and its replacement with a VAT.).

133. Professor Bradford and others have provided outstanding analysis of the X-tax since its introduction in 1988. See, e.g., Bradford, supra note 122; Shaviro, supra note 36, at 93–97; Weisbach supra note 6. The tremendous quantity of work in the intervening years highlights, though, the extensiveness of the X-tax changes, with the aforementioned difficulties.

134. The status quo bias can be seen both on an individual basis and collectively under the legislative process. Lillian R. BeVier, The Communications Assistance for Law Enforcement Act of 1994: A Surprising Sequel to the Break Up of AT&T, 51 STAN. L. REV. 1049, 1062 n.37 (1999) (“The status quo bias exhibited by legislative institutions is in large part the sum of the biases of individual legislators.”); Keohane et al., supra note 128, at 339–45; William Samuelson & Richard Zeckhauser, Status Quo Bias in Decision Making, 1 J. RISK & UNCERTAINTY 7, 33 (explaining individuals' status quo bias as a combination of “(1) rational decision making in the presence of transition costs and/or uncertainty; (2) cognitive misperceptions; and (3) psychological commitment stemming from misperceived sunk costs, regret avoidance, or a drive for consistency.”); Lisa Schultz Bressman, Schechter Poultry at the Millennium: A Delegation Doctrine for the Administrative State, 109 YALE L.J. 1399, 1423 n.155 (2000) (“[T]he Framers anticipated that the Article I legislative process would promote stability and incremental change rather than sudden and significant departures from the status quo.”) (citing William N. Eskridge, Jr. & John Ferejon, The Article I, Section 7 Game, 80 GEO. L.J. 523, 532 (1992)).
transition concerns by incorporating the consumption tax’s risk-free exemption into the existing tax structure.\textsuperscript{135} The Hybrid Approach focuses the legal change on the critical realization problems, long recognized as “the Achilles Heel of the Income Tax.”\textsuperscript{136} Finally, this analysis suggests continuation of an entity-level tax on corporations, similarly converted to a consumption tax through a risk-free exemption.\textsuperscript{137} Part V will explore corporate taxation in greater detail as it balances the respective strengths of the X-tax and the Hybrid Approach.

V. REFORM PROPOSAL: A TRIPARTITE CONSUMPTION TAX

Both the X-tax and the Hybrid Approach appeal due to their sorely-needed correction to interest-free deferral under the realization income tax. Accordingly, both dual consumption taxes would strengthen the tax base while providing desired simplification through the elimination of the complicated capital gains regime and other intricate provisions which protect against interest-free deferral. The comparison of the X-tax and Hybrid Approach highlighted a difficult tradeoff, though. In one sense, the X-tax would further simplify the law by limiting individual taxation to wages. Such additional X-tax simplification carries a heavy transition toll, due to the totality of the X-tax changes. Rather than choosing between the two taxes, this Part endeavors to combine the X-tax’s further simplification with the Hybrid Approach’s transition ease.

I propose a new tripartite consumption tax consisting of: (1) an individual wage tax, (2) a corporate business tax,\textsuperscript{138} and (3) a more limited individual tax on non-wages which exempts certain investments.

\textsuperscript{135} See Alison Bennett, Bush Soon to Appoint Tax Reform Panel, Committed to Real Change, Bodman Says, DAILY TAX REP. (BNA), Nov. 19, 2004, at G-8 (Deputy Treasury Secretary “hinted the administration may be considering an incremental approach to reform”); Ralph Lindeman, Nine-Member Panel on Tax Reform Created; Reactions, Warnings, Suggestions Abound, Daily Tax Rep. (BNA), Jan. 10, 2005, at GG-1 (“Lawmakers and tax analysts generally agree that major changes to the tax code will be difficult to achieve.”); Katherine M. Stimmel, Thomas Says Lawmakers Must Balance Reform Goals Against What Can Be Passed, DAILY TAX REP. (BNA), Nov. 19, 2004, at G-12 (House Ways and Means Chairman suggests that “incremental reforms rather than fundamental overhaul of the tax system has a better chance of getting enacted”); Van Alstine, supra note 124, at 858 (“A sensitivity to legal transition costs could manifest itself in... a systemic preference for targeted change over comprehensive reform.... [I]nitiating change carefully and within the framework of the existing legal regime can diminish substantially the likely transition costs.”).

\textsuperscript{136} Andrews, supra note 64, at 278.

\textsuperscript{137} This would maintain the current double tax regime. Absent a corporate-level tax, the individual Hybrid Approach also would integrate the corporate tax, in this case through a single shareholder tax. See Engler & Knoll, supra note 6, at 60–62 (suggesting the possibility of a corporate tax in connection with the Hybrid Approach). Note the lack of a capital gains preferential rate for corporations under current law. See I.R.C. § 1201(a) (2005) (capping the corporate rate on capital gains at 25%, the same as the top ordinary rate under current law).

\textsuperscript{138} While I also recommend a low-rate dividend tax on shareholders, I consider such tax as part of the corporate business tax for these purposes because such tax would be calculated and collected by corporations. See infra note 150 and accompanying text.
This blended approach harmonizes the relative strengths of the X-tax and the Hybrid Approach; it further simplifies individual taxation without heavy transition concerns. This Part first isolates corporate investments given their unique "double tax" treatment under current law: i.e., a high-rate corporate tax plus a low-rate shareholder tax on dividends and capital gains. This Part then considers other investments which could be disregarded by the individual investment tax.

A. CORPORATE INVESTMENTS

1. Corporate-level Consumption Tax

The transition analysis above for partnerships reverses for corporations. As discussed above, entity taxation of partnerships would trigger significant transition costs as the full tax liability would shift from the partners to the partnership. The converse is true for corporations; elimination of the high-rate corporate tax would cause significant dislocations. Continued entity taxation of corporations therefore appeals under a consumption tax, especially given the administrative advantages of aggregated tax calculations and payments at the entity level.

How should the current corporate tax be converted into a consumption tax? Drawing upon the individual taxpayer analysis above, there are two main possibilities. A cash flow approach would permit current-year deductions for business expenditures as spent, including the cost of assets with value beyond the current year, such as equipment. In contrast, current law requires capitalization of such long-lived assets, which defers deductions until later years through depreciation allowances. This suggests the second consumption tax possibility: maintain depreciation of long-lived assets, but increase deferred costs by the risk-free interest rate. This interest adjustment could be calculated

139. The maximum rate on dividends and capital gains is 15%, I.R.C. §§ 1(h)(1)(C), 1(h)(11) (2005), while the top corporate rate is 35%. Id. § 11(b)(1)(D).

140. If the corporate tax were eliminated, individual returns from the corporate enterprise presumably would then be taxed at the regular individual rates, similar to tax partnerships. Under a consumption tax, this could take the form of the individualized Hybrid Approach. Like current law, qualifying corporations could elect pass-through treatment under "Subchapter S." See I.R.C. §§ 1361-1379 (2005). Similar to above, these returns could be taxed as part of the individualized Hybrid Approach.

141. Depreciation is not available on non-wasting assets like land. The cost of land is recovered only at disposition as an offset against sales proceeds. Separately, there are certain exceptions under current law to the capitalization requirement for assets with useful lives beyond the current year. E.g., I.R.C. § 179 (election to expense certain depreciable business assets).

142. This still corrects the interest-free deferral under the realization income tax. See, e.g., Edwards, supra note 65, at 1296 (noting the timing-advantageous techniques under the corporate income tax such as deferring built-in asset gains and allocating acquisition costs to favorable assets in order to obtain quicker depreciation); see also Engler & Knoll, supra note 6, at 60-62 (the consumption tax corrects the realization defects through its timing neutrality). Notwithstanding such timing neutrality, it might be desirable to accelerate some tax collections, either for current revenue purposes or due to possible concerns that the tax would be deferred indefinitely. If so, as discussed...
separately for each asset\(^{143}\) or on an aggregate basis for all corporate assets.\(^{144}\)

The cash flow approach would further simplify current law by eliminating depreciation calculations.\(^{145}\) On the other hand, the capitalization with interest approach would smooth revenue and transitional concerns.\(^{146}\) A middle-ground approach would extend cash flow treatment for some, but not all, assets that currently must be capitalized.\(^{147}\)

2. **Shareholder Dividend Tax**

In addition to the full-rate corporate tax, a low-rate shareholder tax could be imposed upon corporate distributions of the (risky) investment profits. This might ease revenue and transition concerns given the current low-rate shareholder tax on dividends. The international context further supports maintenance of a dividend tax. International reciprocity exists under current law as foreign countries tax U.S. investors on foreign dividends and the United States taxes foreign investors on U.S. dividends. Some commentators therefore counsel against a unilateral elimination by the U.S. of its tax on cross-border dividends, expressing concern over such issues as weakened treaty leverage in negotiating reciprocal dividend tax reductions.\(^{148}\)
Importantly, this “shareholder” tax should differ from the individual Hybrid Approach tax applicable to non-corporate investments.\(^\text{149}\) The tax should be imposed at a fixed low-rate on corporate distributions of risky investment returns. In addition to addressing the above revenue, transition, and international concerns, this limited shareholder tax could access the administrative advantages of entity taxation. Corporations would calculate the tax, and also could collect it through withholding, as is currently done for foreign shareholders.\(^\text{150}\)

Further drawing upon current law, two international refinements merit further consideration.\(^\text{151}\) Foreign shareholders could be subject to a higher fixed tax rate on U.S. dividends, subject to possible treaty reduction.\(^\text{152}\) This would further address the treaty leverage concerns discussed above. Second, domestic shareholders could be subject to the regular-rate investment tax, not the low-rate dividend tax, on returns from certain foreign corporations. This would address concerns like limitation. In addition, the U.S. corporate income tax has occasionally provided equal—and possibly more favorable—treatment than a cash flow consumption tax due to the combination of accelerated depreciation plus an investment tax credit. See Harry Grubert & T. Scott Newlon, Reply to Avi-Yonah, 49 NAT’L TAX J. 267 (1996); Weisbach, supra note 107, at 643.

149. Application of the regular Hybrid Approach investment tax would (i) significantly increase the tax burden on corporate equity and (ii) eliminate the administrative advantages of corporate-level taxation.

150. Cf. Calvin Johnson, The Bush Administration: 35 Percent Flat Tax on Distributions from Public Corporations, TAX NOTES, Mar. 24, 2003, at 1881, 1881-82, 1890, available at LEXIS 2003 TNT 57-24 (recommending that any tax on distributions be computed by and collected from the corporation itself and not from a million, amateur bookkeeper shareholders). If the corporate tax took the cash flow form, the taxable shareholder distributions amount generally should match the corporation’s taxable amount for the year. One might ask, then, why not just collapse the corporate and shareholder taxes into a single corporate-level tax at a higher rate? The answer is that the separate shareholder component allows variation of the tax rate depending on the particular shareholder(s). For example, the shareholder tax can be reduced by treaty for certain foreign shareholders. See supra text accompanying note 148. This does suggest, though, a possible future elimination of the dividend tax in favor of a single corporate tax, possibly at a higher rate, if additional comfort is reached on the international treaty concerns. See infra note 159 (discussing how a corporate consumption tax facilitates corporate integration).

If the corporate tax rejected the cash flow approach in favor of depreciation with interest adjustments, the shareholder tax should apply to dividends to the extent of the corporation’s “earnings and profits” account, like current law. Such earnings and profits account would naturally take into account the interest adjustments because earnings and profits are calculated by adjustments to the taxable amount. Increasing the undistributed earnings and profits by the risk-free rate would be a worthwhile adjustment as this would maintain timing neutrality over distribution decisions. Additional protection might be provided by a separate rule taxing shareholder distributions in excess of shareholder contributions plus the risk-free return thereon, appropriately reduced for prior distributions.

151. The international analysis herein focuses on key broad-based applications. Additional international refinements might be appropriate as well, given the intricacies of international taxation.

152. Under current law, U.S. shareholders face a top rate of 15% on dividends from U.S. corporations. I.R.C. §§ 1(h)(1)(C), 1(h)(11) (2005) (dividends treated as capital gains for domestic shareholders). In comparison, foreign shareholders face a top rate of 30%. Id. § 871(a)(1)(A) (30% rate on non-resident alien individuals).
insufficient taxation on returns from foreign corporations in tax haven jurisdictions.153

3. Elimination of Shareholder Tax on Stock Sale Gains

Four reasons support my proposed elimination of the current shareholder tax on stock sale gains.154 First, unlike the shareholder dividend tax, taxing stock sale gains would require individual calculations and payments, undercutting the administrative advantages of entity taxation. Second, eliminating the shareholder tax on stock sale gains would not disrupt the current international balance as the United States already exempts foreigners' stock sale gains.155 Third, as a practical matter, individuals tend to grossly understate such gains under current law.156

Fourth, the stock sale tax protects against interest-free deferral under the corporate income tax, but the corporate consumption tax corrects for interest-free deferral on its own. Consider a corporation whose assets appreciate under the original group of stock owners. These stockholders can cash out on their investment without triggering the corporate-level tax by selling their stock. The unrealized gains remain intact at the corporate level under the new ownership group, but such

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153. Under current law, U.S. shareholders receive the capital gains rate only on dividends from domestic corporations and qualified foreign corporations. I.R.C. § 1(h)(11)(B)(i) (2005). Qualified foreign corporations include corporations eligible for treaty benefits under a treaty deemed satisfactory by the Treasury Secretary. Id. § 1(h)(11)(c)(i)(II). The U.S.-Barbados treaty was deemed insufficient for this purpose because it provided double-tax relief benefits to corporations not subject to double taxation. STAFF OF CONF. COMM., J. EXPLANATORY STATEMENT OF THE COMM. OF CONF., 108TH CONG. 29 (2003) (Conference Committee report on H.R 2, "The Jobs and Growth Tax Relief Reconciliation Act of 2003"). Returns from non-qualified foreign corporations under my proposal could be taxed as part of the individualized hybrid approach, and could include stock sale proceeds as well as dividends.

154. Repurchases by corporations of their own stock should be taxed, though. If not, the shareholder tax could be deferred by substituting repurchases for dividends. This raises two concerns even assuming interest rate increases to the (undistributed) earnings and profit account, which generally maintains time value of money neutrality. See supra note 150. First, the deferral could continue indefinitely so long as repurchases are utilized. Second, the tax liability reflected by the earnings and profits account could dwarf the remaining corporate assets because the repurchases would distribute owners' equity to the shareholders. In contrast to the dividend tax, which formally should be a shareholder tax, the tax on repurchases formally should be a corporate level tax for two reasons. First, a discontinuity would arise if shareholders were taxed on sales back to the corporation with an exemption for shareholder sales to third parties. Second, the appropriateness of the tax should turn on whether the funds would have been taxed if distributed by the corporation as a dividend, rather than the specific shareholder's gain.


156. David Cay Johnston, Overstating of Assets Is Seen To Cost U.S. Billions in Taxes, N.Y. TIMES, Jan. 24, 2005, at C2 (noting significant underreporting of capital gains from stock sales and how the Bush administration would like to eliminate the capital gains tax). Separate from such misreporting, current law also treats sales gains more favorably than dividends for domestic shareholders because sales proceeds are taxable only to the extent they exceed the shareholder's stock cost. Furthermore, until recently, dividends were taxed at a higher rate than capital gains (in addition to the earlier basis recovery).
gains can be further deferred without interest, reducing the true tax cost under time value of money principles.\textsuperscript{157} As such, the shareholder stock sale tax backstops the corporate income tax because the corporate income tax insufficiently taxes the cashed out gains of the selling stockholders.\textsuperscript{158} In favorable contrast, a corporate consumption tax corrects for interest-free deferral. If taxes are deferred when stockholders sell the stock, there is a time value of money correction because the deferred taxable gains will increase over time by the risk-free interest rate.\textsuperscript{159}

\section*{B. Non-Corporate Investments}

In addition to most corporate stock returns,\textsuperscript{160} the new blended approach would exempt three other investment categories from the Hybrid Approach’s individual tax on non-wages. First, interest-bearing investments at, or near, the risk-free rate would be completely exempt from individual tax. This includes U.S. Treasury bonds and notes, bank

\begin{footnotesize}
\begin{enumerate}
  \item A related explanation focuses on the purchase price paid by buyers for stock under a single, integrated corporate-level tax. \textit{See, e.g.,} Yin & Shakow, \textit{supra} note 125, at 371–82. While the selling stockholders would not pay actual tax on stock sales under such regime, they should bear some implicit tax because a well-advised purchaser would discount the purchase price for stock in a corporation with appreciated value. This is because the tax burden on the purchaser’s corporate investment will be determined by the corporation’s (low) basis in its assets, rather than the individual purchaser’s (high) basis in his stock. If investors bear the corporate tax, the purchaser assumes the built-in business tax. Reliance on such implicit tax is unsatisfactory under the income tax because the imbedded tax liability might be deferred indefinitely, without interest. Accordingly, the purchase price discount will be less due to the benefits of such interest-free deferral.
  \item See id. at 373–82. The tax shortfall arises even when accepting interest-free tax deferral until realization under the income tax. This is contrary to classic formulations of the income tax, which assume that income generally should be taxed as it accrues. \textit{See, e.g.,} the Haig-Simons formula, which defines income as the sum of consumption and changes in wealth.
  \item Under the corporate-level tax, the buyer effectively gets stuck with the corporation’s low basis in its assets. Under the consumption tax, deferral is offset because the buyer’s shortfall consists not only of the underlying basis differential, but also the risk-free exemption thereon. This results because deferred deductions under the consumption tax are increased by the risk-free interest rate. \textit{See supra} text accompanying note 89. Accordingly, returning to the explanation \textit{supra} note 157, the purchaser is more likely to discount the stock price for the full imbedded tax liability under the consumption tax.

As part of a long-term agenda, the consumption tax’s timing correction also might facilitate a market tax for (public) corporations. While the consumption tax’s interest adjustments correct interest-free deferral, it nonetheless might be desirable to eliminate excessively long periods of tax deferral (either from a revenue collection standpoint or because the interest rate is understated for very long deferral periods). An occasional market value check might appeal in this regard. Importantly, given the annual interest-free correction under the consumption tax, the market value check would not have to be applied on an annual basis, and imprecisions would be more acceptable. For example, every ten years or so, the corporation would have to pay tax to the extent its average market value over some recent period significantly exceeded its tax value (i.e., its basis in its assets). Such limited use should soften imperfections with intriguing market-based income taxes, which have been considered as annual income taxes. \textit{See, e.g.,} Joseph Bankman, \textit{A Market-Value Based Corporate Income Tax}, \textit{TAX NOTES}, Sept. 11, 1995, at 1347, available at \textit{LEXIS} 68 \textit{TAX NOTES} 1347.
  \item As discussed in the prior section, all returns from domestic corporations, as well as some from foreign corporations, would not be subject to the Hybrid Approach’s individual tax on non-wages.
\end{enumerate}
\end{footnotesize}
accounts, and money market accounts. The consumption tax’s risk-free exemption supports this exclusion; the administrative benefits should outweigh any slight imperfections.  

Second, Roth IRA investments also would be exempt from individual tax. This is attractive on both administrative and transition grounds as such treatment would maintain the current tax exemption for Roth IRA accounts.  

Similarly, current law could be maintained for other qualified retirement accounts such as traditional IRAs, 401(k) plans and 403(b) plans. Like current law, individuals would not pay any current tax on wages saved under such plans. At retirement, however, all withdrawals would be subject to tax at the regular rates.

In sum, individuals could hold a variety of standard investments without any individual calculations of the Hybrid Approach’s risk-free interest adjustments. In addition to providing further simplification, this

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161. There would be some imprecision due to (1) the exemption for returns approximating the risk-free rate, and (2) the different rates for different risk-free U.S. treasury investments. This differs from a proposal allowing taxpayers the option to exempt risky investments from a cash flow tax, relying on the assumption that risky investment returns are not burdened under a consumption tax. See Treasury Dep’t, Blueprints for Basic Tax Reform 119–27 (1977). Such a taxpayer option was criticized for its tax avoidance potential. Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1598–1610 (1979). The proposal here would be limited to nearly risk-free investments.

162. Under IRC § 408A(d)(1), “qualified distributions from a Roth IRA [are not] includible in gross income.” In addition to maintaining Roth IRA treatment for existing accounts at transition, taxpayers could be allowed to make new Roth IRA contributions from wages after enactment, subject to the current annual limitations. See infra note 163 for further discussion of Roth IRAs under the refined Hybrid Approach, including the reduced benefits thereunder.

163. This is consistent with consumption tax treatment; recall, e.g., the cash flow version of the consumption tax. Like the Roth IRA, continuation could cover both existing retirement accounts in this category at transition and the ability to make new contributions, subject to the current limits. Such plans might not be as attractive under the consumption tax given the risk-free exemption (although currently, you have to relinquish the capital gains preference). Nonetheless, taxpayers still might like some retirement plans. Roth IRAs might be attractive due to the lack of reporting and inclusions. Regular IRAs and 401(k) investments allow a progressivity shift to the consumption date (and a way to avoid interest accounting). It is important, though, to maintain restrictions on retirement accounts to avoid opening back up the stand-alone wage concern (upon too much expansion of Roth IRA treatment) or the cash flow concerns (upon too much expansion of either regular IRAs or 401(k) plan treatment).

The system might allow taxpayers an election to use their basis offset accounts from the Hybrid Approach investment tax as an offset against taxable retirement distributions from regular IRAs or 401(k) plans. This would lessen the chance of an unusable basis offset account. Importantly, though, if someone is not otherwise subject to the individual Hybrid investment tax, retirement accounts would not require the taxpayer to make any calculations under the individual Hybrid Approach. Separately, though, the system might want to allow some tax reduction for corporate stock held in a 401(k) plan. Taxing the investment return portion at the individual’s regular tax rate upon withdrawal seems excessive given the lesser shareholder tax on corporate stock held outside a 401(k) plan. On the other hand, a similar point could be made about current law because investing in corporate stock through a qualified retirement plan causes the individual to lose the lower capital gains rate on dividends and stock sale gains, although the taxpayer does receive an offsetting interest-free deferral benefit.
new approach should resonate better with the public.\textsuperscript{164}

\textbf{CONCLUSION}

The X-tax and the Hybrid Approach took different paths to their overlapping recommendations for a progressive consumption tax. The X-tax reacted to the conventional VAT's lack of tax-rate progressivity; the Hybrid Approach addressed revenue, transition, and tax avoidance concerns under the traditional cash flow tax. Together, these two independent proposals reinforce the merits of implementing a consumption tax, in part, through a progressive wage tax. The further overlap between these two independent proposals underscores the importance of a supplementary tax on consumption less wages. In addition to raising revenue and protecting the wage tax base, such supplementary tax highlights the serious flaw in the traditional assumption that a consumption tax comparatively exempts all investment return.

Moving beyond their shared characteristics, a comparison of these dual consumption taxes highlights important differences. The X-tax makes a number of significant structural changes to current law, intensifying potential transition and related objections. In contrast, the Hybrid Approach favorably works within the current framework, changing the current individual tax only to exempt the risk-free return and eliminate the capital gains preference. Both changes target the loopholes arising from the realization requirement, long recognized as "the Achilles Heel of the Income Tax."\textsuperscript{165} On the other hand, the X-tax furthers the administration of the consumption tax by limiting individual tax reporting to wages.

My refined proposal combines the relative strengths of the X-tax and the Hybrid Approach. First, the current entity-level tax on corporations would be maintained, modified only to allow a risk-free exemption. Second, a low-rate shareholder dividend tax would be maintained as well. Despite its designation as a shareholder tax, this dividend tax could be calculated and collected by corporations, like the corporate-level tax. Finally, the exemption of designated investments from the Hybrid Approach's individual investment tax further enhances the administration of the tax. These critical, yet concentrated, changes ease the way to a more equitable, efficient, and administrable consumption tax.

\textsuperscript{164} For a possible public perception objection to the interest calculations under the Hybrid Approach, see Bankman, \textit{supra} note 1, at 86--87. For a more general discussion of public perception constraints on taxation, see Zelinsky, \textit{supra} note 39, at 947--55.

\textsuperscript{165} See Andrews, \textit{supra} note 64, at 278.