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Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes

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I. INTRODUCTION

Of the many things we do not know about a national, broad-based consumption tax, this article addresses only one of the important uncertainties: the impact of a consumption tax on the overall intricacy of the federal revenue system. More specifically, this article examines some important issues regarding the effects on tax system complexity of the three principal candidates for a national consumption tax—the European-style, credit method value added tax (VAT), the subtraction method VAT, and the consumed income tax.[1]

Under a credit method VAT, a business subtracts the VAT paid on its purchases (including capital expenditures) from the VAT it collects on sales and either remits to the government the tax collected in excess of tax paid or receives from the government a refund of tax paid in excess of tax collected.[2] This system effectively taxes each business on the value that it adds to goods and services. Under a subtraction method VAT, a business deducts business purchases, including capital outlays, from sales and pays tax on the difference. A subtraction method VAT, sometimes called a business activities tax (BAT), differs from a single-rate credit method VAT only in computation procedure, and the two taxes produce the same revenue if imposed at the same rate.[3] Businesses are usually required to settle VAT accounts with the government more often than annually.

In simplified terms, a consumed income tax is assessed annually on individuals by applying progressive rates to a tax base composed of gross

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1. A national retail sales tax is another possibility. However, the VAT is generally considered a superior method of taxing consumer sales because (1) its multistage collection process is more effective at extracting revenue from tax evaders than the single-stage collection mechanism of a retail sales tax, (2) the states of the United States have found it quite difficult to eliminate nonconsumption sales to other businesses from the retail sales tax base, and (3) European VATs have been more successful at bringing services into the tax base. See generally 3 U.S. Treas. Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 13-16, 31-32, 47 (1984); David F. Bradford, Untangling the Income Tax 72-73 (1986); Sijbren Cnossen, The Value Added Tax: Questions and Answers, 42 Tax Notes 209, 210-11 (Jan. 9, 1989). Perhaps for these reasons, there is little current interest in a national retail sales tax, and this article does not deal with the simplification/complication issues raised by such a tax.

2. See generally 3 Treas. Dep't, supra note 1; Bradford, supra note 1, at 59-72; Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary 217-27 (prelim. ed. 1992); ABA Sec. of Tax'n, Report of the Special Subcommittee of the Committee on General Income Tax Problems on the Value-Added Tax, 24 Tax Law. 419 (1971).

3. See 3 Treas. Dep't, supra note 1, at 7-11; Oliver Oldman & Alan Schenk, The Business Activities Tax: Have Senators Danforth and Boren Created a Better Value Added Tax? 65 Tax Notes 1547, 1551-52 (Dec. 19, 1994). See also General Accounting Office, Implications of Replacing the Corporate Income Tax with a Consumption Tax 2-3 (1993).

income increased by borrowings and withdrawals from savings and reduced by debt payments, additions to savings, and business expenses.[4]

I do not contend that complexity considerations should take precedence over all other tax policy criteria. Even if enactment of a VAT or consumed income tax would lead to a more complex system, other tax and economic policies, including revenue needs, might make that the wisest course. Complexity considerations are, nevertheless, of considerable importance in formulating tax changes, and a consumption tax should not be enacted without carefully considering its effects on systemic complexity. Unfortunately, the determination of these effects is itself a complex and uncertain exercise requiring an analysis of numerous scenarios.

II. WHAT IF CONGRESS ENACTS A VAT?

VAT proponents often say that a VAT is the essence of simplicity,[5] and the suggestion is sometimes made that adoption of a VAT would reduce complexity in the federal tax system.[6] However, the characterization of a VAT as simple may be misleading, and whether a VAT would reduce overall complexity depends on how VAT revenues are used.

A. *Is a Single-Rate VAT Simpler than the Income Tax?*

A single rate VAT effectively imposes tax equal to a flat percentage of the value added at each stage of the production and distribution of goods and services, with the sum of these incremental taxes usually being viewed as borne by consumers.[7] In comparison with the federal income tax, the VAT gets high marks for simplicity. Because businesses are allowed to expense the costs of capital goods and inventory in making value added computations,[8]

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4. See 1 U.S. Treas. Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 191-93 (1984); U.S. Treas. Dep't, Blueprints for Basic Tax Reform 113-44 (1977) [hereinafter Blueprints].

5. See, e.g., Cnossen, supra note 1, at 211.

6. See U.S. Treas. Dep't, Restructuring the U.S. Tax System for the 21st Century: An Option for Fundamental Reform, 92 TNT 247-15 (Dec. 11, 1992) (LEXIS, FEDTAX library, TNT file); M. Carr Ferguson, It's Time to Step Up to the Plate for a BAT, 72 Taxes 639 (1994).

7. Jonathan R. Kesselman, Assessing a Direct Consumption Tax to Replace the GST, 42 Can. Tax J. 709, 724-25 (1994); Oldman & Schenk, supra note 3, at 1548. See also 3 Treas. Dep't, supra note 1, at 29, 43. For a different view of the incidence issue, see Cliff Massa III & David G. Raboy, The Canadian Value-Added Tax: Does Anybody Care? 45 Tax Notes 481, 485-88 (Oct. 23, 1989).

8. Under a credit method VAT, a business subtracts, from the VAT that it collects on its sales, the VAT paid on all of its business purchases, including purchases of productive

the capitalization and capital cost recovery rules that contribute so importantly to the complexity of the income tax are absent from a VAT. Since nothing is capitalized, a VAT has no depreciation or inventory rules, and basis need not be recorded, tracked, or adjusted. Gain or loss, in the sense of the difference between amount realized and basis, never has to be calculated when assets are sold.[9]

Also, under a VAT, compensation payments to a firm's employees are neither deducted in computing the firm's value added nor treated as taxable sales made by the employees to the firm.[10] Thus, a VAT allows both employers and employees to ignore cash compensation payments and deferred cash compensation issues.[11]

Yet another way in which a VAT is less complex than the income tax is that a VAT has no separate entity regimes. Because the tax applies to sales transactions regardless of the seller's form of organization, but does not apply to income distributions, a VAT has no need for provisions dealing specially with corporations, partnerships, or trusts.[12]

For these and other reasons, replacement of the income tax with a VAT would be an enormously simplifying development in the federal revenue system. Unfortunately, for reasons described below, this is also a politically improbable development.[13] In the most likely scenarios, a federal VAT would be an addition to the revenue system that would coexist with the income tax.[14] To understand the effect of such a VAT on the overall intricacy of the tax system, it is necessary to consider the extent to which a VAT possesses inherent complexities and the extent to which those complexities might be increased by the political process.

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assets and goods and services absorbed into inventory. This credit effectively removes all capital expenditures and inventory costs from the VAT base. See 3 Treas. Dep't, supra note 1, at 7-9. See also Bradford, supra note 1, at 61-64.

9. See 3 Treas. Dep't, supra note 1, at 7; Bradford, supra note 1, at 61-64.

10. 3 Treas. Dep't, supra note 1, at 5; Bradford, supra note 1, at 61, 88; ABA Sec. of Tax'n, supra note 2, at 422-23; Hussey & Lubick, supra note 2, at 105, 109; Kesselman, supra note 7, at 709, 718; Oldman & Schenk, supra note 3, at 1550, 155 n.55. See also S. 2160, 103d Cong., 2d Sess. § 10013 (1994), reprinted in 140 Cong. Rec. S6524-30 (daily ed. June 7, 1994).

11. Under a rigorously principled VAT, an employer's furnishing of goods or services to an employee as compensation is a taxable sale if the employee's purchase of these items would be a taxable sale. 3 Treas. Dep't, supra note 1, at 80-81.

12. See generally General Accounting Office, Value Added Tax: Administrative Costs Vary with Complexity and Number of Businesses 29 (1993) [hereinafter VAT Administrative Costs]; General Accounting Office, Choosing Among Consumption Taxes 13-14 (1986).

13. See infra text accompanying notes 42-54.

14. See infra text accompanying notes 55-119.

B. *Is a VAT Inherently Simple or Inherently Complex?*

A VAT inherently entails significant complexity. Millions of businesses must make periodic returns and remittances, perhaps as often as monthly.[15] These payments and returns must be processed, and the returns must be audited. Without audits, taxpayers would cheat by diverting amounts owed to the government,[16] by overstating VAT payments to vendors and understating VAT collections from customers,[17] by misclassifying goods and services if the VAT has multiple rates,[18] and by claiming that domestic sales are zero-rated export sales.[19]

The resulting administrative complexities are hardly trivial. The Internal Revenue Service estimated in 1984 that a VAT would involve up to 20 million taxpayers, would necessitate hiring 20,000 additional IRS employees, and would, when fully phased in, require $700 million of annual IRS administration costs.[20] The General Accounting Office estimated in 1993 that a U.S. VAT would have 9 million to 24 million taxpayers, depending on the size of an assumed small business exclusion,[21] and that administration costs could be as high as $1.83 billion annually, plus up to an additional $700 million if there were exemptions and multiple rates.[22] States

15. See, e.g., Hussey & Lubick, supra note 2, at 224.

16. VAT Administrative Costs, supra note 12, at 43.

17. Id. at 46. See also Kesselman, supra note 7, at 774-75.

18. VATs are often imposed at a lower or zero rate on food and medical supplies. See infra note 24. This creates an incentive for sellers to misclassify items in order to take advantage of the more favorable rate. See generally William H. Morris, A "National Debate" on VAT: The Gibbons Proposal, 60 Tax Notes 1259, 1264-65 (Aug. 30, 1993); James W. Wetzler, The Value Added Tax: The Relevance of States' Sales Tax Experience, 52 Tax Notes 719, 720 (Aug. 5, 1991).

19. The VAT rate for export sales is typically zero. 3 Treas. Dep't, supra note 1, at 11-13, 45-46. See also Morris, supra note 18, at 1268. This gives sellers an incentive to characterize domestic sales as export transactions because a successful misclassification causes the sale to be tax-free even though the seller gets a credit for VAT paid on inputs used to produce the sold item and thus obtains a VAT refund. See VAT Administrative Costs, supra note 12, at 46.

20. 3 Treas. Dep't, supra note 1, at 111, 122. In making these estimates, it was assumed that the VAT would coexist with the income tax. Id. at 111.

21. VAT Administrative Costs, supra note 12, at 3-4, 6, 102. For small business exclusions, see infra text accompanying notes 32-34.

22. VAT Administrative Costs, supra note 12, at 3. The 1984 Treasury Department and 1993 General Accounting Office estimates have been implicitly criticized by Sijbren Cnossen as overly pessimistic. Sijbren Cnossen, Administrative and Compliance Costs of the VAT: A Review of the Evidence, 63 Tax Notes 1609, 1610 (June 20, 1994). Cnossen gives as his own estimates an annual U.S. VAT administrative cost of $1 billion in 1995 and an annual aggregate taxpayer compliance cost of $5 billion in 1995. Id. However, these amounts seem sufficiently large to imply significant complexity. Furthermore, Cnossen's estimates are

with retail sales taxes and European countries with VATs have been unable to resist pressures for exemptions and multiple rates,[23] and we should therefore expect to find such features, and their resulting costs, in a U.S. national VAT.[24] These estimates imply large numbers of taxpayers and

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overly optimistic in that they assume adoption of a single-rate VAT. Id. As noted below, this seems unlikely.

23. See 3 Treas. Dep't, supra note 1, at 44; VAT Administrative Costs, supra note 12, at 71, 78; Comparative Tax Systems: Europe, Canada, and Japan 48, 112-13, 177-78, 232, 278, 315, 334 (Joseph A. Pechman ed., 1987); Jack M. Mintz et al., Canada's GST: Sales Tax Harmonization is the Key to Simplification, 8 Tax Notes Int'l 661, 668-69 (Mar. 7, 1994); Wetzler, supra note 18, at 720.

24. Sheldon S. Cohen, The Classic Pipe Dream: A Perfect U.S. VAT, Letter to the Editor, 64 Tax Notes 275-76 (July 11, 1994); Peter Jakubowicz, Will VAT-Man Cometh to U.S.? Small Business Groups Hope Not, 59 Tax Notes 731 (May 10, 1993). However, Japan was able to enact a single-rate VAT. See Alan Schenk, Japanese Consumption Tax: The Japanese Brand VAT, 42 Tax Notes 1625 (Mar. 27, 1989).

A broad-based, flat-rate VAT is usually considered inherently regressive because consumption expenditures, which are the tax base of a VAT, tend to absorb larger portions of the incomes of low-income individuals than of middle- and high-income individuals. Staff of Joint Comm. on Tax'n, Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens 54-59 (Comm. Print 1993); 3 Treas. Dep't, supra note 1, at 19-20, 43, 87; Bradford, supra note 1, at 320-21, 324; Cnossen, supra note 1, at 212; Kesselman, supra note 7, at 758-60. This fact creates substantial pressure to decrease the VAT's regressivity by creating lower or zero VAT rates for "necessities" such as food, clothing and medical care. 3 Treas. Dep't, supra note 1, at 43, 90, 93. The resulting multiple rates, and the difficult classification issues that they produce, materially complicate VAT compliance and administration. See Morris, supra note 18, at 1264-65; Wetzler, supra note 18.

The preferred method for dealing with the VAT's regressivity is to maintain a flat rate but provide a refundable, phased out income tax credit for low-income taxpayers that effectively rebates all or part of the VAT to them. 3 Treas. Dep't, supra note 1, at 44, 98-100. Although this approach keeps complexity out of the VAT, it adds complexity to the income tax and contributes to the overall complexity of the tax system, particularly if taxpayers whose incomes are so small that they would ordinarily not be required to file tax returns must now do so in order to get the VAT refund credit. See Bradford, supra note 1, at 321.

The concern for low-income individuals that has resulted in the earned income tax credit would surely result in either zero rates for necessities in a U.S. VAT or a VAT credit in the income tax.

Our Canadian cousins have interwoven the preceding themes to create the worst of both worlds in terms of complexity. They have provided both zero VAT rates on necessities and a refundable income tax credit to ameliorate regressivity. Robert Couzin et al., Business Operations in Canada—Taxation, 955 Tax Mgmt. (BNA) A-1 to A-2(1) (1991).

Yet another approach to mitigating the VAT's inherent regressivity is to increase government transfer payments to offset the VAT burden of low-income people. 3 Treas. Dep't, supra note 1, at 43, 89-90. If transfer payments are increased without enlarging the beneficiary group and without creating new benefit programs, this approach does not increase complexity. However, if the beneficiary group is enlarged or new benefit programs are established, overall governmental complexity will increase.

administrators spending significant amounts of time in complying with and enforcing any VAT that is likely to be enacted by Congress.[25]

Further complexities result from sourcing rules needed to distinguish zero-rated exports from taxable domestic sales.[26] Additional rules are required to (1) deal with the treatment of transactions between members of affiliated corporate groups and between other related parties,[27] (2) exclude transactions deemed inappropriate for VAT taxation (as under Code sections 332, 351, and 368),[28] (3) provide for post-sale price adjustments and uncollectible debts arising from sales on credit,[29] (4) allow VAT refunds where the taxes on sales for a period are less than the VAT paid on purchases for the period,[30] and (5) deal with financial services.[31]

European VATs typically contain small business exemptions based on turnover or gross receipts,[32] as does the Japanese VAT.[33] If a small business exemption were included in a U.S. VAT, businesses claiming the exemption would have to be examined for compliance with the qualification requirements, and the exemption would probably be accompanied by complex

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25. See Jakubowicz, supra note 24; 3 Treas. Dep't, supra note 1, at 112-21. The experience with Canada's Goods and Services Tax, a credit method VAT, confirms these implications. See Richard M. Bird, The Cost and Complexity of Canada's VAT: The GST in an International Perspective, 8 Tax Notes Int'l 37 (Jan. 3, 1994); Kesselman, supra note 7, at 713, 765-70.

26. See S. 2160, supra note 10, §§ 10011, 10012, 10024, 10031 (1994); John C. Danforth & David L. Boren, The Comprehensive Tax Restructuring and Simplification Act of 1994: Technical Overview 16-17, 94 TNT 103-26 (May 27, 1994) (LEXIS, FEDTAX library, TNT file) [hereinafter Technical Overview]; Cliff Massa III, The "Business Activities Tax"—A Primer, 64 Tax Notes 1219, 1222, 1227 (Aug. 29, 1994). See also Charles E. McLure, Jr., Substituting Consumption-Based Direct Taxation for Income Taxes As the International Norm, 45 Nat'l Tax J. 145, 148-49 (1992).

27. See S. 2160, supra note 10, §§ 10014(f), 10063. Rules of this type provide for establishing VAT sales prices for goods and services transferred to employees as compensation or to buyers not dealing at arm's length with the seller. They also deal with conversions of business property to consumption uses and with transfers among commonly owned businesses. Technical Overview, supra note 26, at 34.

28. See S. 2160, supra note 10, § 10016; Oldman & Schenk, supra note 3, at 1558-59.

29. See id. § 10023.

30. See id. § 10041. For fiscal 1992-93, Revenue Canada collected gross VAT revenues of $30.5 billion and refunded $10.7 billion to firms whose VAT payments on purchases exceeded VAT due on sales. Kesselman, supra note 7, at 768.

31. See S. 2160, supra note 10, § 10034; Technical Overview, supra note 26, at 21-29; ABA Sec. of Tax'n, Comm. on Value Added Tax, Analysis of Tax Treatment of Financial Services Under a Consumption-Style VAT, 44 Tax Law. 181 (1990).

32. VAT Administrative Costs, supra note 12, at 61; William J. Turnier, Accommodating to the Small Business Problem Under a VAT, 47 Tax Law 963, 970 (1994).

33. Schenk, supra note 24, at 1628-29.

aggregation rules to prevent larger businesses from being subdivided into smaller units that fall below the qualification ceiling.[34]

I do not contend that the VAT is as complex as the income tax. A credit method VAT, even if encumbered by the intricacies described above, is a good deal simpler than the federal income tax. Nevertheless, when evaluating any VAT proposal, the VAT's inherent complexities must not be lightly dismissed.[35]

C. *Can a VAT Be Made Even More Complex?*

In many ways, the political process of developing a VAT law can add significantly to the complexity that is inherent in the multistage collection process, exemptions, and multiple rates of a European-style VAT. An example is the treatment of plant and equipment costs.

Under a credit method system, VAT paid on the purchase of plant and equipment for use in producing goods and services is immediately credited against VAT collected on sales.[36] In other words, VAT paid on long-lived business assets is not amortized over asset lives; all investments in plant and equipment are treated as current costs. Because no distinction is drawn between various classes of business assets employed to produce goods, a credit method VAT does not have the effect of steering investments toward particular assets.

This is, however, radically at variance with American tax culture. The history of the federal income tax is replete with attempts to manage the flow of investment capital by means of credits and other preferences that are not required to measure economic income but are, instead, designed to direct investment capital into assets that are favored for various policy reasons.[37]

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34. See, e.g., IRC § 447(d)(1).

35. For examples of VAT statutes, see S. 2160, supra note 10, §§ 10001-10065 (1994); Hussey & Lubick, supra note 2, at 101-18.

36. 3 Treas. Dep't, supra note 1, at 7-9; ABA Sec. of Tax'n, supra note 2, at 422.

37. See generally C. Eugene Steuerle, The Tax Decade 27, 45-48, 77-79, 189, 191 (1992); Jack Teuber, Tax Expenditure Trends: Growth Is the Word, 62 Tax Notes 943 (Feb. 21, 1994). The real aggregate revenue loss from tax expenditures grew between 1974 and 1993 at an average annual rate of approximately 4%, while average annual real growth in gross domestic product over the same period was only about 2.5%. General Accounting Office, Tax Expenditures Deserve More Scrutiny 35 (1994). Some recent examples of this pattern are the 1993 increases in expensing for equipment investments in enterprise zones, § 1397A, and accelerated depreciation for investments in Indian reservation property. IRC § 168(j). See H.R. Rep. No. 111, 103d Cong., 1st Sess. 791, 794-99 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 1021, 1024-29. Tax expenditures will be further enhanced if Congress accedes to the often made argument that the investment tax credit (repealed in 1986) should be restored because equipment investment has a very high net social return. See J. Bradford DeLong & Lawrence H. Summers, Equipment Investment and Economic Growth: How Strong Is the Nexus? 2-1992

The Congress that included these investment incentives in the income tax will be the architect of any U.S. VAT, and the staff, executive branch officers, and lobbyists assisting Congress in the development of a VAT will be drawn from the same ranks that have counseled in the formulation of income tax preferences. It is not unreasonable to anticipate that the income tax habits of tax law writers will carry over to a VAT and that instead of merely allowing the expensing of the costs of all business assets, a U.S. VAT will include additional credits with respect to preferred assets. These credits will have to be hedged with complex rules to ensure that they apply only to favored types of property acquired from unrelated persons after the effective date of the VAT.[38] There may be recapture of the credits when assets are disposed of or diverted to disfavored uses. Any investment incentives included in a national VAT will add to the VAT's inherent complexity.

In short, there is a more-than-trivial danger that in a U.S. VAT, the inherent complexities of a typical VAT, including the multistage collection process, exemptions, and multiple rates, will be augmented by substantial additional complexities deriving from attempts to direct the flow of investment capital toward the achievement of various policy goals. We cannot, however, evaluate the extent of this additional complexity until we see the details of proposed legislation.

D. *Does It Matter How the VAT Revenues are Used?*

A VAT's complexity or simplification consequences cannot be determined by examining the VAT in isolation. We first have to learn whether this tax will be a revenue-raising addition to the current structure or will be coupled with simplifying changes in that structure. In short, we need to know how the VAT yield will be used.

1. *A VAT Replacing the Individual and Corporate Income Taxes.*—A VAT functions without capitalization rules, capital cost recovery provisions, entity taxation systems, and many other complexities that bedevil the income

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Brookings Papers on Economic Activity 157, 159, 197. Indeed, the 1993 Clinton administration proposal for a temporary revival of the investment tax credit was based on a judgment that macroeconomic policy considerations required a strong incentive for increased investment in equipment. See U.S. Treas. Dep't, Summary of the Administration's Revenue Proposals 5-8 (1993).

38. If adopted, these credits might take the form of new or expanded income tax allowances providing the same results for the revenue system as if they were included in the VAT. Nevertheless, they will have been prompted by the VAT and must be considered VAT-created complexity.

tax.[39] Thus, a VAT that funds a repeal of the individual and corporate income taxes would substantially simplify our tax system,[40] even if it is encumbered with intricate provisions meant to direct investment flows into favored assets and activities.[41]

Unfortunately, substitution of a VAT for the federal income taxes appears to be politically unlikely, principally because the VAT is generally considered to be both inherently regressive[42] and regressive in comparison with the income tax.[43] The VAT has also been criticized as an unfairly large levy on the poorest individuals.[44] These consequences (large and disproportionate burdens on low-income persons) would be exacerbated if VAT revenues are used to fund repeal of the individual and corporate income taxes. This is because, to raise enough money to replace all income tax revenues, a VAT would have to be imposed at a rate that is very high in comparison with the sales taxes familiar to most Americans.[45]

Contrast this state of affairs with Congress' 1993 decision to increase markedly the progressivity of the income tax rate structure, which, in 1986, had become relatively flat.[46] The 1986 flirtation with a nonprogressive system might be viewed as a brief episode succeeded by a return to our historic preference for progression.[47] Furthermore, the expansion in 1993 of

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39. See 3 Treas. Dep't, supra note 1, at 7-11; Bradford, supra note 1, at 60-64.

40. See Bradford, supra note 1, at 312-14.

41. See supra text accompanying notes 36-38.

42. See Staff of Joint Comm. on Tax'n, supra note 24, at 54-59; 3 Treas. Dep't, supra note 1, at 19-20, 43, 87; Cnossen, supra note 1, at 212; Kesselman, supra note 7, at 758-60. For tentative contrary views, see Massa & Raboy, supra note 7, at 486; Morris, supra note 18, at 1264.

43. See Staff of Joint Comm. on Tax'n, supra note 24, at 58.

44. See 3 Treas. Dep't, supra note 1, at 43.

45. The Treasury's 1984 VAT study implied that each percentage point of VAT tax rate, applied to two alternative politically feasible tax bases, would raise $24 billion or $17.1 billion for 1988. 3 Treasury Dep't, supra note 1, at 85-86. Since individual and corporate income tax receipts for 1988 were $516.2 billion, Steuele, supra note 37, at 212-13, the Treasury study suggests that a VAT rate of either 21.5% or 30.2% would have been required in 1988 to replace income tax revenue. See also James M. Bickley, How Much Revenue Could a U.S. VAT Yield? 60 Tax Notes 1273 (Aug. 30 1993); Joel B. Slemrod, The Simplification Potential of Alternatives to the Income Tax, 66 Tax Notes 1331, 1335 (Feb. 27, 1995). VAT rates in this range would be higher than commonly applicable sales tax rates. See Perry D. Quick & Thomas Neubig, Tax Burden Comparison: U.S. vs. The Rest of the G-7, 65 Tax Notes 1409, 1417 (Dec. 12, 1994).

46. H.R. Rep. No. 111, 103d Cong., 1st Sess. 633-36 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 864-67.

47. See Marvin A. Chirelstein, Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts 3-6 (7th ed. 1994). The Danforth-Boren proposal, discussed below in Part II.E, would preserve the progressive income tax, and the Nunn-Domenici proposal (Part III.C) includes a progressive consumed income tax. Although the legislative

the earned income tax credit suggests a continuing consensus that the tax system should at least have the appearance of accommodating the low-income.[48] Thus, replacement of the individual and corporate income taxes with a VAT that imposes relatively large burdens on the poor and is generally viewed as regressive would conflict with major political trends.[49]

Moreover, the preferred technique for dealing with the VAT's regressivity and its impact on the poor is to give low-income taxpayers a VAT credit against the individual income tax.[50] Without an income tax, the credit remedy is unavailable. The two other major techniques for ameliorating the VAT's disproportionate and absolute impacts on the poor—increased transfer payments and zero-rating or exempting food, medical care, and other necessities—are usually considered inadequate because there are no practical tools for keeping high income purchasers from sharing the benefits of this approach.[51] Furthermore, increased transfer payments are problematic in the current political and economic climate.[52]

Thus, it appears inevitable that any proposal to replace the corporate and individual income taxes with a VAT will fall to objections based on the VAT's regressivity and its large absolute impact on low-income individuals. Indeed, there does not appear to be any country that has effected such a

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proposals contained in the House Republicans' "Contract with America" have distributional effects that favor upper income groups, they do not alter the rate tables enacted in 1993. See H.R. 1215, 104th Cong., 1st Sess. (1995). See also Milton Friedman, Why a Flat Tax Is Not Politically Feasible, Wall St. J., Mar. 30, 1995, at A16.

48. See H.R. Rep. No. 111, supra note 46, at 608-10, reprinted in 1993 U.S.C.C.A.N. at 839-41.

49. See Staff of Joint Comm. on Tax'n, supra note 24, at 58 (finding that a broad based consumption tax is substantially more regressive than the present income tax). See also General Accounting Office, supra note 3, at 17-20 (concluding that replacement of the corporate income tax with a consumption tax would likely reduce progressivity).

50. 3 Treas. Dep't, supra note 1, at 44, 98-100.

51. VAT Administrative Costs, supra note 12, at 75-76; General Accounting Office, Value-Added Tax Issues for U.S. Tax Policymakers 29-31 (1989); Morris, supra note 18, at 1265-66. See also Kesselman, supra note 7, at 759-60. Indeed, zero rating or exempting consumer purchases of clothing might increase a VAT's regressivity. See David F. Bradford, What are Consumption Taxes and Who Pays Them? 39 Tax Notes 383, 389-90 (Apr. 18, 1988).

52. David F. Bradford has proposed mitigating the VAT's regressivity and impact on the poor by rebating part or all of the federal payroll taxes. Bradford, supra note 1, at 320-21. However, this approach does not address the problems of low-income taxpayers who are outside the federal payroll tax system and flies in the face of increasing public resistance to more or larger transfer payments.

change in its tax structure.[53] Consequently, I do not consider substitution of the VAT for the income taxes to be a realistic possibility.[54]

2. *A VAT Used to Pay for Deficit Reduction, Income Tax Cuts, or Spending Programs.*—As indicated above, a VAT under which all productive assets are uniformly treated is moderately complicated, and a VAT that provides disparate treatment for various classes of productive assets could be very complex. Thus, a VAT grafted onto the existing tax structure to generate funds for deficit reduction, income tax cuts, national health insurance, or other spending programs would be a complicating addition to the federal tax system, under any assumptions, and a substantially complicating addition in a worst-case scenario.[55]

3. *A VAT Financing Corporate Integration.*—If VAT revenues are used to make up revenue losses incurred in achieving the long-sought goal of integrating the corporate and individual income taxes, will the result be a simpler system?[56]

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53. Lee A. Sheppard, Will America Ever Adopt a Consumption Tax? 61 Tax Notes 1040, 1041 (Nov. 29, 1993). See also Slemrod, supra note 45, at 1335.

54. See also id. at 1335-38. However, the simplification/complication consequences of using the VAT to pay for reduced income tax rates are discussed below in the text at note 56, the effects of using the VAT to pay for larger personal exemptions and standard deductions are covered in the text at notes 69-71, and the consequences of using the VAT to pay for repeal of the corporate income tax are examined in the text at notes 56-68, 72-119.

55. Morris, supra note 18, at 1262.

56. In 1992, the Treasury issued a report advocating two alternative approaches to corporate tax integration—a dividend exclusion and a comprehensive business income tax (CBIT) under which both interest payments and dividends are nondeductible by corporate payors but are excluded from the incomes of investor-payees. U.S. Treas. Dep't, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once viii (1992) [hereinafter Treasury Integration Study]. The dividend exclusion was estimated to have an annual cost, when fully phased in, of $13.1 billion in lost revenue (at 1991 income levels). Id. at 151. By contrast, the CBIT, imposed at 31%, was projected to increase annual tax revenues by $3.2 billion if capital gains on sales of business interests were not taxed or $41.5 billion if present treatment of capital gains is preserved. Id. at 151. These projections assumed that the CBIT would be imposed on the incomes, calculated without an interest deduction, of all sole proprietorships, partnerships, and S corporations with annual gross receipts of $100,000 or more. Moreover, the CBIT would apply regardless of the identity of the shareholders and debtholders and would therefore effectively reach business income paid out as dividends or interest to foreign investors, charities, and retirement plans. Id. at 40-42; Samuel C. Thompson, Jr., Reform of the Taxation of Mergers, Acquisitions, and LBOs 221-23 (1993). In addition, the $41.5 billion projection assumes that Congress retains the capital gains tax for all sales of business interests, even if the gains derive from retained earnings that have already been subjected to the 31% CBIT. Treasury Integration Study, supra, at 151. Taxation of such gains is inconsistent with integration. Id. at 81, 83. Because congressional adoption of these crucial

A useful way to begin searching for an answer is to note that although the taxation of partnership income is integrated with the individual income tax, partnerships are treated as entities that can engage in realization events with other partnerships and with their own partners. For example, if partnership *A* acquires the assets of partnership *B*, *B* generally recognizes the gains and losses inherent in its assets,[57] but these gains and losses are not recognized if the acquisition consideration consists of equity interests in *A*.[58] Also, when a partnership distributes money or other property to its partners, neither the partnership nor the partners recognize gain or loss, as a general rule, but recognition is required in some instances.[59] (Few students of partnership taxation would urge it as a model for simplification.)

Similarly, administratively feasible integration models typically treat corporations as entities distinct from each other and their shareholders,[60] and employ realization and recognition concepts with respect to transactions between corporations and shareholders and between two or more corporations.[61] Thus, an integration regime must deal with such issues as when stock dividends should trigger the consequences of a cash distribution and when they should be ignored. Statutory provisions distinguishing between taxable and nontaxable stock dividends thus will probably persist in an integrated system.[62] An integration model must also specify the circumstances under which the acquisition of a corporation's stock or assets by another corporation will, and will not, produce recognized gain or loss. Corporate reorganization provisions thus will probably remain with us.[63] An integration scheme must deal with transfers of net operating losses and other corporate tax attributes, demanding that sections 381 and 382 also endure.[64]

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predicates is highly doubtful, a revenue-gaining integration scheme should not be viewed as a realistic possibility. It seems likely that corporate integration will require a funding source to offset lost revenue.

57. IRC § 1001.

58. IRC § 721.

59. IRC §§ 707(a)(2)(B), 731, 751(b).

60. See Treasury Integration Study, supra note 56, at 23, 40-41, 55; Alvin C. Warren, Jr., Reporter's Study of Corporate Tax Integration 13-20 (1993) [hereinafter ALI Reporter's Study].

61. See Treasury Integration Study, supra note 56, at 17, 23, 40, 55; ALI Reporter's Study, supra note 60, at 101, 143-50.

62. See IRC §305; Treasury Integration Study, supra note 56, at 17, 21, 40; ALI Reporter's Study, supra note 60, at 143; Michael L. Schler, Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models, 47 Tax L. Rev. 509, 538-41 (1992).

63. Treasury Integration Study, supra note 56, at 23, 55; ALI Reporter's Study, supra note 60, at 99; Thompson, supra note 56, at 233-35.

64. The partnership integration model, which would pass corporate-level losses and other tax attributes through to shareholders, is generally considered not feasible for

Finally, integration models typically treat ordinary corporate distributions differently from disproportionate stock redemptions.[65] Accordingly, the statutory provisions and case law governing when redemptions qualify as stock sales will persist in an integrated system.[66]

In addition to these continuing Subchapter C complexities, the various integration models have their own peculiar, and dauntingly extensive, intricacies.[67] Furthermore, virtually all complexities of the individual income tax persist in an integrated system.[68]

In sum, the combination of a VAT, an integration regime, and the individual income tax would likely not be meaningfully simpler than the

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corporations with large numbers of shareholders. Thus, the partnership approach will probably be confined to a universe very much like that of the present S corporation. See Treasury Integration Study, supra note 56, at 27; ALI Reporter's Study, supra note 60, at 47-49. Feasible integration systems for larger corporations will require keeping track of important tax attributes at the corporate level and also require rules governing the transfer of those attributes. See Treasury Integration Study, supra, at 17, 23-24, 40, 55; ALI Reporter's Study, supra, at 99-100.

65. See Treasury Integration Study, supra note 56, at 83-86; ALI Reporter's Study, supra note 60, at 143-46; Schler, supra note 62, at 541-43.

66. See Treasury Integration Study, supra note 56, at 222 n.23; ALI Reporter's Study, supra note 60, at 143-46; George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431, 451-56, 467-68 (1992). This also seems to require preservation of § 304. In addition, if dividend distributions are treated differently from share sales and disproportionate stock redemptions and if § 305 is retained in some form (see supra text accompanying note 62), § 306 will likely have to be kept. See Treasury Integration Study, supra note 56, at 196 n.37.

The enduring popularity of § 1014 suggests that in an integrated world, corporate shares will continue to get a stepped-up basis at death. Thus, § 303 will probably continue as a device for estates to make tax-free withdrawals from closely-held corporations.

67. The Treasury Integration Study advocates a dividend exclusion model that retains the § 11 tax and the corporate alternative minimum tax, continues corporate earnings and profits accounts, and requires corporations to keep a new "excludable distributions account." Treasury Integration Study, supra note 56, at 17, 19, 24. Alternatively, the Treasury Study advocates a comprehensive business income tax that preserves the § 11 tax, but without a deduction for interest payments, id. at 40, and requires corporations to maintain an "excludable distributions account," id., and perhaps an earnings and profits account. Id. at 207 n.21.

The ALI Reporter's Study (1) continues the § 11 and corporate alternative minimum taxes as parts of an advance withholding system, ALI Reporter's Study, supra note 60, at 93-94, (2) creates new dividend and interest withholding taxes, id. at 92-93, 112-13, (3) requires corporations to maintain a "taxes paid account" (but abolishes the earnings and profits account), id. at 93, (4) requires corporations to report to dividend and interest recipients the amounts of associated dividend and interest withholding taxes, id. at 102, 112-13, and (5) imposes new taxes on dividends and interest received from U.S. corporations by tax-exempt and foreign investors and new taxes on the gains of such investors from sales of stock and debt of U.S. corporations. Id. at 163-64, 190-91.

68. See Treasury Integration Study, supra note 56, at 17, 39-40; ALI Reporter's Study, supra note 60, at 13-20, 143.

current regime. It is probably impossible, however, to get clarity on these points without examining the details of a fully articulated VAT-integration proposal.

4. *Dropping Taxpayers Out of the System.*—Would the tax system be simplified by the enactment of a VAT to finance expanded personal exemptions or standard deductions that would have the effect of sharply reducing the number of itemizers and of dropping large numbers of taxpayers from the federal income tax system? For example, the Treasury's December 1992 comprehensive reform proposal included a single-rate subtraction method VAT, called a Business Transfer Tax, which would have, among other things, financed an expanded standard deduction ($33,800 for marrieds filing jointly).[69] This change would have reduced itemizers by 94% and removed 52% of individual taxpayers with positive tax liabilities from the federal income tax rolls. VAT revenues spent in this way clearly achieve impressive simplification for large numbers of taxpayers. However, if a refundable income tax credit is used to mitigate the VAT's regressivity,[70] many of those whose positive income tax liabilities are eliminated must still file returns to get the credit refund or must file appropriate forms to get advance refunds through the withholding system.[71]

E. *The Danforth-Boren Proposal: Using a VAT to Eliminate the Corporate Income Tax and Pay for Other Good Stuff*

VAT revenues need not be ear marked for a single purpose. Indeed, by mixing the VAT revenue uses discussed above and varying the emphasis given to particular items in the mix, one can imagine a wide variety of ways to spend a VAT's yield, with an equally wide variety of complexity implications. A proposal by Senators John C. Danforth and David L. Boren,

69. Treas. Dep't, supra note 6. The proposed Business Transfer Tax would also have financed corporate integration through a dividend exclusion.

70. See supra note 24.

71. General Accounting Office, supra note 51, at 33; Bradford, supra note 1, at 321. Data with respect to the earned income tax credit (EITC) suggest that the number of taxpayers required to file income tax returns solely to claim a refundable VAT credit would be significant. For example, Treasury's December 1992 proposal contemplated a 36% increase in the number of returns filed to obtain EITC refunds. It is estimated that 84% of the EITC claimed on 1994 income tax returns will be received as refunds. House Comm. on Ways and Means, Overview of Entitlement Programs, W.M.C.P. 27, 103d Cong., 2d Sess. 702 (1994).

the Comprehensive Tax Restructuring and Simplification Act of 1994,[72] illustrates the point. It would:

1. Impose a subtraction method VAT,[73] called a Business Activities Tax (BAT), at a flat-rate of 14.5% on all businesses, both corporate and noncorporate.[74]
2. Repeal the corporate income tax, including the corporate alternative minimum tax, the section 531 tax on accumulated earnings, and the section 541 personal holding company tax,[75] making the BAT the only entity-level tax on C corporation business income. (The individual income tax would be preserved, and would apply to the incomes of pass-through entities unless they elect C corporation treatment.)
3. Permit S corporations and unincorporated businesses to elect C corporation treatment so that the BAT would usually be the only business-level tax applicable to their incomes.[76]
4. Defer income taxation of the incomes of C corporations and C-electing unincorporated businesses and S corporations until earnings are distributed to individuals.[77]

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72. S. 2160, supra note 10. See Massa, supra note 26, at 1219; Oldman & Schenk, supra note 3. For the economic and distributional effects of a bill similar to the Danforth-Boren proposal, see General Accounting Office, supra note 3, at 3-4. For preliminary analysis of the Danforth-Boren proposal's economic consequences, see John Copeland, Thumbs Down on the BAT, Letter to the Editor, 65 Tax Notes 249 (Oct. 10, 1994); Alan D. Viard, Who Would Really Get Bitten By the BAT? Letter to the Editor, 65 Tax Notes 784 (Nov. 7, 1994); John Copeland, Further Analysis of the BAT, Letter to the Editor, 66 Tax Notes 617 (Jan. 23, 1995).

73. See Massa, supra note 26, at 1220, 1224; Oldman & Schenk, supra note 3, at 1548, 1552, 1565; Viard, supra note 72. Under a subtraction method VAT, a business subtracts business purchases, including capital costs, from its sales receipts and pays tax on the difference. A flat-rate, subtraction method VAT produces the same revenue as a flat-rate, credit method VAT at the same rate. See 3 Treas. Dep't, supra note 1, at 7-11. See also General Accounting Office, supra note 3, at 2-3.

74. S. 2160, supra note 10, §§ 10001, 10051(7).

75. Id. § 1400(a); Technical Overview, supra note 26, at 1 n.1., and Simplification Act of 1994, at 1 n.1. However, the § 881 withholding tax and the § 884 branch profits tax would be preserved. S. 2160, supra note 10, § 1400(c).

76. S. 2160, supra note 10, § 1402(a)(1).

77. Id. §§ 1401(a), 1402(a)(2), (c)(2). For purposes of subjecting earnings distributions to the individual income tax, each equity owner of a partnership or sole proprietorship would be treated as a shareholder in proportion to his or her equity interest. Id. § 1402(a)(2).

Interest from both incorporated and unincorporated businesses would be taxed to the creditors as income under existing rules. This means that interest from C corporations, electing S corporations, and electing unincorporated businesses would generally be taxed on an accrual basis, whereas distributions to equity holders would presumably be taxed when distributed. Id.

5. Impose a new tax on C corporation passive income,[78] which would also apply to S corporations, partnerships, and sole proprietorships that elect C corporation treatment.[79]
6. Reduce the old age, survivors, and disability insurance (OASDI) portion of the federal payroll taxes by half for both employers and employees.[80]
7. Substantially increase the standard deduction for low- and middle-income taxpayers.[81]
8. Mitigate the BAT's regressivity by a refundable income tax credit, receivable in advance, for part of the BAT borne by low- and middle-income taxpayers.[82]

The Danforth-Boren proposal would have two important simplification consequences. First, it would eliminate capitalization and capital cost recovery provisions from business taxation because the BAT, like other VATs, permits business assets to be expensed.[83] Second, the enlargement of the standard

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§§ 1401(a), 1402(a)(1).

Interest expense would generally be nondeductible under the BAT. Id. § 10015(a)(2)(A); Technical Overview, supra, at 13, 24-27. Thus, corporate receipts paid out as interest and earnings distributions would be net of the BAT. See Technical Overview, supra, at first unnumbered page; Massa, supra note 26, at 1225.

78. S. 2160, supra note 10, §§ 1400(b), 1402(a)(1); Technical Overview, supra note 26, at 2, 5-6. Receipts of dividends and interest would not typically be subject to the BAT. S. 2160, supra, §§ 10012, 10014; Technical Overview, supra note 75, at 11-13, 19, 25. The tax on C corporation passive income, which applies unless the income is distributed, is designed to interdict taxpayers who would otherwise accumulate business earnings in passive investments instead of distributing the earnings, thus deferring the individual income tax. The tax would apparently not reach passive investments that produce only unrealized appreciation. See S. 2160, supra, §§ 1400(b)(1)(A), (3)(B).

Dividends and interest received by businesses in providing financial intermediation services would be subject to the BAT but not to the passive investment tax. Technical Overview, supra, at 3 n.6. The proposal intentionally does not resolve the issue of how to apply these rules to businesses that are primarily engaged in selling goods but also receive substantial amounts of interest on deferred payment sales. Id. at 19-20.

79. S. 2160, supra note 10, § 1402(a)(1).

80. Technical Overview, supra note 26, at 9.

81. For married persons filing 1994 joint returns, the standard deduction would increase from $6,350 to $15,000. Id.

82. Id. at 9-10. This approach avoids the complexities that arise when exemptions or multiple rates are adopted to ameliorate regressivity. See supra text accompanying notes 22-24. However, the credit mechanism creates its own complexities. See infra text accompanying notes 85, 102-03.

83. Technical Overview, supra note 26, at 7 n.12, 13-14, 18. Capitalization and capital cost recovery rules would continue to apply to S corporations and unincorporated businesses not electing C corporation treatment. See Technical Overview, supra note 26, at 8.

deduction would reduce the number of itemizers and drop many low- and middle-income taxpayers out of the income tax system,[84] except for those required to file returns or advance refund eligibility certificates in order to get a BAT credit refund through the income tax system.[85]

1. *Complexities Preserved and Expanded by Danforth-Boren.*—The Danforth-Boren proposal preserves and expands some important complexities. Although it reduces the OASDI taxes, it otherwise leaves that taxing regime intact. The proposal also continues the individual income tax.

For purposes of determining whether distributions of business earnings are subject to the individual income tax, the proposal would continue the rules on stock dividends and extend them to distributions by electing unincorporated businesses.[86] To determine the individual income tax consequences of corporate distributions, the proposal would preserve the corporate tax rules on (1) distributions in excess of earnings and profits,[87] (2) distributions in full or partial liquidation of a corporation,[88] and (3) distributions in complete redemption of a shareholder's stock.[89] The proposal would also make these rules applicable to distributions by electing S corporations and electing unincorporated businesses.[90] In addition, the proposal would apparently preserve the anti-*General Utilities* rules of sections 311(b), 336, and 337 for purposes of measuring the gross receipts of corporate and electing noncorporate businesses under the BAT,[91] and the rules on corpo-

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84. See supra text accompanying notes 69-71.

85. See Technical Overview, supra note 26, at 9-10 and supra note 71.

86. IRC § 305; S. 2160, supra note 10, §§ 1402(a), (c)(2); Technical Overview, supra note 26, at 8. This may require preservation of § 306.

87. IRC § 301(c)(2), (3); Technical Overview, supra note 26, at 6-8. These rules would apply only if the corporation maintains adequate records of earnings and profits.

88. IRC §§ 331-346; Technical Overview, supra note 26, at 6-8.

89. IRC § 302(b)(3); Technical Overview, supra note 26, at 6-8. The retention of § 302(b)(3) would seem to require preservation of §§ 302(c)(2), 318, and 304. Section 303 would also probably persist in a Danforth-Boren world. See supra note 66.

90. S. 2160, supra note 10, §§ 1402(a), (c)(2); Technical Overview, supra note 26, at 1. The proposed statute provides that "all distributions made by a corporation to a shareholder with respect to its stock shall be treated as ordinary income," except distributions in excess of earnings and profits, in full or partial liquidation, and in complete redemption of a shareholder's stock. S. 2160, supra, § 1401. However, the Technical Overview states that "the bill is not intended to change present law as to whether or when distributions are taxable. Thus, for example, proportionate stock distributions would continue to be excluded from gross income . . . ." Technical Overview, supra note 75, at 8. This suggests that §§ 354, 355, and 356 would be preserved under the proposal. If this supposition is correct, §§ 354, 355, and 356 would also be extended to electing unincorporated businesses. S. 2160, supra, § 1402(a)(2).

91. See S. 2160, supra note 10, § 1402(a)(1), (c)(2); Technical Overview, supra note 26, at 8, 11-13.

rate formations and reorganizations would apply to identify transactions of corporate and electing noncorporate businesses to be ignored for BAT purposes.[92]

In addition to the continuation and expansion of these complex corporate tax rules, the BAT portion of the proposal would utilize much of the income tax law regarding accounting periods and methods, as well as a rule requiring the "clear reflection" of gross sales and business purchases.[93] The BAT would also require imputed interest rules.[94]

2. *New Complexities Created by Danforth-Boren.*—Regrettably, the Danforth-Boren proposal also imposes new complexity. For example, if a sole proprietorship, partnership, or S corporation does not elect C corporation treatment, its income is currently taxable to the owners of the business, whether distributed or not, even though the business is subject to the BAT.[95] If the election is made, the BAT would continue to apply, but the individual income tax would only attach to funds distributed from the business to individual owners.[96] Presumably, the election would usually be made, but it would give small business owners one more item of red tape to worry about.[97]

The proposal would also impose a complicated new penalty tax on undistributed passive income of C corporations and electing S corporations and noncorporate businesses.[98] Although this tax would fill the role of the present taxes on inappropriate corporate accumulations, it would use a new computational approach based on IRS determinations of reasonable accumula-

92. S. 2160, supra note 10, §§ 1402(a)(1), (c)(2), 10016(b); Technical Overview, supra note 26, at 13.

93. Technical Overview, supra note 26, at 18-19, 33.

94. Id. at 19-20. Also, under a BAT, employees must be distinguished from independent contractors because payments to the former are not deductible under the BAT while payments to the latter are. See Massa, supra note 26, at 1225.

95. Technical Overview, supra note 26, at 1.

96. Under the proposal, no income tax would be imposed on C corporation earnings until the earnings are distributed to shareholders. Thus, C corporations would become a device for deferring income tax, and this would make them preferable to pass-through business entities (S corporations, partnerships, and sole proprietorships) because the owners of pass-through entities are subjected to income taxation of business earnings on a current, non-deferred basis. The election for S corporations and unincorporated businesses to be treated as C corporations is provided to remove what would otherwise be a systemic bias in favor of doing business through C corporations.

97. Since the election would usually be advantageous, complexity could be reduced by applying the C corporation regime to any S corporation, sole proprietorship, or partnership that does not elect otherwise, thus ensuring that the commonly preferred outcome is also the default outcome.

98. Technical Overview, supra note 26, at 5-6.

tions of working capital for various industries, and it would apply to organizations that elect C corporation treatment.[99]

The proposal's substantial increase in the standard deduction would be accomplished by an additional standard deduction that would be phased out starting at $45,000 of adjusted gross income for joint returns and lesser amounts for other filing categories.[100] Since this phaseout calculation would apply at income levels far below the levels at which the present phaseout of the personal exemption begins, it would introduce millions of additional taxpayers to the complexities of phaseout rules.[101]

The BAT credit that would be added to the individual income tax would be phased out based on a new concept called modified adjusted gross income.[102] The phaseout would begin at $15,000 of modified adjusted gross income for 1994 joint returns and lesser amounts for other filing categories. This additional phaseout computation would burden millions more taxpayers.[103]

The new BAT would have most of the complexities described above that are inherent in VATs.[104] Furthermore, since the BAT would be the only entity-level tax for corporations and unincorporated businesses, it would usually be the only available device for affecting business behavior through the tax system. This would virtually ensure that the BAT would be adorned with most, or all, of the following complex tax incentive provisions presently found in the income tax:[105]

a. Qualified electric vehicle credit.[106]
b. Alcohol fuels credit.[107]
c. Research credit.[108]

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99. Id. at 3.

100. Id. at 9.

101. For 1994 joint returns, the personal exemption phaseout begins at $167,700. Rev. Proc. 93-49, 1993-2 C.B. 581, § 3.07.

102. Technical Overview, supra note 26, at 10.

103. See supra note 101 and accompanying text.

104. The BAT, which would be a flat-rate tax, would avoid the complexities of a multiple-rate VAT. However, the complexities of the multistage collection process would be present, as would most of the complexities referred to in the text at notes 26-34.

105. See supra text accompanying notes 37-38. Although the BAT is viewed as borne by consumers, the tax incentives described below would, to the extent they effectively reduce the BAT rate, allow some goods and services to be sold at lower prices and thus induce producers of goods and providers of services to pursue these tax incentives. See, e.g., 3 Treas. Dep't, supra note 1, at 10.

106. IRC § 30.

107. IRC § 40.

108. IRC § 41.

d. Low-income housing credit.[109]
e. Enhanced oil recovery credit.[110]
f. Disabled access credit.[111]
g. Renewable electricity production credit.[112]
h. Empowerment zone employment credit.[113]
i. Indian employment credit.[114]
j. Targeted jobs credit.[115]

Similarly, we should not be surprised if the BAT were to include credits accomplishing results analogous to the present provisions allowing limited expensing of business equipment,[116] increased expensing for enterprise zone investments,[117] and accelerated depreciation for investments in Indian reservation property.[118] Finally, if investment tax credit proponents are ultimately successful in their persistent advocacy,[119] we might find an investment tax credit added to the BAT.

3. *Transition from the Corporate Income Tax to the BAT.*—If the BAT replaces the corporate income tax as the taxing regime for businesses conducted in corporate form, corporations will, when the substitution is made, have billions of dollars of undepreciated asset costs and undeducted inventory costs. These costs would be unusable in a Danforth-Boren world because the BAT requires such outlays to be expensed when they are incurred, which for these costs was before the BAT's effective date. Corporations can be expected to object strenuously. (Unincorporated businesses may also object but because they have the option, unattractive to be sure, to remain under the income tax, their objection may carry less force.)

A simple response is to allow corporations no deduction or credit under the BAT for unrecovered pre-BAT costs. After all, the deduction allowed under the BAT for plant, equipment, and inventory costs is a means of recovering the BAT included in the prices paid for these items. The prices of items purchased before the BAT's enactment do not include BAT, and

109. IRC § 42.

110. IRC § 43. See also Frank M. Burke, Jr., Recent Study Recommends Incentives for Marginal Oil and Gas Properties, 64 Tax Notes 947 (Aug. 15, 1994).

111. IRC § 44.

112. IRC § 45.

113. IRC § 1396.

114. IRC § 45A.

115. IRC § 51.

116. IRC § 179.

117. IRC § 1397A.

118. IRC § 168(j).

119. See supra note 37.

arguably, no deduction for their cost is appropriate under the BAT, even if the items are used or sold after the BAT takes effect. For example, if widgets cost $100 each before the BAT is enacted, their price can be expected to rise to $117 after the enactment of a BAT at 14.5% ($117, less 14.5% thereof, is $100). Assume business *A* buys widgets for $100 each before the BAT comes into effect and sells them to customers after enactment, and business *B* buys widgets after enactment for $117 and also sells them to customers after enactment. If *B* is allowed a BAT deduction for its inventory costs, but *A* is not, the after-BAT cost of each widget to both businesses is $100. Nevertheless, businesses can be expected to insist on obtaining at least some tax benefit for their unrecovered pre-BAT costs.[120]

A second simple approach is to give corporations an immediate BAT deduction for all unrecovered plant, equipment, and inventory costs. This approach might be justified by a judgment that the effect on prices of the repealed corporate income tax is not materially different from that of the new BAT. It would, however, entail a large revenue loss for the initial BAT period. Consequently, this solution seems unlikely to be adopted.

The remaining approach is to permit unrecovered pre-BAT costs to be deducted over a post-BAT transition period. This could be accomplished by requiring corporations to follow the present income tax rules under the BAT with respect to unrecovered pre-BAT costs of plant, equipment, and inventory. Alternatively, an arbitrary period could be selected over which the pre-BAT basis and inventory costs would be spread and claimed as BAT deductions. Either solution would be a complicating element because it would require pre-BAT assets to be accounted for separately.

The Danforth-Boren proposal seems to adopt the simple approach of allowing no recovery for unrecovered pre-BAT costs. Taxpayer objections, however, will surely be raised in Congress, and if the proposal is enacted, the preceding analysis indicates that it will likely contain a recovery provision that will erode simplicity gains.

4. *Does Danforth-Boren Simplify the Tax System?*—The proposal contains several simplifying features—elimination of capitalization and capital cost recovery rules for corporations, repeal of corporate-level income taxes, and decreases in the numbers of both itemizers and taxpayers by virtue of the enlarged standard deduction. However, other features increase complexity—the assured and probable BAT intricacies, the phaseouts of the standard deduction enlargement and the BAT credit under the income tax, the election for S corporations and unincorporated businesses to be treated as C corpora-

120. See Ernest S. Christian & George J. Schutzer, Unlimited Savings Allowance (USA) Tax System, 66 Tax Notes 1485, 1534 (Mar. 10, 1995).

tions, the preservation of various corporate tax rules and their extension to electing unincorporated businesses, and the complex new tax on excess passive income. It is difficult to say whether the simplifications or the complexities predominate. However, if the proposal yields net simplification, it is likely not of the magnitude that taxpayers seem to hope for or that is typically implied in the political rhetoric that accompanies simplification proposals.

More importantly, this review of the Danforth-Boren proposal reaffirms that responsible assertions about whether and to what extent a VAT should be adopted as a simplification measure cannot be made until the provisions of the VAT and uses of VAT revenues are both known and analyzed in detail.

III. WHAT IF CONGRESS ENACTS A CONSUMED INCOME TAX?

Another consumption tax regime that has recently attracted attention is an annual tax on consumed income, also known as a cash flow tax or consumption-based income tax. Would the adoption of such a tax be a simplifying measure?

A. *Addition to or Replacement for the Accretion Income Tax?*

Professor William D. Andrews has cogently argued that a consumed income tax and an accretion tax should be utilized concurrently,[121] with only high-income taxpayers being burdened by both levies and low- and middle-income taxpayers being subjected to only the accretion tax.[122]

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121. Our income tax might more accurately be called a hybrid accretion-consumption tax because of its many consumption tax features. See, e.g., Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145, 1149-1155 (1992). However, for simplicity reasons, this article refers to the current tax as an accretion income tax.

122. William D. Andrews, A Supplemental Personal Expenditure Tax, in What Should Be Taxed: Income or Expenditure? 127, 133-34 (Joseph A. Pechman ed., 1980). According to Professor Andrews, a consumed income tax that applied concurrently with the income tax, but covered only high-income individuals (who would also remain subject to the accretion income tax), could accomplish the following useful things:

1. Pay for a reduction in the top accretion income tax rates, thus easing the distortions occasioned by those rates but without causing a major loss of progressivity. Id. at 136-37.
2. Serve as a better minimum tax. Id. at 139-41.
3. Provide tax relief for savers. Id. at 141.
4. Allow a trial run of a consumed income tax and ease the transition to full substitution of such a tax for the accretion income tax. Id. at 141-42.

However, the Andrews proposal seems politically unfeasible. A VAT might conceivably be adopted in addition to the individual income tax because a VAT is collected from consumers on daily transactions, independently of the payment of income taxes and the filing of annual income tax returns. Individuals never file VAT returns unless they operate businesses. By contrast, a consumed income tax would involve annual filings by consumers, presumably at the same time as the accretion income tax returns. The concurrent application of the two taxes would be much more visible and attention-grabbing than the concurrent application of a VAT and an income tax. It seems unlikely that voters and members of Congress could be persuaded to require a significant number of individuals to annually compute liabilities under both an accretion income tax and a separate, highly visible consumed income tax.

Also, most of the support for a consumed income tax rests on a belief that it is inherently superior to an accretion income tax and should therefore replace the present income tax.[123] Thus, enactment of a consumed income tax would most likely be coupled with repeal of the accretion tax.[124]

For these reasons, the consumed income tax probably does not present the unresolved issue of how will the revenue be used, which is critical to the complexity implications of a VAT.[125] Rather, it appears likely that revenues generated by a consumed income tax would substitute for the yield of the accretion income tax and that to determine whether a consumed income tax would simplify the federal revenue raising system, the tax should be evaluated as a replacement for the present individual and corporate income taxes.

B. *Simplifications Resulting from Substituting a Consumed Income Tax for All Accretion Taxes*

A consumed income tax can be conveniently thought of as a levy on individuals assessed annually on the following base: (1) the sum of all receipts, including borrowings, withdrawals from savings, and in-kind receipts, (2) reduced by income-earning outlays, amounts added to savings,

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The impact of the Andrews proposal on systemic complexity is clear; its adoption would significantly increase the intricacy of the federal revenue system.

123. See, e.g., Center for Strategic and Int'l Studies, The Strengthening of America Commission First Report 82-86, 96-100 (1992) [hereinafter Nunn-Domenici Report]; David F. Bradford, The Case for a Personal Consumption Tax, in What Should Be Taxed: Income or Expenditure? 75 (Joseph A. Pechman ed., 1980).

124. This is the approach proposed by both Treasury, Blueprints, supra note 4 at 113, and by the Nunn-Domenici plan. Nunn-Domenici Report, supra note 123, at 96.

125. See supra Part II.D.

and payments of principal and interest on debt.[126] This base is designed to ensure that the tax reaches only amounts spent on consumption (whether borrowed or drawn from current earnings or savings) and not to amounts added to savings or spent to produce income.[127] Thus, a consumed income tax effectively allows a taxpayer to remove any cash receipt, including borrowed funds, from the tax base simply by purchasing or adding to an investment, thereby obtaining a savings deduction that offsets the cash receipt.

The conventional wisdom is that replacement of the accretion income tax with a tax on consumed income would be a simplifying move[128] because:

1. Capital cost recovery provisions would no longer be needed since all investments are expensed under a consumed income tax.[129]
2. Because all investments are expensed, the distinction between current expenses and capital expenditures would be irrelevant,[130] and section 263A and *INDOPCO*[131] issues would disappear.
3. Basis (and the indexing thereof) would be irrelevant because the expensing of investments dispenses with depreciation and the computation of gain and loss on asset dispositions and, with these features eliminated, the basis rules have no role.[132]
4. There would be no need for entity-level taxes because an entity's retention of earnings adds to the investment of its

126. See 1 Treas. Dep't, supra note 4, at 191-93; Bradford, supra note 1, at 84-85, 93-97; ABA Sec. of Tax'n, Committee on Simplification, Complexity and the Personal Consumption Tax, 35 Tax Law. 415, 417 (1982) [hereinafter Simplification Committee Report].

127. Bradford, supra note 1, at 82, 87-89.

128. See, e.g., Nunn-Domenici Report, supra note 123, at 85-86, 97-100.

129. Blueprints, supra note 4, at 119.

130. Simplification Committee Report, supra note 126, at 419.

131. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) (addressing issue of whether expenditure may be deducted or must be capitalized).

132. Blueprints, supra note 4, at 134; Simplification Committee Report, supra note 126, at 419. For example, if A sells Blackacre for $100 but reinvests the sales proceeds in corporate stock, no tax would be paid on the sales proceeds. Conversely, if *A* spends the sales proceeds on consumption, the entire $100 would be taxed. The amount *A* paid for Blackacre would not, in either case, affect the tax result.

Although disappearance of the basis concept would eliminate any need to index basis, progressive rate brackets would have to be indexed under a consumed income tax in order to avoid "bracket creep." Simplification Committee Report, supra, at 419 n.12.

owners and this addition, like the original investment, should not be taxed until withdrawn and consumed.[133]

5. The realization doctrine would disappear because the taxing event under a consumed income tax is consumption, not realization.[134] With the disappearance of realization, the nonrecognition rules, which modify that concept, can go as well. Moreover, there would no longer be any need to distinguish between capital gains and ordinary income.

These simplifying aspects of a consumed income tax are impressive by any standard. Does such a tax, however, entail sufficient new complexity, or preserve so much old complexity, that the simplifications are substantially neutralized, or even outweighed, by the complexity? This question was extensively addressed in a 1982 report by the Committee on Simplification of the ABA Section of Taxation[135] and a 1979 article by Professor Michael J. Graetz.[136] In general, they concluded that a tax adhering strictly to the principles of a consumed income levy would probably be significantly simpler than the accretion income tax. However, they warned that a consumed income tax was vulnerable both to errors in selecting design options and to intricate deviations from principle that would substantially erode the simplification advantages and, in a worst case scenario, could make it even more complex than the present income tax. In other words, these studies adopted the view taken in this article regarding the VAT: The impact of a consumed income tax on systemic complexity cannot be judged until the details are known.

This article does not comprehensively restate the analysis of the Graetz piece and the Simplification Committee report, and the reader is referred to the full versions of those items. Instead, this article examines the recent consumed income tax proposal of Senators Sam Nunn and Pete Domenici as a case study of the simplification effects of a consumed income tax.

C. *Nunn-Domenici Proposal: Carrying Danforth-Boren the Rest of the Way*

Unlike the Danforth-Boren plan, the Nunn-Domenici proposal does not (as this article is being written) exist in statutory language with a detailed technical explanation. The published specifics of the Nunn-Domenici plan are

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133. Simplification Committee Report, supra note 126, at 419-20; Blueprints, supra note 4, at 133-34.

134. See Simplification Committee Report, supra note 126, at 419.

135. Id.

136. Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, (1979).

principally contained in two documents—a 1992 report by the Center for Strategic and International Studies,[137] which gives only a brief description, and a recent law review article by Senator Domenici,[138] which provides considerably more information but also leaves many details unspecified. Thus the following analysis of the Nunn-Domenici proposal is necessarily tentative and qualified.

The proposal would:

1. Replace the accretion income tax, including the corporate income tax, with an annually-assessed consumed income levy at progressive rates that would reach only consumption expenditures by individuals.[139]
2. Impose a flat-rate (approximately 10%), subtraction method value added tax,[140] called a cash-flow tax, on all businesses engaged in selling goods or services.[141] This tax (the Nunn-Domenici VAT) would be the only levy on business activity.
3. Allow employers a credit against the Nunn-Domenici VAT for the employer portions of the OASDI and hospital insurance payroll taxes,[142] and allow employees two credits against the consumed income tax—an earned income tax credit and a phased-out, refundable credit for part of the employee portions of the federal payroll taxes.[143]

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137. Nunn-Domenici Report, supra note 123.

138. Pete V. Domenici, The Unamerican Spirit of the Federal Income Tax, 31 Harv. J. on Legis. 273 (1994) [hereinafter Unamerican Spirit]. For a more fully articulated consumed income tax proposal, see Christian & Schutzer, supra note 120.

139. Id. at 288, 304-05; Nunn-Domenici Report, supra note 123, at 98-99. Repeal of the accretion income tax would eliminate all of its complex international elements. Unamerican Spirit, supra note 138, at 288, 316 n.127.

140. Senators Nunn and Domenici disclaim any intention to include a VAT in their proposal. Unamerican Spirit, supra note 138, at 313. See also Nunn-Domenici Report, supra note 123, at 96-97. However, their disclaimer should be understood as rejecting only a European-style credit method VAT. See supra text accompanying note 2. Their cash-flow tax would be a flat-rate levy on the domestic sales minus the business outlays, including capital expenditures, of every business. Unamerican Spirit, supra, at 307-09, 317-18. This is a classic description of a subtraction method VAT. General Accounting Office, supra note 51, at 11; 3 Treas. Dep't, supra note 1, at 7-11; Oldman & Schenk, supra note 3, at 1547. See also General Accounting Office, supra note 3, at 2-3. Consequently, this article refers to the cash-flow tax as the Nunn-Domenici VAT.

141. Unamerican Spirit, supra note 138, at 307-08. Dividends and interest received by a business would not generally be included in its sales receipts. Id. at 310-11.

142. Id. at 313. It is not clear whether this credit would be refundable.

143. Id. at 296.

4. Replace the present standard deduction and personal and dependent exemptions with a family living allowance deduction under the consumed income tax.[144]

A quick comparison of the Nunn-Domenici proposals major features with those of the Danforth-Boren plan shows that the two schemes are structurally alike in that would both repeal the corporate income tax and impose a subtraction method VAT on all sales of goods and services by both incorporated and unincorporated businesses.[145] Their principal point of difference is that Danforth and Boren would retain the individual accretion income tax,[146] but Nunn and Domenici would wholly replace it with a consumed income tax. Thus, while the Danforth-Boren plan represents a major shift toward consumption taxation, Nunn-Domenici is a proposal for complete replacement of accretion income taxation with consumption taxation.

1. *Simplifying Features of Nunn-Domenici.*—The Nunn-Domenici proposal would fully capture the impressive simplification gains, described above, that flow from replacing an accretion income tax with a consumed income levy. It is also anticipated that the proposal would enlarge the number of low- and middle-income taxpayers who are relieved of having to file tax returns because the proposal's family allowance would be much more generous for these taxpayers than the sum of the standard deduction and the personal and dependent exemptions under present law.[147] Unfortunately, this number would not be as large as might first appear because many people with no consumed income tax liability would, nevertheless, have to file returns to get the refundable payroll tax and earned income tax credits.[148]

There is an important point on which Nunn-Domenici is simpler than both current law and Danforth-Boren. The Danforth-Boren proposal generally eliminates the accretion income tax for businesses but retains it for individuals; business income is subjected to accretion taxation when it is distributed to individuals.[149] Consequently, Danforth-Boren preserves, and extends to electing unincorporated businesses, some of the most complex of the corporate tax rules for characterizing and taxing distributions to business

144. Id. at 295.

145. See supra text accompanying notes 73-74, 139-41.

146. See supra text accompanying notes 75-77.

147. For 1994, a family of joint-filing parents and two dependent children is entitled to a $6,350 standard deduction and four exemptions of $2,450 each. Rev. Proc. 93-49, 1993-2 C.B. 581, §§ 3.03, 3.07. The total of these items is $16,150. The Nunn-Domenici consumed income tax would provide this family with a family living allowance of $25,160. Unamerican Spirit, supra note 138, at 295.

148. Unamerican Spirit, supra note 138, at 296.

149. See supra text accompanying notes 75-77.

owners.[150] Furthermore, to discourage deferral of the individual accretion tax through excessive accumulation of income within businesses, Danforth-Boren imposes a complex penalty tax on undistributed passive income of businesses.[151] Because Nunn-Domenici completely eliminates accretion taxation, it avoids the necessity for these complicating features.

An additional simplifying aspect of Nunn-Domenici is that its basic elements are mandatory. This avoids the complications arising from the Danforth-Boren rule allowing pass-through entities to elect out of the accretion income tax.[152]

The payroll tax system would remain intact under the Nunn-Domenici proposal, although employers would be allowed a credit against the VAT for their portions of the OASDI and hospital insurance payroll taxes[153] and employees would be allowed a credit against the consumed income tax for part of the employee portions of the federal payroll taxes.[154] Thus, the taxpayer compliance and IRS enforcement burdens of the payroll taxes would not be reduced. The Danforth-Boren proposal, however, also continues these taxes.[155]

2. *Why Two Consumption Taxes?*—Nunn-Domenici employs two broad-based consumption taxes—the Nunn-Domenici VAT[156] and the progressive consumed income tax.[157] The bases of these two levies are probably quite similar,[158] raising the question of why Nunn and Domenici did not make the plan even simpler by using only one consumption tax. There are, however, reasonable grounds for employing both a consumed income tax and a VAT.

First, the decision to convert the federal revenue system to a consumption tax regime means that all savings, including retained corporate earnings and distributed corporate earnings that are saved by the distributees, are removed from the tax collector's reach.[159] Thus, if Nunn and Domenici employed only a consumed income tax, the rates would probably have to be

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150. See supra text accompanying notes 86-92.

151. See supra text accompanying notes 98-99.

152. See supra text accompanying notes 95-97.

153. Unamerican Spirit, supra note 138, at 313.

154. Id. at 296.

155. See supra text accompanying notes 85-86.

156. See supra text accompanying notes 140-41.

157. See supra text accompanying note 139.

158. See Bradford, supra note 1, at 87-89; Kesselman, supra note 7, at 730-31. See also Congressional Budget Office, Revising the Individual Income Tax 114 (1983); Simplification Committee Report, supra note 126, at 416-17; Unamerican Spirit, supra note 138, at 289, 307-08.

159. Unamerican Spirit, supra note 138, at 289-90, 307-08.

higher than current accretion income tax rates in order to avoid revenue losses.[160] Also, withholding and estimated tax systems are difficult to fashion under a consumed income tax because individuals pay tax only on what they consume and many would find it difficult to estimate their taxable consumption and nontaxable savings closely enough to avoid underwithholding and insufficient estimated tax payments.[161] The combined problem of higher rates, underwithholding, and underpayment of estimated tax is considerably mitigated if a broad-based VAT is used in tandem with a broad-based consumed income tax. The VAT effectively functions as a surrogate withholding system by collecting tax from consumers throughout the year,[162] and the VAT revenues permit the consumed income tax rates to be lower than would otherwise be possible.

Second, if Nunn and Domenici relied solely on a VAT, the tax rate would substantially exceed the sales tax rates familiar to most Americans.[163] Furthermore, since a VAT, standing alone, seems to be inherently and irreparably regressive,[164] sole reliance on a VAT would probably result in the federal revenue system being perceived as both burdensome and regressive. By employing an annually-assessed, progressive, consumed income tax in addition to a VAT, Nunn and Domenici can have both a lower VAT rate and progressivity through the consumed income tax.[165] A workable progressive rate structure is impossible in a VAT because the VAT is applied to separate purchases and not to a taxpayer's total consumption.[166]

These reasons provide a practical basis for the decision of Nunn and Domenici to employ two consumption taxes instead of one, even though a single-tax regime would be simpler. Moreover, the lower rates facilitated by the two-tax approach may reduce the incentive to engage in tax planning and tax evasion and may thus reduce compliance and enforcement burdens for taxpayers and the IRS.[167] Factoring in this point may narrow the complexity

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160. 1 Treas. Dep't, supra note 4, at 194; Congressional Budget Office, supra note 158, at 117; Simplification Committee Report, supra note 126, at 420. See also Graetz, supra note 136, at 1580-81. Nunn-Domenici is intended to be revenue neutral. Unamerican Spirit, supra note 138, at 288.

161. See 1 Treas. Dep't, supra note 4, at 202-03; Graetz, supra note 136, at 1595-96.

162. See Unamerican Spirit, supra note 138, at 288.

163. See supra note 45. See also Unamerican Spirit, supra note 138, at 287-88.

164. See supra text accompanying notes 42-52.

165. With respect to progressive rates under the Nunn-Domenici consumed income tax, see Unamerican Spirit, supra note 138, at 304-05. The Nunn-Domenici plan is said to be no less progressive than the current income tax. Id. at 288.

166. See 1 Treas. Dep't, supra note 4, at 191; Graetz, supra note 136, at 1578-79.

167. See generally 3 Treas. Dep't, supra note 1, at 26; Simplification Committee Report, supra note 126, at 420; Graetz, supra note 136, at 1584-85.

difference between the two-tax approach and a system that relies exclusively on either a VAT or a consumed income tax.

3. *Complexities in Calculating Gross Receipts.*—Although the Nunn-Domenici consumption taxes are markedly simpler than the accretion income tax, their system is significantly complex and has the potential for becoming even more intricate as it passes through the political process. For example, calculation of the consumed income tax begins by summing up gross income in much the same way that it is computed under the accretion income tax.[168] The record keeping, reporting, and enforcement burdens required by this approach seem to be approximately the same as under the current tax regime.

4. *Fringe Benefits.*—Although the Nunn-Domenici consumed income tax is described by its authors as a levy that "would rely on cash receipts and outlays"[169] and is "based on cash-flow principles,"[170] its authors surely do not intend to excuse taxpayers from reporting compensation received in the form of consumer goods and services. Thus, fringe benefit and related valuation issues raised by noncash compensation under the accretion income tax[171] are likely to be substantially replicated in the Nunn-Domenici regime.[172] Likewise, that system might require an analog to section 7872 in order to deal with interest-free loans made by employers to employees.[173]

168. Unamerican Spirit, supra note 138, at 289. Business income is not included in the consumed income tax base until it is received by individuals as interest, earnings distributions, compensation for services, or loans. See id. at 289-90, 294, 310-12.

169. Nunn-Domenici Report, supra note 123, at 99.

170. Unamerican Spirit, supra note 138, at 289. See also Nunn-Domenici Report, supra note 123, at 99.

171. See IRC §132; Regs. §1.61-21.

172. See 1 Treas. Dep't, supra note 4, at 191, 193; Bradford, supra note 1, at 84; Christian & Schutzer, supra note 120, at 1509-10; Graetz, supra note 136, at 1586-88.

173. The premise underlying § 7872 is that an interest-free loan from employer to employee is properly characterized as an interest-bearing loan coupled with an interest payment from employee to employer and an equal compensation payment from employer to employee. See Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 528-29 (Comm. Print 1984). If this characterization applies under the Nunn-Domenici system, the imputed compensation payment would presumably be included in the employee's gross receipts under the consumed income tax, see Unamerican Spirit, supra note 138, at 289, but the employee would apparently not be allowed an offsetting interest deduction if the loan were a home equity loan. See id. at 293-94. There might also be no offsetting interest deduction if the borrowed funds were used to purchase a long-lived consumer asset other than a principal residence. See infra text accompanying notes 189-94.

5. *Savings and Dissavings.*—Two distinctive features of a consumed income levy are that no tax is imposed on receipts that are saved but dissavings are taxed.[174] Under the Nunn-Domenici consumed income tax, savings are removed from the tax base by allowing individuals "a 'net new savings deduction' for net additions to savings accounts, investments in stocks, bonds, mutual funds, life insurance, and other savings assets."[175] Although Nunn and Domenici give no details on their plan's handling of dissavings, the flip side of the net savings deduction is presumably a net dissavings inclusion for years in which a taxpayer's withdrawals from savings exceed additions.[176] The record keeping and enforcement burdens of tracking components of the net savings deduction and the net dissavings inclusion seem to be about the same as the burdens of accounting for those items under the accretion income tax.[177]

6. *Business Versus Personal Under Nunn-Domenici.*—Under a consumed income tax, individuals are allowed to deduct expenses of business and investment activities, as under sections 162 and 212 of present law, because these expenses, while not additions to savings, are not consumption either.[178] Although the Nunn-Domenici documents do not address the point,[179] a fully-developed Nunn-Domenici consumed income tax will likely follow the classic pattern. This means that much of the present law distinguishing personal (consumption) outlays from business expenses will have to be preserved in the consumed income tax.[180] For example, the consumed income tax regime will have to deal with the issues of when entertainment expenses,[181] travel expenses,[182] education expenses,[183] job-hunting expenses,[184] and moving expenses[185] are sufficiently distinguishable from

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174. 1 Treas. Dep't, supra note 4, at 192; Bradford, supra note 1, at 82; supra text accompanying notes 126-27.

175. Unamerican Spirit, supra note 138, at 290.

176. See Bradford, supra note 1, at 82-84; Christian & Schutzer, supra note 120, at 1505; Nunn-Domenici Report, supra note 123, at 99.

177. See Graetz, supra note 136, at 1585, 1595.

178. See id. at 1588-91; William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1151 (1974). See also 1 Treas. Dep't, supra note 4, at 191; Bradford, supra note 1, at 82.

179. See supra notes 137-38.

180. See Graetz, supra note 136, at 1588-91.

181. See IRC § 274(a), (d), (e).

182. See IRC §§ 162(a)(2), 274(c), (h).

183. See Regs. § 1.162-5.

184. See Rev. Rul. 75-120, 1975-1 C.B. 55.

185. See IRC § 217.

consumption outlays to be deductible.[186] Similarly, under the consumed income tax it will have to be determined when items furnished to, and consumed by, an employee for the convenience of the employer, such as sleeping quarters on the employer's business premises, are so unlike ordinary consumption that they should be excluded from the tax base.[187] Under the accretion income tax, all of these issues have provided profitable employment for lawyers and accountants and burdens for taxpayers and the IRS, and they would seem to be equally alive in a consumed income tax world.[188]

7. *Long-Lived Consumer Assets.*—The proper treatment under a consumed income tax of consumer durables and owner-occupied housing (long-lived consumer assets) is an enduring conundrum with two solutions, one of which is theoretically correct but impractical and the other of which is regarded as an acceptable alternative in a world requiring practical results. The theoretically correct solution is to treat a long-lived consumer asset like any other income-producing property, allowing a deduction for its cost but taxing the income flow (the consumption benefits) from the asset. This approach relieves the purchaser from paying tax when the asset is acquired, but it requires an annual inclusion in the tax base of an imputed flow of consumption benefits from the asset. Since the imputed amount is immediately consumed through personal use of the asset, there would be no savings deduction to offset its inclusion in gross income. If the asset were ultimately sold, the proceeds would be included in gross income for the year of the sale.[189]

Unfortunately, this approach collides with the long-standing expectation that imputed income from the use of consumer assets will not be taxed, particularly when the asset is the sacrosanct family residence. Taxpayer opposition would likely be heightened by the lack of any associated cash-flow from which tax on imputed consumption benefits could be paid and by the fact that valuation of those benefits would be burdensome and complex if done accurately and often inaccurate if done by reference to statistical averages or returns on financial investments.[190] The theoretically correct approach seems to have no chance of adoption.

186. See generally 1 Treas. Dep't, supra note 4, at 191; Graetz, supra note 136, at 1588-91.

187. See IRC § 119; Christian & Schutzer, supra note 120, at 1510.

188. See Graetz, supra note 136, at 1585-86.

189. Bradford, supra note 1, at 85; Andrews, supra note 178, at 1155-58; Graetz, supra note 136, at 1599, 1614, 1620.

190. See generally 1 Treas. Dep't, supra note 4, at 201; Bradford, supra note 1, at 85; Andrews, supra note 178, at 1155-56; Graetz, supra note 136, at 1614, 1621.

The alternative is essentially the flip side of theoretical correctness—allow no deduction for the cost of a long-lived consumer asset but exclude from gross income both the flow of consumption benefits from the asset and the proceeds of its eventual sale. Thus, if the acquisition of a car or residence is financed from current earnings, no purchase deduction would shelter those receipts from immediate taxation. If the purchase is financed from savings, the consumer would have a large, taxable withdrawal from savings, but no offsetting purchase deduction.[191] If the purchase is financed with a loan, the loan proceeds would be included in taxable receipts without any offsetting deduction.[192] Under each of these scenarios, the asset's purchase price would be fully taxed in the acquisition year, but there would be no further income inclusions as the asset was used and ultimately sold.[193]

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191. Supra text accompanying notes 126-27; Bradford, supra note 1, at 85-86. The problem of the taxpayer being pushed into a higher rate bracket by a large savings withdrawal could be alleviated with an averaging provision. Id. at 86. Both this problem and the related problem of the taxpayer having to pay a large tax, irrespective of the marginal rate, could be mitigated by a provision for a special account into which a taxpayer could make nondeductible deposits while saving for a long-lived consumer asset and from which nontaxable withdrawals could be made when the purchase occurs. Id. Alternatively, the large tax might be allowed to be paid in interest-bearing installments over several years. See 1 Treas. Dep't, supra note 4, at 202. All of these solutions, however, would erode the simplification gains of a consumed income tax.

192. This consumer would be helped by the averaging and installment payment provisions referred to in note 191.

An alternative method for dealing with the higher rate bracket and large tax liability problems of taxpayers who finance purchases of long-lived consumer assets by borrowing is to permit them to exclude the loan proceeds from gross receipts in exchange for forgoing the deductions for principal and interest payments that are usually allowed to borrowers under a consumed income tax. 1 Treas. Dep't, supra note 4, at 192, 202; Bradford, supra note 1, at 86; Graetz, supra note 136, at 1618-19, 1621. If this alternative were employed, taxpayers would be required to handle loans in two different ways: (1) exclusion of loan proceeds from income and no deduction for loan payments where the loan finances the purchase of a long-lived consumer asset and (2) in all other cases, inclusion of loan proceeds and deduction of principal and interest payments. To the extent that a loan handled under the first alternative was forgiven, the forgiven amount would have to be treated as income. Simplification Committee Report, supra note 126, at 423. This might lead Congress to retain the exceptions to debt discharge income presently found in §§ 108(a)(1)(A) (bankruptcy discharge), 108(a)(1)(B) (discharge when insolvent), and 108(e)(5) (purchase money debt reduction). All of this would complicate the consumed income tax for both taxpayers and IRS. See generally Graetz, supra note 136, at 1618-20.

193. Blueprints, supra note 4, at 122; Bradford, supra note 1, at 85; Simplification Committee Report, supra note 126, at 419-20; Andrews, supra note 178, at 1155-56; Graetz, supra note 136, at 1614-18.

However, matters become complicated if an asset accounted for under this approach is sold for more than its original cost (a common outcome for residences). Arguably, the theoretically correct result is to include any unexpected market gain in the seller's consumption

By contrast, under the present accretion regime, there is no tax, at time of purchase, on funds used to acquire long-lived consumer assets unless the funds come from current income.

This alternative treatment of long-lived consumer assets is based on the familiar insight that expensing an asset and taxing the returns from it (the method described above for achieving a theoretically correct result) is the economic equivalent of allowing no deduction for the cost of an asset (thus taxing the purchase price) and exempting all returns from the asset.[194] Nevertheless, taxpayers can be expected to oppose this alternative because it would give them a large tax liability on top of a large purchase price. Taxpayer objections would be particularly sharp with respect to the acquisition of a personal residence which taxpayers have been conditioned to think of as a tax-preferred asset.

8. *Personal Residences.*—Nunn and Domenici, having seemingly weighed these considerations, adopt an approach for personal residences that gets the economics partly wrong but undoubtably gets the politics right. Under this approach, the acquisition of a personal residence is treated like the purchase of an investment asset; the purchase price is fully deductible.[195] Purchase money borrowing would apparently be included in the tax base, but deductions would be allowed for payments of principal and interest.[196] Because the purchase price deduction would effectively offset purchase money loan proceeds as well as current earnings or savings withdrawals used to finance the purchase, there would be no consumption tax liability associated with the acquisition of a residence.

To this point, the Nunn-Domenici treatment of owner-occupied housing follows the theoretically correct approach outlined above. However, the next step deviates fundamentally from theoretical correctness—the flow

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tax base. Stated differently, the taxpayer should arguably be taxed on the portion of the sales price representing an unexpected windfall that was not taxed on a present-value basis when the house was purchased. Graetz, supra, at 1617-18, 1621. See also Andrews, supra, at 1158. Implementation of this refinement would be so complicated as to seriously erode the simplification gains of a consumed income tax. At a minimum, taxpayers would be required to keep track of their basis in long-lived consumer assets, forgoing one of the virtues of a consumed income tax.

194. Blueprints, supra note 4, at 123-24; Andrews, supra note 178, at 1126, 1155-56; Alvin C. Warren, Jr., Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 Tax Law. 549, 550-52 (1985). For an argument that this insight is wrong in most real-world situations, see Graetz, supra note 136, at 1598-1609. Blueprints, supra note 4, at 128-29 also raises questions about its validity.

195. Unamerican Spirit, supra note 138, at 294.

196. Id. However, the interest deduction would be subject to an unspecified cap, and residential real property taxes would not be deductible.

of consumption benefits from the residence would be ignored; no attempt would be made to value and tax this imputed income.[197] This solution gets high marks for simplicity, but it puts investments in personal residences in a privileged position.[198] Nunn and Domenici frankly recognize this economic flaw in their plan and seemingly confess that they are bowing to political realities.[199]

9. *Other Long-Lived Consumer Assets.*—The Nunn-Domenici proposal apparently has a different approach to long-lived consumer assets other than housing. It does not seem to permit purchase price deductions for such assets and appears to exempt the related flow of consumption benefits.[200] In other words, the alternative approach described above seems to be adopted for long-lived consumer assets other than residences. The proposal apparently includes an averaging provision for taxpayers pushed into higher tax brackets by large purchases of this type, but the details of the averaging provision have not yet been published.[201]

Although this approach to long-lived consumer assets may be theoretically correct,[202] the averaging provision adds complexity. Inclusion of the averaging provision is virtually compelled, however, by a contradiction between two of the principal justifications for the consumed income tax. The first of these justifications is that the consumed income tax, unlike the VAT, can utilize graduated rates and serve as a means for effectuating progression.[203] Indeed, it has been asserted that "[t]he decision to adopt a progres-

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197. Id.

198. See 1 Treas. Dep't, supra note 4, at 201-02. See also Graetz, supra note 136, at 1622-23.

199. Unamerican Spirit, supra note 138, at 294.

200. Id. at 292. By treating personal residences more favorably than other long-lived consumer assets, the proposal raises the issue of whether a yacht or motor home in which the owner lives most of the year is a personal residence or a nonresidential consumer durable. Presumably, answering this question will not be unduly complicated. However, if the answer is that any property, real or personal, that serves as the taxpayer's principal residence qualifies under the residence rule, the Nunn-Domenici system would have to deal with whether a newly-acquired yacht or motor home was, in fact, purchased as a principal residence or as a less-favored recreational asset. See Temp. Regs. §§1.163-10(p)(3)(ii), 1.1034-1(c)(3)(i) (drawing this distinction under current law). This would be a complicating addition to the Nunn-Domenici system.

201. Unamerican Spirit, supra note 138, at 292.

202. But see Graetz, supra note 136, at 1598-1609, 1614-15 (implicitly arguing that this approach is not theoretically correct but concluding that it is an acceptable practical solution).

203. 1 Treas. Dep't, supra note 4, at 191; Congressional Budget Office, supra note 158, at 114; Nunn-Domenici Report, supra note 123, at 97-100. See also Unamerican Spirit, supra note 138, at 304.

sive rate structure is thus the principal basis for choosing an expenditure [consumed income] tax over other taxes levied on a consumption base."[204] The second of the conflicting justifications is that the consumed income tax achieves neutrality between consumers and savers, thereby overcoming a major distortion of the accretion income tax.[205]

The contradiction is illustrated by individual *A*, who earns $100 and enjoys an annual return on investments of 10%. In a no-tax world, her choice is between $100 of consumption today and $110 of consumption next year. Under a 50% flat-rate consumption tax, *A* could consume $50 today or save for one year and consume $55. The tax has cut her consumption in half, but it has left her able to consume 10% more if she defers consumption for one year. The relative tradeoff between present and future consumption has not been disturbed.[206] However, if the tax is imposed at progressive rates—say, 50% on the first $100 and 80% on consumed income in excess of $100, *A*'s tax under the savings alternative is $58 ($50 on the first $100 and $8 on the investment earnings), and the amount remaining for consumption is only $52 ($110 less $58), which is only 4% more than the $50 she could have consumed without saving.

Progressive rates thus have the effect of altering the relative tradeoff between present and future consumption in a way that disfavors saving. For this reason, the Nunn-Domenici authors are virtually forced to provide a complicating averaging rule for taxpayers pushed into a higher tax brackets when they purchase expensive long-lived consumer assets from savings withdrawals. Having come this far, Nunn and Domenici are forced to make the averaging provision available to all purchasers of long-lived consumer assets because it would be quite complicated to differentiate between taxpayers financing purchases of these assets from savings and those using other financing approaches.[207]

Another interesting consequence of the Nunn-Domenici treatment of long-lived consumer assets other than housing is that purchasers of valuable items of tangible personal property producing no cash-flow would prefer that

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204. Graetz, supra note 136, at 1579.

205. Nunn-Domenici Report, supra note 123, at 98-99; Blueprints, supra note 4, at 40.

206. Congressional Budget Office, supra note 158, at 116. By contrast, under a 50% flat-rate income tax, A would have only $50 to save after tax, would have an investment return of $5, pay $2.50 in tax on that amount, and have only $52.50 to consume after one year. Thus, the income tax would allow the saver to consume only 5% more than the consumer who immediately spent the $50 of after-tax income and saved nothing.

207. For example, if averaging applied only to acquisitions out of savings and a taxpayer with $100 of savings and $100 of current earnings purchases a long-lived consumer asset for $100, it would have to be determined whether the asset was purchased from the savings or the earnings.

these items be treated as investments, rather than long-lived consumer assets. This is because consumer-asset classification means that the purchase price for the item is immediately included in the tax base,[208] whereas investment asset classification means that the purchase price is deducted from the tax base and the absence of cash flow ensures that there is no taxation while the taxpayer uses the asset even though the taxpayer is receiving current consumption benefits through that use.[209] Thus, taxpayers who purchase expensive art objects and jewelry can be expected to argue that these items are investments, even though the art is displayed in a personal residence and the jewelry is occasionally worn by the owner or members of the owner's family.[210] Under Nunn-Domenici, taxpayers and the IRS would bear the costs of making the factual distinctions required to properly classify property of this type. If the proposal attempts to avoid this issue by denying a deduction for investments in art objects and jewelry, taxpayers will presumably make such investments through business entities. The proposal would then either have to acquiesce in this strategy or adopt complicating rules that look through business ownership interests to the underlying assets.

10. *Gifts and Inheritances.*—The Nunn-Domenici treatment of gifts and bequests is based on three premises: (1) The making of a gift or bequest is not taxable consumption by the transferor;[211] (2) gifts and inheritances should be taxed only once under a consumed income tax;[212] and (3) the appropriate imposition of the tax is on the donee when the gift or inheritance is consumed.[213] Thus, the proposal "treats inheritance [or a gift] as income to the recipient and taxes it to the extent that it is consumed rather than saved. If the entire inheritance [or gift] is saved, inheritance [or inter vivos giving] is not a taxable event for either the donor or the beneficiary."[214]

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208. See 1 Treas. Dep't, supra note 4, at 201-02; supra text accompanying notes 191-92, 200-01.

209. See supra text accompanying note 191-93. Under the Nunn-Domenici proposal, income is not imputed from any asset. Thus, property that is treated as an investment but produces no cash-flow generates no tax liability when it is acquired or while it is held. The proceeds of a sale of such an asset are included in gross income but can be offset by a savings deduction if reinvested.

210. See generally 1 Treas. Dep't, supra note 4, at 201-02.

211. Unamerican Spirit, supra note 138, at 302.

212. Id. at 303-04. Accord: Simplification Committee Report, supra note 126, at 427; Andrews, supra note 178, at 1163-64; Graetz, supra note 136, at 1626-27.

213. Unamerican Spirit, supra note 138, at 302. However, the wealth transfer taxes would be retained.

214. Id. at 302. This outcome is arguably correct under consumed income tax principles. See Blueprints, supra note 4, at 12, 15; Simplification Committee Report, supra note 126, at 427; Andrews, supra note 178, at 1162-63; Graetz, supra note 136, at 1624-25. But see 1 Treas. Dep't, supra note 4, at 193; Bradford, supra note 1, at 89.

This system is relatively simple for donees, but it has significant complexity on the donor's side. The following examples illustrate this point:

> *Example 1*: Individual *A* makes a $100 gift out of current receipts (e.g., salary or dividends) to individual *B*. Since the receipts are part of *A*'s consumption tax base in the year of the gift, *A* is presumably allowed a $100 deduction for the gift.[215] Without the deduction, *A* would be taxed on the $100, violating the policy of not taxing the donor.
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> *Example 2*: Instead of making a cash gift, *A* uses the $100 of current receipts to buy corporate stock, which she immediately gives to *B*. *A* receives a $100 savings deduction for the stock purchase.[216] If she also gets a $100 gift deduction, she will have leveraged her $100 transfer into $200 of deductions, deflecting tax from both the $100 investment outlay—a correct result under a consumed income tax—and an additional $100 that *A* could consume tax free.
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> *Example 3*: *A* makes a gift to *B* of stock that was acquired years earlier out of current receipts for $100 but is worth $200 at the time of the gift. If *A* gets a $200 gift deduction in addition to the $100 savings deduction allowed when she bought the stock, she will have deducted her investment cost twice, once when she bought the stock and again as a component of her $200 gift deduction. Furthermore, the gift deduction will have included $100 of untaxed appreciation.[217] For a $100 cost, she will get $300 of deductions that will, in addition to deflecting tax from her $100 investment outlay, shelter $200 of otherwise taxable consumption expenditures.

The tax shelter outcomes in Examples 2 and 3 are indefensible, but the published details of the Nunn-Domenici plan do not explain how they will be prevented. A possible solution is to require *A* to treat the stock gifts as deemed withdrawals from savings that are added to the tax base for the year of the gift. In Example 2, this approach produces the following computational steps for *A*: (1) a $100 inclusion of the cash receipts; (2) a $100 deduction for the stock purchase; (3) a $100 inclusion for the deemed savings

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215. See Simplification Committee Report, supra note 126, at 427; Andrews, supra note 178, at 1163; Graetz, supra note 136, at 1624.

216. See supra text accompanying note 126 and 175. *B* also excludes the stock from her income. See supra text accompanying note 214.

217. Because the gift is not a consumption event, Unamerican Spirit, supra note 138, at 302, the $100 of appreciation is apparently not included as consumption in A's tax base.

withdrawal; and (4) a $100 gift deduction. In Example 3, the steps are: (1) a $100 inclusion of the cash receipts; (2) a $100 deduction for the stock purchase; (3) a $200 inclusion for the deemed withdrawal from savings; and (4) a $200 deduction for the gift. In both cases, items (3) and (4) cancel each other so that *A* is limited to one $100 deduction and only the $100 of cash receipts is sheltered from taxation. This system reaches the right results in Examples 2 and 3,[218] but it is hardly simple. *A* must go through four steps, and the IRS has to make sure that *A* gets them right.

An alternative is to deny the gift deduction for gifts of business or investment property, thereby eliminating the need to treat gifts of such property as constructive withdrawals from savings.[219] In Examples 2 and 3, this system would restrict *A* to the $100 deduction for the stock purchase, and her deduction would not exceed the amount originally included in her tax base. This is a far simpler solution, but it is moderately complex because it requires donors to handle cash gifts differently from gifts of business and investment property.

However, this is not the end of the complexity arising from the Nunn-Domenici treatment of gifts. Recall that purchases of long-lived consumer assets, other than residences, would apparently be treated as taxable consumption expenditures.[220] Thus, amounts spent on cars, boats, jewelry, and art objects acquired as consumer items would be taxed when these items are purchased. Assume *A* gives a personal-use car to *B*. If *B* is also taxed on the receipt of the car and is allowed no offsetting deduction (as is appropriate if *B* holds the car for personal use),[221] there is a violation of the Nunn-Domenici principle that gifts and inheritances should be taxed only once.[222]

There are three ways out of this problem. First, the transferee could be taxed notwithstanding the earlier tax on the transferor. This is a very simple solution because it treats all transferees the same and requires no inquiry into whether the transferred asset was previously taxed. However, this

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218. Simplification Committee Report, supra note 126, at 427; Graetz, supra note 136, at 1624-25.

219. See Simplification Committee Report, supra note 126, at 427; Andrews, supra note 178, at 1162-63; Graetz, supra note 136, at 1625.

220. See supra text accompanying notes 200-10.

221. Since Nunn and Domenici would not impute income to owner-users of long-lived consumer assets and since such assets, other than housing, are apparently treated as consumed when acquired, see supra text accompanying notes 200-10, a donee would seemingly be required to include the full value of nonresidential consumer assets in income when received. A donee who holds the property for business or investment use would presumably be allowed an offsetting deduction.

222. See supra text accompanying note 214. More precisely, there would be double taxation to the extent that the value of the property at the time of the gift does not exceed its original purchase price.

solution also conflicts with the Nunn-Domenici principle that gifts and inheritances should be taxed only once and only when devoted to consumption by the transferee.

A second solution would be to absolve the transferee from tax if the transferor was previously taxed.[223] For example, if an art object or jewelry was acquired for investment, the purchase price should have been treated as a deductible savings outlay, eliminating any tax at the time of purchase, and if so, the item would be included in the tax base of a donee or heir. In contrast, if the item was acquired for personal use, its cost should have been treated as a taxable consumption expenditure, and if so, a donee or heir would not be taxed on receipt of the item. However, there can be no guarantee that the purchase was correctly reported. Furthermore, a transferee of an art object or jewelry would not be able to tell by examining the property whether tax was paid by the transferor. Thus, if transferees are to be excused from tax with respect to consumer assets that were earlier taxed to the transferors, transferors and their estates must be required to maintain and disclose records allowing the transferees to determine whether consumer durables passing by gift or bequest were previously taxed.

A third solution would be to tax the transferee if the property is put to personal use, but give the transferor (or the transferor's estate) a refund of any tax paid by the transferor.[224] This approach entails approximately the same record-keeping burden as the second solution, except that the transferor's records would also need to show how much tax was paid.

From a simplification standpoint, none of these solutions is particularly attractive, but one of them has to be chosen. Nunn and Domenici have hinted at the third.[225] This is a perfectly reasonable resolution,[226] but the record keeping that it requires must be scored as a complicating feature of the consumed income tax.

Furthermore, consider the situation of an individual who purchased a $100,000 boat for personal use and transfers it by gift or inheritance after it has declined in value to $50,000 because of wear and tear, not market changes. Because the transferor consumed one half of the boat's value before the transfer, it is inappropriate to give the transferor, or the transferor's estate, a refund of the consumed income tax paid on the entire $100,000 price of the boat and collect a tax from the donee on only the remaining $50,000 of value. Since the donee can consume only $50,000 in using the boat, it is equally inappropriate to give a full refund of the earlier tax and charge the

223. Unamerican Spirit, supra note 138, at 303 n.86; Graetz, supra note 136, at 1626-27.

224. See Simplification Committee Report, supra note 126, at 427.

225. Unamerican Spirit, supra note 138, at 303 n.86.

226. See Simplification Committee Report, supra note 126, at 427.

donee with tax on the original $100,000 price. The Nunn-Domenici principle of taxing the person who engages in consumption would be properly implemented by giving the transferor or her estate a refund for only half of the earlier tax payment and collecting tax from the donee on the boat's remaining value of $50,000. However, the record keeping, computations, and valuations required by this solution detract further from simplification gains.[227]

11. *Income Splitting.*—As noted above, the Nunn-Domenici proposal apparently allows a donor to deduct cash gifts from current receipts (e.g., salary or dividends) and includes the gifts in the donees' gross receipts for purposes of the consumed income tax.[228] This permits high-bracket donors to shift the tax burden on current salary, interest, and dividend income to low-bracket donees,[229] a result that is anathema under the income tax.[230]

If this income-splitting superhighway is considered unacceptable, cash gifts to family members might be removed from the general pattern by taxing them as nondeductible consumption expenditures of the donor. This approach would, however, create several disagreeable problems. First, in order to avoid double taxation, a donee would have to separate a cash gift from other cash receipts and exclude it from the consumed income tax base.[231] The IRS would then have to police the exclusion to make certain that the amount really was a gfit from a related donee.

Second, if intra-family cash transfers were treated as nondeductible consumption by the donor and as excludable from the donee's income, a decision would have to be made and administered regarding the definition of

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227. In the example, the decline in value is from wear and tear, not market decline. If value is lost as a result of market decline, the solution of refunding the entire tax paid by the transferor, while collecting tax from the transferee only on the remaining value, is less obviously wrong. Arguably, if the value declines from $100,000 to $50,000 before any consumption occurs, the transferor was overtaxed on the $100,000, and the appropriate tax is on the $50,000 of consumption that the transferee can enjoy. However, it is not feasible to determine whether a loss in value resulted from market decline or wear and tear. In the example, for instance, the $50,000 loss in value might be partly from wear and tear and partly from market decline. The solution suggested in the text should therefore apply to any decline in value in property that was treated as a consumption item when purchased by the transferor, regardless of the cause of this decline.

228. See supra text accompanying notes 211-14.

229. See Simplification Committee Report, supra note 126, at 427; Graetz, supra note 136, at 1625. Nunn and Domenici apparently would not require the family to report income as a unit. See Unamerican Spirit, supra note 138, at 288, 304-06.

230. See Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930). See also Chirelstein, supra note 47, at 200-01.

231. See Simplification Committee Report, supra note 126, at 427; Unamerican Spirit, supra note 138, at 303. Taxing gifts only once seems to be a major goal of Nunn and Domenici. Id. at 287, 303-04.

family. Specifically, when would a relative be considered sufficiently distant to permit a donor to make deductible cash gifts to that individual?[232] This could involve many of the complexities of current law on the dependency exemptions. Third, denying the deduction for cash gifts to family members might simply cause donors to make loans to relatives, requiring the IRS to police the bona fides of nominal loan transactions. Finally, denial of the deduction would distort individual behavior by encouraging potential donors to consume more than they otherwise would or to accumulate property and pass it to relatives at death.

An alternative means of blocking income splitting by intra-family cash gifts would be to allow donors to deduct the gifts but tax the donees at the donor's marginal tax rate when the donees consume the gifts. This would involve many of the complexities of the present kiddie tax (section 1(g)), with the added twist that tracing would be required to determine the source of funds spent by donees on consumption. From a simplification standpoint, these are not happy consequences.

Arguably, income splitting is not a problem under a consumed income tax because the tax should be imposed on the consumer, based on the amount the consumer consumes. If high-income individuals choose to shift consumption to family members taxed at lower marginal rates, the resulting revenue losses are inherent in the nature of the tax.

However, without restraint on income shifting, parents would effectively have the ability to shift to their children the tax burden on support provided by the parents, and working spouses could shift to nonworking spouses the tax burden on support furnished by the working spouses. What is bad about this is that it would not happen automatically, only through tax planning. Parents who simply put food on the table and clothes in the children's closets would be taxed on funds spent on the children's support, while parents who made cash gifts to the children, which the children used for their needs, would shift the tax burden to the children. If cash gifts are deductible by donors, the only way to stop this tax planning would be to wade into the problems, described above, of prohibiting tax deductible cash gifts to family members or to permit such gifts only to the extent that they exceed support. The latter approach would embroil taxpayers and the IRS in controversies over support levels—a most disagreeable prospect from a simplification standpoint—unless an arbitrary support level is specified by statute.

Regrettably, there is yet another income splitting problem here. If the consumed income tax permits donors to make untaxed gifts of income-

232. The Nunn-Domenici treatment of gifts apparently covers transfers to nonfamily members. See Unamerican Spirit, supra note 138, at 302-04.

producing property to donees, the tax burden on future income from the property would be shifted to the donees. This was judged unacceptable under the present income tax for donees who had not reached age 14. The result was section 1(g), the so-called kiddie tax, which generally taxes the property income at the marginal tax rate of the child's parent. A similar approach might be used under the consumed income tax; income from property might be taxed at the parent's rate when consumed by the child. To implement this approach, however, it would be necessary to trace the child's consumption expenditures to their sources—not a pretty thought if one is concerned about simplification.

It is now clear why Nunn and Domenici have not (as this article is being written) published a proposal dealing with the income splitting problems resulting from the treatment of gifts. The problems are truly daunting, and none of the solutions is attractive. It is evident, however, that unless Nunn and Domenici are prepared to tolerate income splitting to a degree far in excess of what can be accomplished under current law, they will be drawn inexorably into complicating solutions.

12. *Charitable Contributions and Tax-Exempt Organizations.*—The broad public support for charitable giving incentives is accommodated in the Nunn-Domenici plan by a tax credit for charitable contributions, in lieu of the deduction of present law.[233] Although details have not been provided, the credit could be quite complex, particularly if it is amended as it works its way through the political process.

For example, if the credit percentage is less than a donor's marginal tax rate, the donor would be better off making cash gifts to noncharitable donees and claiming the gift deduction, instead of giving the cash to a charity and taking the less generous credit.[234] Presumably, this state of affairs would encourage donors to give directly to a multiplicity of needy individuals, rather than making a smaller number of larger gifts to charitable organizations. The IRS would then have to audit many more deduction claims, and taxpayers would have to substantiate more gifts—an obvious increase in complexity for everyone. If the credit were set between the highest and lowest tax rates, it would encourage high-bracket donors to make

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233. Unamerican Spirit, supra note 138, at 297-98.

A recent example of strong political support for the charitable contribution deduction is the 1993 repeal of § 57(a)(6), under which the deduction for charitable gifts of property was reduced for purposes of the alternative minimum tax by the amount of any long-term capital gain that would have been recognized on a sale of the property for its fair market value. See also Gene Steuerle, Charitable Donations of Grants: Expanding the Hatch Bill, 64 Tax Notes 1101 (Aug. 22, 1994).

234. For the gift deduction, see supra text accompanying notes 211-14.

deductible cash gifts to low-bracket family members, who would contribute the cash to charity and use the resulting credit to eliminate tax on receipts exceeding the amount given to charity.

These problems could be avoided by providing a deduction, instead of a credit, for charitable contributions. This would put charitable and noncharitable gifts on an equal footing, but it would also allow high-bracket taxpayers a larger tax benefit from charitable transfers than low-bracket taxpayers.

These problems could also be finessed by allowing noncharitable gifts to be deducted only if made to family members. This would deprive donors of the opportunity to make tax deductible gifts directly to unrelated needy individuals, but it would require a definition of family that might involve difficult distinctions. For example, would a former son-in-law or daughter-in-law qualify as a member of the donor's family? Would it make any difference if the former in-law had custody of the donor's grandchildren? Also, this solution would not address the use of low-bracket family members as conduits for charitable gifts.

Clearly, the simplest way through this thicket is to set the charitable contribution credit at a percentage equal to the highest marginal tax rate, thereby ensuring that the deduction for cash gifts to noncharitable donees would never be more attractive than the charitable contribution credit. Senators Nunn and Domenici propose this solution.[235] However, the revenue loss from allowing low-bracket taxpayers to use Ross Perot's marginal rate in calculating the tax savings from their charitable gifts might make this approach too costly. If so, the drafters will be driven back to the complexities described above.

Furthermore, the proposed solution does not avoid a frustrating issue posed by gifts of property other than money, which is illustrated by the following examples:

> *Example 4*: Individual *A* wishes to make a $100 charitable donation. If she gives cash, she will receive a consumed income tax credit equal to a percentage of $100. But suppose she uses $100 out of her next paycheck to buy corporate stock that she immediately gives to charity. Would *A* be entitled to both a savings deduction for the purchase of the stock and a charitable contribution credit for the gift of the stock? If *A* is taxed at the top marginal rate and the credit percentage equals that rate, the credit is the economic equivalent of a $100 deduction, and if a savings deduction and a charitable

235. Unamerican Spirit, supra note 138, at 297-98.

contribution credit are both allowed, a single $100 outlay would effectively create $200 of deductions.

Although tax incentives encouraging charitable giving have broad public and congressional support, allowing *A* to double her tax benefits in this manner seems to be more than is required to stimulate donor generosity.[236] Furthermore, many would surely balk at the appearance created by allowing a charitable contribution credit for *A*'s $100 cost after it has generated a $100 savings deduction. Thus, the credit will probably be crafted so that it does not apply to *A*'s $100 stock gift.[237]

Example 5: *A*'s charitable gift instead consists of stock purchased years ago for $100 that is worth $200 at the time of the gift.

The long-standing policy of encouraging charitable gifts of appreciated property will probably lead Nunn and Domenici to make their credit available with respect to the $100 of appreciation in Example 5.[238] But what about the portion of the stock value that represents *A*'s $100 cost? Does the analysis of Example 4 establish that the credit should not apply to the cost portion of *A*'s stock gift in Example 5 or does the fact that the stock investment is old and cold at the time of the gift argue for awarding the credit with respect to the stock's entire value as an incentive to make the gift?

The answer to these questions is unclear.[239] However, if the credit

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236. For a possible contrary argument, see Graetz, supra note 136, at 1632-33.

237. See generally id. at 1632.

238. Gifts are not taxable events to donors under the Nunn-Domenici proposal. See supra text accompanying notes 211-14. Consequently, A would not be taxed on the appreciation when she gives the stock to charity, and, with respect to the untaxed appreciation, her credit would provide approximately the same charitable giving incentive that she would get from the present charitable deduction. See Graetz, supra note 136, at 1632.

239. Under present law, A's charitable deduction includes her $100 cost, but because the cost consists of after-tax dollars, *A* could have sold the stock and consumed the $100 without further tax. Under the consumed income tax, by contrast, because *A* would have been allowed a $100 deduction for her stock purchase, this cost would consist of pre-tax dollars that she could not consume without paying tax but could give to a charity free of any tax. Thus, if there is any structural bias in the Nunn-Domenici plan between charitable giving and consumption of the cost of an existing investment, the bias favors charitable donations over consumption. Consequently, denying a charitable contribution credit for a donation of the $100 of untaxed original investment in the stock may not make her incentive to give that $100 to a charity materially less than her incentive to give after-tax dollars under the income tax. However, under Nunn-Domenici, *A* has the option of continuing to hold the stock and saving the returns thereon so that those returns compound at a pretax rate. This option is not available under an accretion tax and continuing to hold the shares may be so comparatively attractive under Nunn-Domenici that it will be necessary to give *A* the contribution credit with respect

is denied with respect to a charitable donor's original cost, taxpayers will effectively be required to maintain records of the costs of all investments, even though the consumed income tax is supposed to dispense with the cost basis concept. On the other hand, if *A* is allowed the credit with respect to the cost of old and cold stock (Example 5) but not the cost of newly acquired stock (Example 4), the drafters will have the difficult problem of drawing the dividing line between Examples 4 and 5. If the distinction is made by an intent test (*A* bought the stock in Example 4 for the purpose of giving it to a charity but bought the stock in Example 5 as an investment), taxpayers and the IRS will have to deal with an uncertain, fact sensitive issue. If, alternatively, the drafters use an arbitrary holding-period rule to distinguish Examples 4 and 5, *A* will have to maintain holding period records for her various blocks of investment shares, and there will surely be rules that allow *A* to tack the holding period of old shares onto new shares if she can trace the old to the new. In short, regardless of how this issue is resolved, the result will be complex.

In addition, most of the percentage-limitation paraphernalia of present section 170(b) will probably be retained under the charitable contribution credit, and the credit will surely be reserved for gifts to organizations satisfying criteria which ensure that contributions to them will further approved charitable purposes. These rules will probably require the persistence of provisions like the private foundation rules. Furthermore, Nunn and Domenici have stated that charities will be exempt from the Nunn-Domenici VAT,[240] suggesting a strong likelihood that section 501-type criteria will also be used to determine eligibility for the VAT exemption. Nunn and Domenici have also stated that under their approach for tax-exempt organizations, unrelated business income tax issues will continue to be a source of complexity.[241] Thus, their plan does not seem to threaten the continued employment of lawyers and accountants who specialize in exempt organizations issues.

13. *Accommodating Low- and Middle-Income Taxpayers.*—The Nunn-Dominici proposal includes a family living allowance, varying with family size, that would combine and enlarge the standard deduction and the personal and dependent exemptions of present law.[242] This allowance would apparently not be subject to a phaseout. Its adoption would be a simplifying

to her $100 cost as a donation incentive.

240. Unamerican Spirit, supra note 138, at 311.

241. Id.

242. Unamerican Spirit, supra note 138, at 295.

measure if it eliminates the personal and dependent exemption phaseout of current law.[243]

The Nunn-Domenici plan also includes both an equivalent of the present earned income tax credit and a new refundable credit for part of the federal payroll taxes paid by employees.[244] Although the documents describing the proposal do not mention a phaseout for the earned income tax credit, a phaseout would probably be employed since the credit is intended to "accomplish the same objectives as the current EITC."[245] Nunn and Domenici have stated that the payroll tax credit would contain a phaseout beginning at $25,001 of income.[246]

The phaseout of the earned income tax credit will probably not increase complexity over present law, but it erodes the simplification gains of a consumed income tax, as does the payroll tax credit phaseout. Moreover, the complexity would increase substantially if the two phaseout mechanisms employ separate formulas, requiring two different phaseout computations. In addition, many taxpayers dropped out of the consumed income tax system by the family living allowance will find that they have to file returns to get refunds of the earned income and payroll tax credits. For these taxpayers, the credits detract from the simplification brought about by the family living allowance.

To assist working parents, Congress is likely to include a child-care credit, with a phaseout, in any consumed income tax it might enact.[247] There might also be a phased-out second earner credit to facilitate participation of married women in the work force, regardless of whether child-care is involved.[248] These would be additional complicating features.

14. *Qualified Retirement Plans.*—Under the Nunn-Domenici consumed income tax, employees would continue to defer paying tax on

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243. See IRC § 151(d)(3). However, since the allowance would depend on family size, a definition of the family unit would be needed. Furthermore, the family living allowance would likely mimic the present standard deduction by differing in amount for joint filers, marrieds filing separately, surviving spouses, heads of household, and unmarried individuals, see § 63(b)(2), and perhaps for the elderly and the blind, see § 63(f). The rules required to distinguish between these categories will preserve the corresponding complexities of current law.

244. Unamerican Spirit, supra note 138, at 296.

245. Id.

246. Id.

247. See, e.g., IRC § 21.

248. See Edward J. McCaffery, Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code, 40 UCLA L. Rev. 983, 996, 1004-05, 1040 (1993). But see Deborah A. Geier, Restoration of the Two-Earner Couple Deduction: Why? 65 Tax Notes 497 (Oct. 24, 1994).

employer contributions to retirement plans until withdrawals occur.[249] If this feature of the plan is ultimately coupled with an employer credit or deduction under the Nunn-Domenici VAT for employer contributions to retirement plans,[250] complex nondiscrimination rules would also probably be included to prevent creditable or deductible employer contributions from being unduly skewed in favor of highly-compensated employees.[251] The trusts that hold and invest employer contributions surely would also be subjected to prohibited transaction rules and other regulations.

15. *State and Local Government Bonds.*—Since all investment expenditures are deductible under the consumed income tax, bonds issued by state and local governments should lose their preferred status. Nunn and Domenici have stated, however, that this status will be preserved by allowing "the interest earned from tax-exempt bonds to be spent without being taxed."[252] Presumably, this would be accomplished simply by having the taxpayer exclude the interest from the tax base. However, the present complications relating to municipal bonds in sections 103 and 141-147 would surely be preserved.

16. *Transition Problem.*—A consumed income tax does not use the basis concept. When an asset is sold and the sales proceeds are spent on consumption, 100% of those proceeds are subjected to the consumed income tax, regardless of how much the taxpayer paid for the asset.[253] Under an accretion income tax, basis consists of after-tax dollars.[254] Consequently, if an asset is purchased under the present accretion tax and, after adoption of a consumed income tax, the asset is sold and the proceeds consumed, the consumed income taxation of the proceeds amounts to a second income tax on the portion representing the taxpayer's cost for the asset.

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249. Unamerican Spirit, supra note 138, at 298. Employees paid in cash, who invest both the cash and the resulting investment earnings, would have offsetting savings deductions that would spare them from taxation until they withdraw from savings for consumption spending. Employer contributions to retirement plans create the economic equivalent of employee investments of cash compensation, and Nunn and Domenici would give them equivalent tax treatment.

250. The persistent concern over the adequacy of Social Security funding might lead Congress to encourage private retirement savings by including in the Nunn-Domenici VAT a deduction or credit for employer contributions to qualified retirement plans.

251. See IRC §§ 401, 410, 411, 416.

252. Unamerican Spirit, supra note 138, at 298.

253. See supra text accompanying note 132.

254. See IRC § 1012; Simplification Committee Report, supra note 126, at 439.

This double taxation is probably politically unacceptable and will have to be avoided or at least mitigated.[255] The Nunn-Domenici proposal would deal with this problem by selecting a period of years over which taxpayers could spread and deduct part or all of their investments acquired before the effective date of the consumed income tax.[256] The consequent revenue loss would be offset by a two percentage point increase in the consumed income tax rates during the deduction years.[257] It is not clear whether the deduction would apply to asset basis or asset value and whether real estate would be included.[258] In addition, the time period and the percentage that could be spread and deducted have apparently not yet been selected. Regardless of what this transition provision looks like when fully developed, it will be a complicating element.

Furthermore, many taxpayers will have purchased assets at prices reflecting the fact that the assets were entitled to more favorable depreciation treatment than other assets under the accretion tax. These taxpayers can be expected to insist that the preferred status of their assets be preserved under the transition provision. If they are successful, this provision could be very complex indeed.

17. *Nunn-Domenici VAT.*—Recall the VAT employed by the Nunn-Domenici plan as a device to lower consumed income tax rates and ease the difficulty of implementing withholding and estimated tax systems under the tax.[259] This VAT will possess all of the intricacy that is inherent in single-rate VATs.[260] Furthermore, many in Congress may see the Nunn-Domenici VAT as an important instrument for managing the economy through manipulation of corporate behavior, particularly because the VAT would be the only entity-level tax on corporate income.[261] Thus, we should expect that the Nunn-Domenici VAT would emerge from the political process with many of the complicated investment incentive provisions that were projected for inclusion in the Danforth-Boren BAT.[262] The Nunn-Domenici VAT would likely be a significantly intricate tax regime.

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255. See generally 1 Treas. Dep't, supra note 4, at 210-11; Blueprints, supra note 4, at 181; Simplification Committee Report, supra note 126, at 439-41; Graetz, supra note 136, at 1653-58, 1660.

256. Unamerican Spirit, supra note 138, at 301-02.

257. Id. at 301.

258. Id. at 300-02.

259. See supra text accompanying notes 156-67.

260. See supra text accompanying notes 15-22, 26-35.

261. See Simplification Committee Report, supra note 126, at 433-34.

262. See supra text accompanying notes 104-19. Indeed, the authors of the Nunn-Domenici VAT contemplate provisions conferring tax-favored status on health care fringe benefits. Unamerican Spirit, supra note 138, at 312.

D. *The Devil is in the Details*

In short, the devil is in the details. Although the replacement of accretion income taxation with either a consumed income tax, or with a VAT/consumed income tax combination as proposed by Senators Nunn and Domenici, would seem to yield a tax system that is less intricate than the present accretion regime, we cannot know the precise extent of the resulting simplification until we learn a great many details that may not be revealed until the political process is well-advanced. However, we can say that although the consumption tax system that comes forth will probably be significantly simpler than the present income tax law, it will be a complex structure that provides a comfortable living for many lawyers and accountants.

IV. CONCLUSION

The goal of simplifying the tax system does not occupy a paramount position that allows it to trump all other tax policy objectives. Thus, there may be good reasons for enacting a federal consumption tax, regardless of its impact on tax system complexity.[263] However, if adoption of a consumption tax is determined to be substantially dependent on the extent to which the change alleviates complexity, it is important to recognize that a meaningful answer to this question cannot be provided by an inquiry directed solely to the theoretical characteristics of a pure VAT or consumed income tax. As the preceding discussion has indicated, the precise impact of a VAT or consumed income tax on the intricacy of the federal tax system cannot be evaluated until we know how VAT revenues will be used and the details of the VAT or the consumed income tax that ultimately emerges from the political process. The preceding discussion has also shown that while these unknowns can be answered in ways that dramatically reduce systemic complexity, they are quite likely to be resolved in a manner that leaves us with a highly complex tax regime. Thus, so long as we lack firm answers to these critical inquiries, neither a VAT nor a consumed income tax should be promoted at the national level as a measure guaranteed to accomplish major simplification.

Nevertheless, an analysis of the most likely answers to these uncertainties suggests that:

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263. See 3 Treas. Dep't, supra note 1, at 17-23; Bradford, supra note 123; Nunn-Domenici Report, supra note 123, at 20; Andrews, supra note 178; Ferguson, supra note 6; Morris, supra note 18, at 1261; Laurence J. Kotlikoff, The Case for the Value-Added Tax, 39 Tax Notes 239 (Apr. 11, 1988).

1. Substitution of a VAT for the current individual and corporate income taxes would be a major simplifying development, but this is an unlikely outcome.[264]
2. A deficit control VAT that is simply added to present law would significantly complicate the system.[265]
3. A VAT that pays for corporate integration and nothing else would not significantly simplify the system.[266]
4. A VAT that pays for enlarged personal exemptions and standard deductions, and thus reduces the numbers of taxpayers and itemizers, would be a moderately simplifying development.[267]
5. The Danforth-Boren proposal, which uses a VAT to substitute for the corporate income tax but draws unincorporated businesses into the business tax system and preserves the individual income tax, may be a simplifying move but the resulting simplification is hardly dramatic.[268]
6. Substitution of a consumed income tax for all forms of accretion income taxation would make the tax system much simpler, but would still leave us with a significantly complex revenue-raising regime.[269]
7. The Nunn-Domenici plan, which replaces all forms of accretion income taxation with a combination of a VAT and a consumed income tax, appears simpler than both the current system and the Danforth-Boren proposal. Nevertheless, Nunn-Domenici is a significantly intricate system in its own right, and it is more complex than plans to replace accretion income taxation solely with a VAT or solely with a consumed income tax.[270]

A persistent theme of this article has been that the political process is quite likely to deliver a much more complicated consumption tax package than initially seems possible when one reads textbook descriptions of the VAT and the consumed income tax. Consumption tax advocates will probably

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264. See supra text accompanying notes 39-54.

265. See supra text accompanying note 55.

266. See supra text accompanying notes 56-68.

267. See supra text accompanying notes 69-71.

268. See supra Part II.E.

269. See supra Part III.B. "A consumption-type tax is indeed more complicated than a simple tax on ordinary income alone that omits capital gains." Andrews, supra note 178, at 1149 n.81.

270. See supra Part III.C.

view this as unduly pessimistic, and they may be correct. However, it is useful to recall that in 1913, when America stood optimistically poised to adopt a new tax system, the House Ways and Means Committee said:

> In view of the many valuable governmental purposes to be subserved, those citizens required to do so can well afford to devote a brief time during some one day in each year to the making out of a personal return of income for purposes of taxation. This is done without complaint under the operation of all the general property tax laws of the States. All good citizens, it is therefore believed, will willingly and cheerfully support and sustain this, the fairest and cheapest of all taxes, in order to secure to the largest extent equality of tax burdens, an adjustable system of revenue, and in all respects a modernized fiscal system.[271]

These confident predictions of compliance burdens that would involve no more than a brief period of time on a single day and of warm public support for the income tax now seem laughable. The 1913 income tax proponents, being merely human, could not begin to foresee the complexities that would emerge over time from a system that appeared so promising at the outset. Likewise, unimagined and extensive complications may be lurking in the VAT and the consumed income tax, particularly in the latter, that will make this article's complexity speculations seem naively understated. As our experience with the income tax shows, U.S. tax systems have a way of coming to reflect thoroughly the intricacy of our society and its economy.

271. H.R. Rep. No. 5, 63d Cong., 1st Sess (1913), reprinted in 1939-1 C.B. (Part 2) 1, 3.