Essay

100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System

Michael J. Graetz[†]

INTRODUCTION

We are now in a quiet interlude awaiting the next serious political debate over the nation's tax system. No fundamental tax policy concerns were at stake in the 2002 disputes over economic stimulus or the political huffing and puffing about postponing or accelerating the income tax rate cuts of the 2001 Act.[1] Those arguments were concerned principally with positioning Democratic and Republican candidates for the 2002 congressional election, not tax policy.

But the coming decade, with its paint-by-numbers phase-ins and phase-outs of 2001 Act tax changes, the tax cuts waiting to spring into effect, and the sunset of the entire Act in 2011, makes this a propitious time to take a

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1. For a discussion of the political implications of the 2002 tax debate, see Richard W. Stevenson, *House Passes Bill To Make Bush's Tax Cut Permanent*, N.Y. TIMES, Apr. 19, 2002, at A18.

hard look at the nation's tax system.[2] Describing the nation's current federal tax system in anything other than tentative and uncertain terms is impossible. Even the most sophisticated tax lawyer cannot be sure what the current statute means for the future. Should we, for example, believe that more than thirty-five million taxpayers—nearly one-third of all individual filers—will be subject to the alternative minimum tax (AMT), as the current law implies?[3] Or should we instead be confident that some future Congress will avert that train wreck? The 2001 Act repeals the estate tax only for the year 2010. That is why Paul Krugman described that year as an auspicious time to throw Momma from the train[4]—at least if she is rich. But has the estate tax really been repealed?

There will be four congressional and two presidential elections before the 2001 Act sunsets in 2011. Absent constitutional amendment, President Bush cannot serve past January 2009. Congress has enacted nearly one hundred different laws amending the tax code in the past fifteen years.[5] The structure of the 2001 Act makes congressional reexamination of the nation's tax law inevitable. People with an abiding interest in the nation's tax policy should treat the 2001 Act's sunset in 2011—its "Ax-the-Act" provision—as a unique opportunity to debate what kind of tax law should govern the nation in the twenty-first century.[6] We need to be prepared when a tax reform opportunity knocks. We have no stable status quo.

Nor has it been easy to embrace the status quo for quite a long time. No politician spearheaded a "Save the Code" movement in opposition to Republicans' recent efforts to "scrap the code" by terminating it a decade hence.[7] But if we cannot admire the tax law we have, what should we wish for? In this Essay, I offer observations about the nation's current tax law and my recommendations for change.

2. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, §§ 102, 302, 511, 901, 2001 U.S.C.C.A.N. (115 Stat.) 38, 44, 54, 70, 150.

3. Jerry Tempalski, The Impact of the 2001 Tax Bill on the Individual AMT (Nov. 10, 2001) (unpublished manuscript, on file with author); *see also* LEONARD E. BURMAN ET AL., THE INDIVIDUAL AMT: PROBLEMS AND POTENTIAL SOLUTIONS 6, 21 (Urban-Brookings Tax Policy Ctr., Discussion Paper No. 5, 2002) (estimating that one in three taxpayers—36 million taxpayers—will be subject to the AMT by 2010 under the 2001 Act).

4. Paul Krugman, *Bad Heir Day*, N.Y. TIMES, May 30, 2001, at A23.

5. STAFF OF THE JOINT COMM. ON TAXATION, PUB. NO. JCS-3-01, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, app. D at 91-93 (2001) [hereinafter JCT SIMPLIFICATION REPORT].

6. § 901, 2001 U.S.C.C.A.N. at 150.

7. *See, e.g.*, Date Certain Tax Code Replacement Act, H.R. 4199, 106th Cong. (2000); Tax Code Termination Act, H.R. 3097, 105th Cong. (1998); *see also* Ryan J. Donmoyer & Heidi Glenn, *Congress Passes Unified GOP Spending and Tax Cut Blueprint*, TAX NOTES TODAY, Apr. 14, 2000, 2000 TNT 73-1 (LEXIS).

I. REPEAL OF THE ESTATE TAX

First, repeal of the estate tax in 2010 by the 2001 Act was a mistake. The estate tax clearly has had problems requiring repair, including the need to increase its exemption substantially, to lower and flatten rates, and to take more family circumstances into account in determining tax liability. There also was a political necessity to expand existing relief for interfamily transfers of closely held businesses and farms, perhaps even to exempt them from estate taxation.

But estate tax repeal succeeded because of the powerful political forces aligned against the tax, not because of these substantive shortcomings. First, the National Federation of Independent Business (NFIB), representing owners of small businesses, made estate tax repeal its top legislative priority,[8] and President Bush concurred.[9] Second, the aging baby boom generation is now thinking about its mortality. The marketplace—including the market for legislation—has long been very responsive to the desires and concerns of this large generation.

Third, although the estate tax is imposed only on the wealthiest 1% or 2% of people who die in any year, a Zogby poll found that 71% of the public favored its repeal.[10] Some observers dismiss such polls, insisting that two out of every three Americans would be in favor of repealing any tax. But I instead applaud the unflappable optimism of the American people—more than 70% of Americans apparently believe they will be in the richest 1% or 2% when they die.

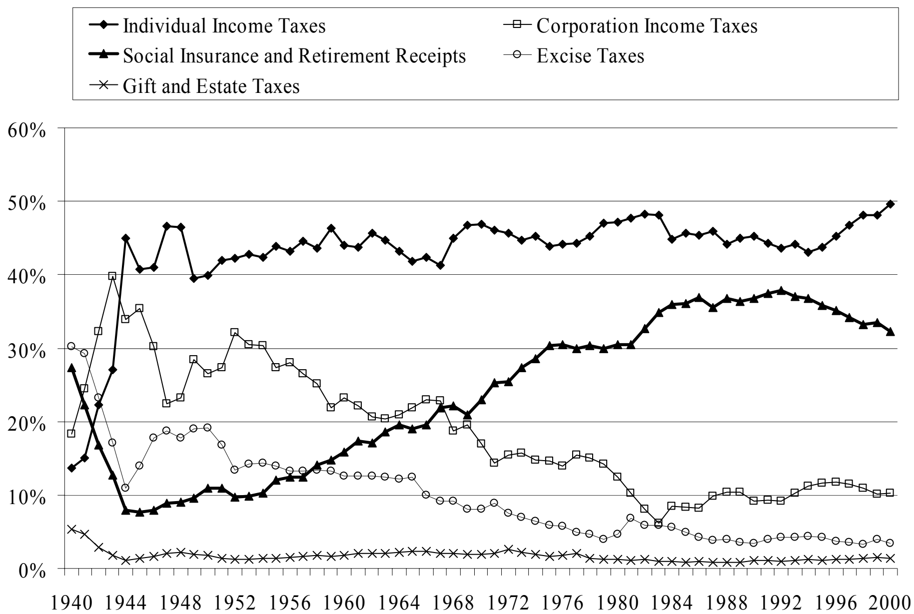
Nevertheless, there are good reasons for retaining a death-time tax on wealth. The first is revenue. Those who want repeal of the estate tax always point out that it has long been a minor source of federal revenues, now less than 1.5% of the total. (See Figure 1.)

8. *See* 146 CONG. REC. S6431 (daily ed. July 11, 2000) (statement of Sen. Feingold); William H. Miller, *The New Congress*, INDUSTRY WK., Jan. 5, 1999, *at* http://www.industryweek.com/currentarticles/asp/articles.asp?ArticleID=399; Press Release, Cal Dooley, Dooley Urges Conferees To Adopt Senate Estate Tax Version (July 21, 1997), *at* http://www.house.gov/dooley/072197estatetax.html ("This is NFIB's top tax priority.").

9. Remarks on Transmitting Proposed Tax Cut Plan to the Congress, 36 WEEKLY COMP. PRES. DOC. 271 (Feb. 12, 2001).

10. *Talk of the Nation* (NPR radio broadcast, Feb. 21, 2001) (reporting on a Zogby poll conducted December 2000).

FIGURE 1. PERCENTAGE COMPOSITION OF FEDERAL RECEIPTS BY SOURCE: 1940-2000[11]



But there are sizeable dollars at stake. In 1999, fewer than 50,000 taxable estates contributed $28 billion to finance the federal government.[12] Without the 2001 Act changes, estate tax receipts had been projected to grow to about $40 billion by 2008.[13] This revenue could pay for a reduction in the top individual income tax rate from 39.6% to 33%, a reduction in the corporate income tax rate from 35% to 30%, or an exemption of all corporations with assets of $100 million or less from the corporate income tax.[14] It is not chump change.

Second, estate tax repeal favors the very wealthy, those families who least need tax relief. About half of all estate tax revenue is collected from the largest 10% of estates—those valued at more than $5 million—and in recent years the largest 1% of taxable estates—fortunes exceeding $20

11. OFFICE OF THE PRESIDENT, HISTORICAL TABLES: BUDGET OF THE UNITED STATES GOVERNMENT tbls.2.1, 2.2, 2.5 (2002).

12. William G. Gale & Joel Slemrod, *Overview*, *in* RETHINKING ESTATE AND GIFT TAXATION 1, 24 tbl.1-7 (William G. Gale et al. eds., 2000); David Joulfaian, *Taxing Wealth Transfers and Its Behavioral Consequences*, 53 NAT'L TAX J. 933, 933 (2001).

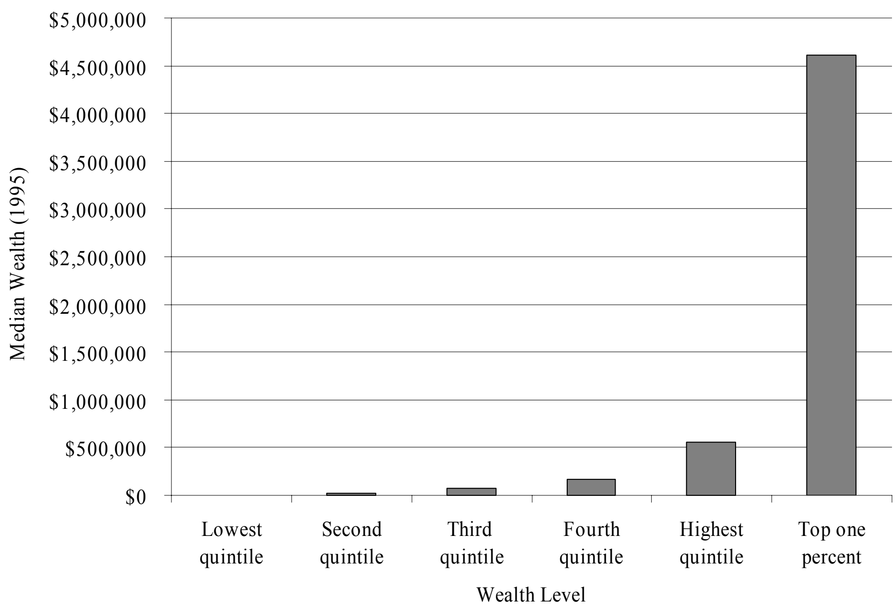
13. STAFF OF THE JOINT COMM. ON TAXATION, PUB. NO. JCX-14-01, DESCRIPTION AND ANALYSIS OF PRESENT LAW AND PROPOSALS RELATING TO FEDERAL ESTATE AND GIFT TAXATION 26 (2001).

14. *See* Joulfaian, *supra* note 12, at 933; Matthew Scoffic & Patrice Treubert, *Corporation Income Tax Returns, 1996*, STAT. INCOME BULL., Summer 1999, at 50, 61-63 tbl.1.

million each—have paid more than one-fifth of total estate taxes.[15] Moreover, most of these large estates are composed of liquid assets, not family businesses or farms.[16]

The estate tax has long been an important factor contributing to the progressivity of the federal tax system.[17] Without a direct tax on wealth or a tax on large transfers of wealth, the income tax will be the only source of progressivity in the nation's tax system. Indeed, if repeal of the estate tax succeeds in increasing capital accumulations, as some of its proponents believe, it will also substantially increase the inequality of wealth.[18] And as Figure 2 shows, the top 1% already owns much of the nation's wealth.[19]

FIGURE 2. WEALTH DISTRIBUTION[20]



15. Joulfaian, *supra* note 12, at 938 tbl.3; *see also* Barry W. Johnson & Jacob M. Mikow, *Federal Estate Tax Returns, 1998-2000*, STAT. INCOME BULL., Spring 2002, at 133, 156 tbl.1a [hereinafter Johnson & Mikow, *Returns, 1998-2000*]; Barry W. Johnson & Jacob M. Mikow, *Federal Estate Tax Returns, 1995-1997*, STAT. INCOME BULL., Summer 1999, at 69, 113 tbl.2 [hereinafter Johnson & Mikow, *Returns, 1995-1997*].

16. Johnson & Mikow, *Returns, 1998-2000*, *supra* note 15, at 151 tbl.1a.

17. Michael J. Graetz, *To Praise the Estate Tax, Not To Bury It*, 93 YALE L.J. 259, 271-72 (1983).

18. *See* John Laitner, *Inequality and Wealth Accumulation: Eliminating the Federal Gift and Estate Tax*, *in* RETHINKING ESTATE AND GIFT TAXATION, *supra* note 12, at 258, 278-81 (stating that the replacement of the estate tax with a proportional income tax could cause a 16% to 32% increase in the wealth held by the top 1%).

19. EDWARD N. WOLFF, TOP HEAVY 65-67 (1996).

20. BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY 225 tbl.3 (1999).

Contrary to the political rhetoric driving the repeal effort, the estate tax targets only the wealthiest segment of the U.S. population.[21]

Third, estate tax repeal is likely to have an important adverse effect upon many charities, particularly universities and colleges, hospitals, and museums. The estate tax permits unlimited deduction of charitable bequests.[22] After the tax is repealed, it will be no more costly to give a bequest to a family member than to a charity. Typically, more than one-third of estates over $5 million make charitable bequests; nearly half of such estates leave assets to charity if the decedent is not married.[23] In 2000, charitable bequests from otherwise taxable estates totaled $16 billion.[24] And more than $60 billion of assets were held by charitable remainder trusts.[25] Economists have estimated that repeal of the estate tax will reduce charitable bequests anywhere from 12% to 80%.[26] And the economist who offered the lowest estimate also predicted that lifetime gifts to charity would drop by as much as 12% if the estate tax were repealed.[27]

Even if the 2001 Act's repeal of the estate tax actually takes effect, there will be pressures for its reinstatement. Due largely to the aging of the nation's population, the long-term federal budget picture is not rosy.[28] As Figure 3 illustrates, beginning with the retirement of the baby boom generation, financial pressures on Medicare, Medicaid, and Social Security will all escalate.

21. *See* Joulfaian, *supra* note 12, at 938.

22. I.R.C. § 2055 (2000).

23. David Joulfaian, *Estate Taxes and Charitable Bequests by the Wealthy*, 53 NAT'L TAX J. 743, 753 tbl.5c (2000); Joulfaian, *supra* note 12, at 949 tbl.12A.

24. Johnson & Mikow, *Returns, 1998-2000*, *supra* note 15, at 166 tbl.1c.

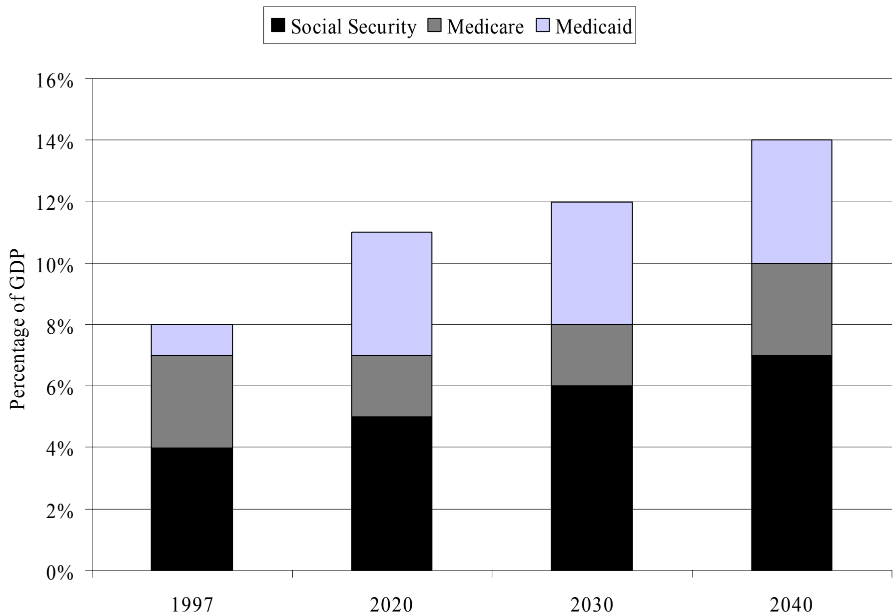
25. Melissa J. Belvedere, *Charitable Remainder Trusts, 1998*, STAT. INCOME BULL., Winter 2000-2001, at 58, 58 fig.A.

26. *See* B. Douglas Bernheim, *Does the Estate Tax Raise Revenue?*, *in* 1 TAX POLICY AND THE ECONOMY 113, 131 (Laurence H. Summers ed., 1987) (estimating a 79.3% decrease in charitable giving); Charles T. Clotfelter & Richard L. Schmalbeck, *The Impact of Fundamental Tax Reform on Nonprofit Organizations*, *in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 211, 233-34 (Henry J. Aaron & William G. Gale eds., 1996) (estimating a 24% to 44% decrease in charitable giving); David Joulfaian, *Charitable Giving in Life and in Death*, *in* RETHINKING ESTATE AND GIFT TAXATION, *supra* note 12, at 350, 364 (estimating a 31% decrease in charitable giving); Joulfaian, *supra* note 12, at 951 (estimating a 12% decrease in charitable giving).

27. Joulfaian, *supra* note 12, at 952.

28. According to the Congressional Budget Office, the total budget, without regard to Social Security Trust Fund receipts and disbursements, will remain in deficit throughout the next ten years. *See An Analysis of the President's Budgetary Proposals for 2003: Hearing Before the Senate Budget Comm.*, 107th Cong. 1 (2002) (statement of Dan L. Crippen, Director, Congressional Budget Office). *See generally* CONG. BUDGET OFFICE, THE LONG-TERM BUDGET OUTLOOK (2000) (showing the financial pressures on the federal budget beyond the ten-year budget period).

FIGURE 3. PROJECTIONS OF FEDERAL EXPENDITURES ON SOCIAL SECURITY, MEDICARE, AND MEDICAID[29]



Large tax-free bequests will be a fat target for a Congress looking for money. Proposals linking taxation of large bequests to popular spending plans—to help fund long-term care for the elderly, for example—will be hard to defeat.

Moreover, alternative ways of taxing large gifts or bequests of wealth, which might produce nearly as much revenue as reinstating the estate tax, are available to Congress. One possibility would be to tax recipients of large bequests with an accessions tax, a tax studied by the American Law Institute in the 1960s but largely forgotten since.[30] An accessions tax would tax recipients of large gifts and bequests based on the total amount of such gifts and bequests received during their lifetimes rather than according to

29. CONG. BUDGET OFFICE, LONG-TERM BUDGETARY PRESSURE AND POLICY OPTIONS tbl.2-1 (1998). For a discussion of the taxes that fund these expenditures, see *infra* text accompanying note 34.

30. The accessions tax was first proposed in 1945 by Harry J. Rudick, *A Proposal for an Accessions Tax*, 1 TAX L. REV. 25 (1945). For further discussion of the accessions tax, see INST. FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION 321 (1978); William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967); William D. Andrews, *Reporter's Study of the Accessions Tax Proposal*, *in* AM. LAW INST., FEDERAL ESTATE AND GIFT TAXATION 446 (1969); Edward C. Halbach, Jr., *An Accessions Tax*, 23 REAL PROP. PROB. & TR. J. 211 (1988); Richard D. Kirshberg, *The Accessions Tax: Administrative Bramblebush or Instrument of Social Policy?*, 14 UCLA L. REV. 135 (1966); Harry J. Rudick, *What Alternative to the Estate and Gift Taxes?*, 38 CAL. L. REV. 150 (1950); and Stanley S. Surrey, *An Introduction to Revision of the Federal Estate and Gift Taxes*, 38 CAL. L. REV. 1 (1950).

the total value of each legacy. Like the estate tax, an accessions tax would have a substantial lifetime exemption level, imposing no tax, for example, on a person who receives less than $1 million in gifts or bequests; it would also ignore annual gifts of less than a specified amount, say $10,000.[31] Imposing an accessions tax on recipients rather than an estate tax on transferors would impose the tax on the people who suffer its real burden and better align the tax rate with the individual's ability to pay taxes.

A federal inheritance tax, structured like the taxes now imposed by nearly half the states, offers another alternative for taxing recipients rather than transferors of wealth.[32] Rather than basing the exempt amount or tax rate on the cumulative amount of wealth transfers received in a lifetime, an inheritance tax would treat each bequest separately. It is feasible under either an accessions tax or an inheritance tax to vary the rate of tax depending upon the recipient's affinity to the transferor and to adjust the tax for other family circumstances. Neither tax, for example, need be imposed upon gifts or bequests of interests in a small business or farm until the asset is sold outside the family.

An inheritance tax or an accessions tax could be imposed at either a progressive or flat rate. A flat rate would simplify both estate planning and tax administration. A flat rate, for example, would facilitate equivalent taxation of outright gifts and those in trust. A flat rate would also substantially alleviate distinctions in tax burdens based on the timing of transfers of wealth. By taxing recipients rather than transferors of wealth, both an accessions tax and an inheritance tax might avoid the charge of "double" taxation often leveled at the estate tax. Either of these taxes on "windfalls" might prove politically more popular and more stable than the disappearing "death" tax. Alternatively, Congress might decide simply to include large bequests in the recipients' income.[33] Given these alternatives, even if Congress allows the 2001 Act's repeal of the estate tax to take effect, I would wager that some tax on large wealth transfers will reappear.

II. THE PAYROLL TAX

Looking ahead beyond the next decade, even the payroll tax—the nation's most popular federal tax—faces challenges. As Figure 4 illustrates,

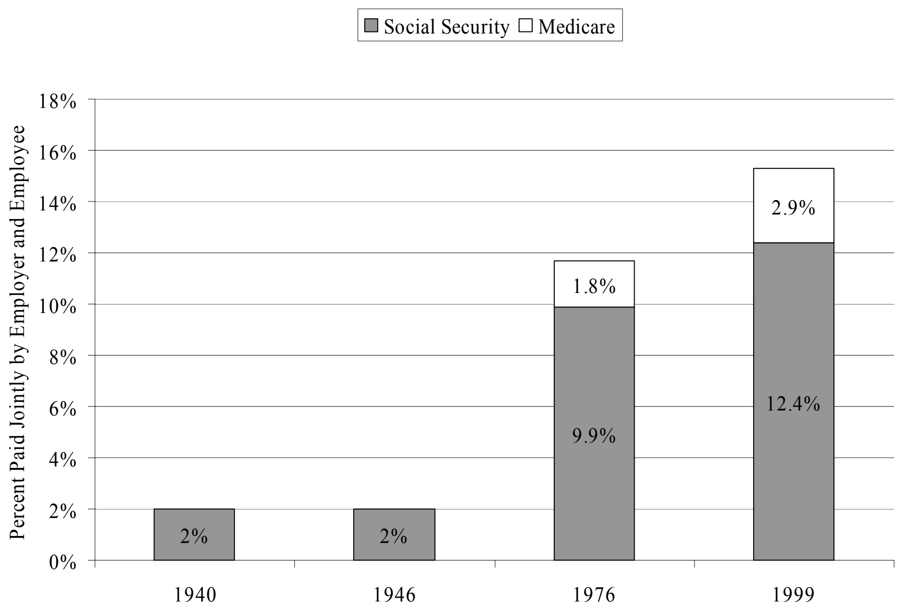
31. An exclusion for annual gifts of $10,000 or less is a feature of current law. I.R.C. § 2503(b) (2000).

32. *See* John M. Janiga & Louis S. Harrison, *The Case for the Retention of the State Death Tax Credit in the Federal Transfer Tax Scheme: "Just Say No" to a Deduction*, 21 PEPP. L. REV. 695, 701-02 (1994) (reporting that eighteen states impose both the inheritance and estate taxes while five states use just the estate tax). Since the publication of this article, Montana and North Carolina have repealed their inheritance taxes. Act Repealing State Inheritance Taxes, § 36, 2000 Mont. Laws 46, 69; Act effective Jan. 1, 1999, 1997 N.C. Sess. Laws 1295.

33. *See* HARRY S. ROSEN, PUBLIC FINANCE 498 (2d ed. 1988).

payroll taxes started off at very low rates, but they now impose a substantial burden on working families.

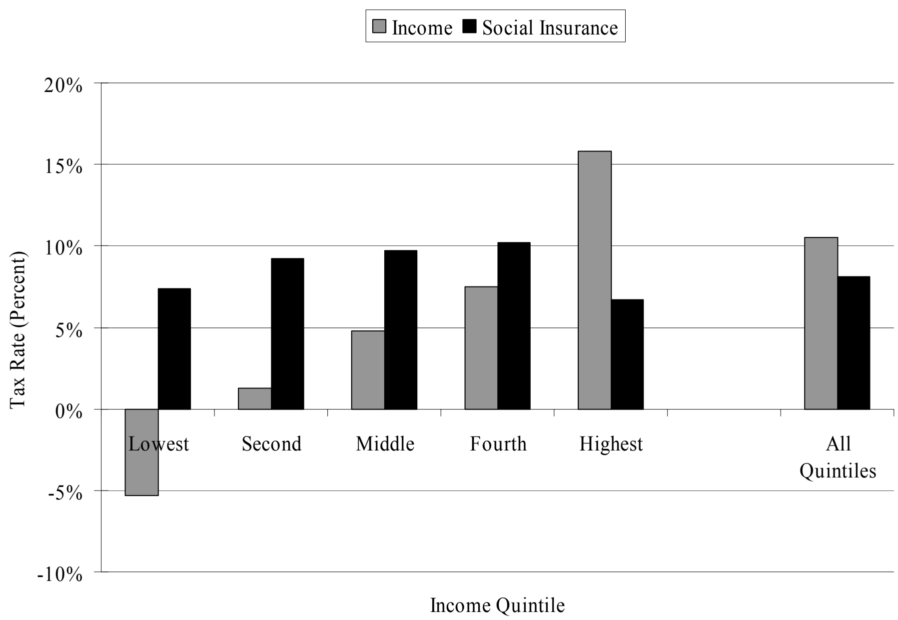
FIGURE 4. U.S. PAYROLL TAX RATES: SELECTED YEARS[34]



For most families, payroll taxes are greater than income taxes; indeed, payroll taxes to fund social insurance are the most burdensome tax they pay. (See Figure 5.)

34. RAYMOND J. KEATING & THOMAS N. EDMONDS, U.S. BY THE NUMBERS: FIGURING WHAT'S LEFT, RIGHT AND WRONG WITH AMERICA STATE BY STATE 11 (2000).

FIGURE 5. EFFECTIVE FEDERAL INDIVIDUAL AND SOCIAL INSURANCE TAX RATES, USING COMPREHENSIVE HOUSEHOLD INCOME[35]



Despite this fact, people rarely protest payroll taxes because they both know and like what these taxes pay for: Social Security and Medicare. Moreover, many families underestimate their payroll tax burden because the employers' share is hidden to employees.[36]

But the aging of the population portends new pressures to raise these taxes, pressures which should be resisted. Returns to capital have outstripped returns to labor over a long period of time.[37] To be fair, if new taxes become necessary to pay for the aging of the nation's population, they should not be imposed, as payroll taxes are, solely on labor. This implies using general revenues, which include income taxes (and, for now at least, estate and gift taxes) for funding the additional government expenditures required by demographic changes.

35. CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES, 1979-1997, at tbl.G-1a (2001).

36. Employers pay one-half of the payroll tax attributable to an employee's wages. I.R.C. § 3101 (employees); *id.* § 3111 (employers). Economists agree, however, that both halves of the tax generally burden employees in the form of lower wages. Janet Stotsky, *Payroll Taxes and the Funding of Social Security Systems*, *in* TAX POLICY HANDBOOK 177, 178-79 (Parthasarathi Shome ed., 1995).

37. *See, e.g.*, CARMEN DENAVAS-WALT ET AL., U.S. DEP'T OF COMMERCE, MONEY INCOME IN THE UNITED STATES: 2000, at 11-13 (2001) (describing income inequality over time); MICHAEL J. GRAETZ & JERRY L. MASHAW, TRUE SECURITY: RETHINKING AMERICAN SOCIAL INSURANCE 31-32 (1999).

Not only is the population aging, but increasing life expectancies have made persons age 85 and older the fastest growing age group in America.[38] Anticipated demographic changes now imply an average annual deficit in Social Security funding of more than 1.8% of taxable wages over the next 75-year period—the lifetime perspective over which Social Security finances have typically been measured.[39] The estimated gap between benefits and taxes increases each year, as years of trust fund surpluses are replaced with years of deficit. Accordingly, if no changes are made, it will take about a 5.5% tax rate hike to cover the gap 50 years from now.[40] Probably the easiest way to comprehend the magnitude of the forthcoming demographic changes is this: In 1940, there were 11 workers for each retiree. Today there are about 3.4.[41] By 2040, there will be only 2 workers per recipient.[42] Thus, if current benefits were financed only from current taxes and if 3 workers today pay 33 cents each for every dollar of benefits, 50 cents each would be required from 2 workers to fund a dollar of benefits. Or if taxes are not increased, benefits will have to be cut by one-third.[43]

Unfortunately, projections of Medicare finances are even more dire. Health cost projections assume the relatively benign increases of recent years, not the accelerating costs since 1999. State finances are also threatened by the aging of the population since most spending on long-term care for the elderly now comes from Medicaid.[44]

To date, most of the political debate about the forthcoming gap between payroll taxes and anticipated benefits has focused on whether to institute individual retirement accounts as a substitute for or supplement to Social Security benefits.[45] This is an important debate. Although there is great skepticism about the wisdom of using individual accounts to replace Social Security benefits, tax-favored asset accumulation devices for a variety of purposes enjoy wide and growing bipartisan support. The movement for

38. GRAETZ & MASHAW, *supra* note 37, at 104-05.

39. BD. OF TRS. OF THE FED. OLD-AGE & SURVIVORS INS. & DISABILITY INS. TRUST FUNDS, 2002 ANNUAL REPORT 3, *at* http://www.ssa.gov/OACT/TR/index.html [hereinafter TRUSTEES' REPORT].

40. GRAETZ & MASHAW, *supra* note 37, at 48 tbl.IV.B1.

41. *Id.* at 52.

42. *Id.*

43. For further discussion, see *id.* at 106-07.

44. According to a study by the Kaiser Family Foundation's Kaiser Commission on Medicaid and the Uninsured, Medicaid spending averages 15% of state budgets. HENRY J. KAISER FAMILY FOUND., THE ROLE OF MEDICAID IN STATE BUDGETS 10 (2001), *at* http://www.kff.org/content/2001/4024/4024.pdf.

45. *See, e.g.*, Laurence J. Kotlikoff & Jeffrey Sachs, *It's High Time To Privatize*, BROOKINGS REV., Summer 1997, at 16; Steven Greenhouse, *Union Warning Label on Social Security*, N.Y. TIMES, Feb. 19, 1999, at A16; Hugh Price & Julian Bond, Editorial, *Social Security's Stable Benefit*, N.Y. TIMES, July 16, 2001, at A25; Daniel J. Mitchell, A Brief Guide to Social Security Reform (Aug. 7, 1997) (on file with author); KILOLO KIJAKAZI & ROBERT GREENSTEIN, MARKET RISK VERSUS POLITICAL RISK: WHY SOCIAL SECURITY FACES GREATER RISK UNDER PRIVATIZATION (2002), *at* http://www.cbpp.org/3-28-02socsec.pdf.

universal individual accounts in connection with the Social Security system could create an infrastructure for widespread holding and building of financial wealth. Facilitating wealth accumulation for poorer and middle-class families should be a national priority. This could prove to be one of the most significant tax and economic policy developments in decades.

As President Bush's 2001 Commission on Social Security learned, however, individual accounts alone will not solve the financing gap.[46] When the President's Commission on Social Security released its revised final report in March 2002, it failed to agree on a solution—despite a membership that had been chosen for its like-minded views. The Commission offered three alternative approaches to funding the shortfall between Social Security's finances and its promises of benefits.[47] All three alternatives had one thing in common: a large infusion of funds into the Social Security Trust Fund from general federal revenues.[48] Down the road, some use of general revenues to fund income and health care for retirees seems inevitable. And if the alternative is an increase in payroll taxes paid by low- and moderate-income families, turning to general revenues also seems right.

But the linchpin of our system for raising general revenues—the income tax, which, as Figure 1 illustrates, has served as the mainstay of federal finance for the past sixty years—has lost public and political support.

III. THE INCOME TAX

During the past twenty-five years, the income tax has fallen into disrepute. A substantial part of my book on the income tax endeavors to explain why this has happened, a story I shall not repeat here, but the key facts are these: From the period immediately following World War II until 1972, the American people viewed the income tax as the fairest tax in the nation.[49] Since 1980, they have consistently viewed it as the least fair.[50] This dramatic and unpredictable shift in public opinion has changed the politics of taxation. In the presidential campaign of 1996—for the first time since the enactment of the Sixteenth Amendment in 1913—important presidential candidates made serious calls to repeal the income tax.[51] And

46. PRESIDENT'S COMM'N TO STRENGTHEN SOCIAL SECURITY, STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS (2002), *at* http://www.csss.gov/reports/final_report.pdf [hereinafter CSSS REPORT].

47. *Id.* at 14.

48. *Id.* at 23.

49. MICHAEL J. GRAETZ, THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE 3-4 (1999).

50. *Id.* at 24.

51. *Id.* at 4-5.

the exit polls favoring the replacement of the income tax with a flat tax on consumption showed far more popular approval than was revealed by simply looking at the votes for Steve Forbes, the flat tax's chief proponent.[52]

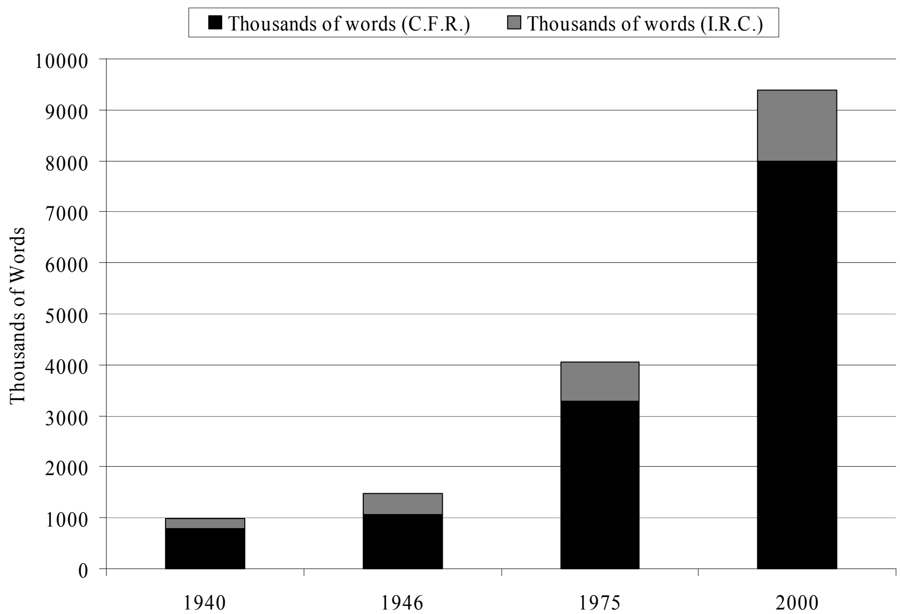
Although the overall level of federal taxes is now at a post-World War II high,[53] income taxes for many middle class families have been reduced by a variety of tax cuts for specified expenditures.[54] Those tax cuts, along with more promised by the 2001 Act, coupled with the press's focus on forthcoming financial troubles with Social Security and Medicare, have kept the public clamor for tax reform at bay. Nevertheless, a poll in 1999 revealed that nearly half of the American people favor changing to a "completely different" tax system.[55]

They have a point. Substantively, the income tax is a mess. Taxpayers at every income level confront extraordinary complexity. In 1940, the instructions to the Form 1040 were about 4 pages long.[56] By 1976, they had expanded to 48 pages.[57] For the tax year 2001, the instruction booklet alone was 122 pages.[58] Form 1040 for the year 2001 had 11 schedules and 20 additional worksheets.[59]

As of May 2000, the Code contained about 700 provisions affecting individuals and more than 1500 provisions affecting businesses—a total of 1.4 million words—making the tax law more than six times larger than *War and Peace*, and considerably harder to parse.[60] (See Figure 6.)

52. *Id.* at 212.
53. *Id.* at 295.
54. Isaac Shapiro, Ctr. on Budget and Policy Priorities, Overall Federal Tax Burden on Most Families—Including Middle-Income Families—at Lowest Level in More Than Two Decades (Apr. 10, 2002), *at* http://www.cbpp.org/4-10-02tax.pdf (explaining that the average total federal tax burden has been decreasing); *see also* Curt Anderson, *Middle Class Paying Lowest Tax Since '57*, DESERET NEWS (Salt Lake City), Apr. 15, 2002, at D1 (quoting the Center on Budget and Policy Priorities study).
55. Bruce Bartlett, *The Trouble with Tax Cuts*, POL'Y REV., Dec. 1999-Jan. 2000, at 3, 13 (citing a March 1999 Harris Poll).
56. I.R.S. 1040 Instructions (1939).
57. I.R.S. 1040 Instructions (1975).
58. I.R.S. 1040 Instructions (2001).
59. *Id.*
60. JCT SIMPLIFICATION REPORT, *supra* note 5, at 4.

FIGURE 6. APPROXIMATE WORDS IN I.R.C. AND C.F.R.[61]



The regulations contained another 8 million words, spanning almost 20,000 pages.[62] During calendar year 2000, the Treasury and the IRS published 60 Treasury Decisions, 45 sets of proposed regulations, 58 Revenue Rulings, 49 Revenue Procedures, 64 Notices, 100 Announcements, 2400 Private Letter Rulings and Technical Advice Memoranda, 10 Actions on Decisions, and 240 Field Service Advice documents.[63] No one can know with any confidence what the income tax law requires.

In the past decade, the President and Congress have used the income tax the way my mother employed chicken soup: as a magic elixir to solve all the nation's economic and social difficulties. If the nation has a problem in access to education, child care affordability, health insurance coverage, or the financing of long-term care, an income tax deduction or credit is the answer.[64]

61. Author's estimates for 1940 and 1946 are derived from random samples of pages found in the *United States Code* and the *Code of Federal Regulations*. Numbers for 1975 are taken from Tax Found., Growth of the Number of Words in the Internal Revenue Code Selected Years, 1955-2000 (2000), *at* http://www.taxfoundation.org/compliancetestimonytable1.html. Numbers for 2000 are taken from JCT SIMPLIFICATION REPORT, *supra* note 5, at 4.

62. JCT SIMPLIFICATION REPORT, *supra* note 5, at 4.

63. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES, at v (4th ed. 2001).

64. *See, e.g.*, I.R.C. § 530 (2000) (education); *id.* §§ 45F, 501(k) (childcare); *id.* § 220 (health insurance); *id.* § 7702B (long-term care).

Tax legislation during the 1990s completed the unraveling of the 1986 Tax Reform Act, which had promised, but failed to deliver, a broad-based, low-rate, fairer, and simpler income tax.[65] The bipartisan coalition that enacted income tax reforms in the 1980s has come unglued. Republican supply-siders and deregulators, determined to lower tax rates and eliminate tax incentives by which government channels private investments and spending, and traditional Democratic tax reformers, interested in taxing all income alike, have both become endangered species.[66] Republicans in the Congress have never seen a tax cut they will not embrace, and Democrats now view income tax benefits as the best way to achieve domestic policy goals blocked by political barriers or legal limitations on additional spending.

Senator William Roth, the former Chairman of the Senate Finance Committee, added a new wrinkle to the tax law in 1997 by naming the "Roth IRA" after himself.[67] Ways and Means Committee Chairman Bill Archer blessed us with the "Archer MSA."[68] If members of Congress continue to believe they can attach their names to a new tax break, they might add 535 new items each year.

Despite its complexity, the bipartisan congressional strategy to promote social programs through targeted tax cuts seems to please the public. But trying to rectify the nation's social and economic problems through income tax breaks fails to solve the problems being addressed. For example, this nation—contrary to the practice of other industrialized nations, which have universal health coverage and spend far less on health care than we do—relies on a tax advantage for employers and employees as its main mechanism for providing health insurance coverage to working Americans. The result: Our health-care costs are the highest in the world and about forty million Americans remain uninsured.[69] Placing so much reliance on the tax law to produce adequate health insurance has been the Titanic of twentieth-century American domestic policy.

And Congress seems destined to repeat that mistake by enacting a new tax break for long-term care.[70] The long-term care problem is momentous. The general aging of the population, along with longer life expectancies,

65. *See generally* Michael J. Graetz, *The Truth About Tax Reform*, 40 U. FLA. L. REV. 617 (1988).

66. The 1986 Act was made possible by a bipartisan coalition of such politicians. *See id.* at 623.

67. I.R.C. § 408(A).

68. I.R.C. § 220.

69. *See* GRAETZ & MASHAW, *supra* note 37, at 165. Americans spent over $1.2 trillion on health care in 1999. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 92 (2001). More than forty-two million Americans were uninsured in 1999. *Id*. at 102 tbl.145.

70. H.R. 831, 107th Cong. (2001); *see also* White House Office of the Press Sec'y, The President Triples His Long-Term Care Tax Credit (Jan. 19, 2000), *at* http://clinton4.nara.gov/WH/New/html/20000119_4.html.

increases the need for long-term care and poses a serious financial threat to families and the budgets of federal, state, and local governments. An extended period of long-term care can be extremely costly. A year in a nursing home costs an average of about $50,000.[71] Medicare's failure to provide adequate coverage for long-term care means that retirees must become impoverished in order to qualify for coverage. As a result, Medicaid has become the safety net for the middle class as well as the poor, financing some portion of nursing home care for nearly seventy percent of nursing home residents.[72]

The current bipartisan solution is a tax break—a tax deduction or credit—to defray some of the costs of people needing long-term care or relatives who take care of them. A bill passed by an overwhelming bipartisan majority of the House of Representatives in July 2002 would save these taxpayers an average of about $9 a day in income tax.[73] This is at best a fig leaf, offering minimal financial support to those who must pay for long-term care. The real danger is that enacting a tax break for long-term care will allow politicians to congratulate themselves on "making a start" toward resolving the problem, and divert us from seeking a real solution to the looming long-term care crisis.[74] Meanwhile, the income tax becomes more and more complicated.

Given recent changes in the economy, technology, and business operations, the income tax would have become more complex even had it not become the politicians' favored mechanism for addressing social and economic problems. The shift from a predominately manufacturing economy to a service economy spurred by innovative technology, along with the increasing importance of intangibles in the production of income, has resulted, for example, in a worldwide struggle over how to resolve long troublesome income tax transfer pricing issues,[75] and has also put new pressure on the age-old question of whether an expenditure is currently

71. *See* BARBARA R. STUCKI & JANEMARIE MULVEY, AM. COUNCIL OF LIFE INSURERS, CAN AGING BABY BOOMERS AVOID THE NURSING HOME? (2000); U.S. DEP'T OF HEALTH & HUMAN SERVS., HEALTH, UNITED STATES, 2002, at 285-86 tbl.111, 293-94 tbl.117.

72. GRAETZ & MASHAW, *supra* note 37, at 271-72.

73. Improving Access to Long-Term Care Act of 2002 was passed on July 25, 2002, by a vote of 362 to 61, and would allow caregivers a $2500 a year tax credit. H.R. 4946, 107th Cong. § 3(d)(2) (2002).

74. For further discussion and proposals requiring either universal purchases of a specified level of private long-term care insurance or a prefunded public long-term care insurance program, see GRAETZ & MASHAW, *supra* note 37, at 273-77.

75. *See generally* ORG. FOR ECON. COOPERATION & DEV., TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2001); Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357, 1419-20 (2001).

deductible or must be capitalized.[76] New financial derivatives have likewise put enormous pressure on longstanding tax distinctions.[77]

While old income tax problems have worsened, new problems have emerged. Probably the most important are due to the internationalization of the world economy. Flows of both direct and portfolio investments into and out of the United States have increased dramatically in recent years.[78] Foreign trade is increasingly important, as are international business and investment activities. Tax-favorable foreign financial centers and global trading have become commonplace. Individuals have also increased their foreign business activities. These developments, along with innovations in ways of doing business, especially innovative financial instruments, pose striking new challenges for taxation, especially income taxation.[79]

Elsewhere, I have urged a fundamental reexamination of U.S. international income tax policies.[80] No one can doubt the necessity of this task. Without it, the taxation of international income may completely unravel.

The Clinton Administration insisted that the greatest threat to the income tax comes from corporate tax shelters.[81] The Bush Administration has responded by urging greater disclosure of tax shelter transactions and by increasing enforcement efforts.[82]

The corporate tax shelter phenomenon dates from at least the early 1980s, when Congress stimulated corporate tax planning by enacting "safe-harbor leasing," a device by which corporations that were unable to use income tax benefits (such as deductions for accelerated depreciation or foreign tax credits) to reduce their own taxes could sell the tax savings attributable to such provisions to a company that could use the deductions or credits to reduce its tax liability.[83] The straightforward means of allowing companies that did not owe any income taxes to capture the business tax breaks of the 1981 legislation would have been for the government simply to write them checks, but this would have smacked of "corporate welfare." Congress was more comfortable with companies selling tax reductions to other companies. This "lease-a-deduction" scheme was so easy to

76. *See Proposed Regs To Address Intangibles Capitalization Issues*, TAX NOTES TODAY, Jan. 18, 2002, 2002 TNT 13-7 (LEXIS).

77. *See, e.g.*, Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 470-71 (1993).

78. *See* Russell B. Scholl, *The International Investment Position of the United States at Yearend 1999*, SURV. CURRENT BUS., July 2000, at 46, 54-55; Russell B. Scholl, *The International Investment Position of the United States: Developments in 1971*, SURV. CURRENT BUS., Oct. 1972, at 18, 20-21.

79. *See* Warren, *supra* note 77.

80. Graetz, *supra* note 75.

81. *See* Lawrence H. Summers, U.S. Dep't of the Treasury, Tackling the Growth of Corporate Tax Shelters (Feb. 29, 2000), *at* http://www.ustreas.gov/press/releases/ls421.htm.

82. *See* Abusive Tax Shelter Shutdown Act of 2001, H.R. 2520, 107th Cong.

83. *See* GRAETZ, *supra* note 49, at 126-28.

understand that even cartoonists captured it. Art Buchwald, the Washington humorist, had a field day describing potential extensions of the idea,[84] and Dianne Bennett, a Buffalo, New York, tax lawyer, suggested that low- and moderate-income families should be able to "lease" a welfare family to obtain their children's tax allowances.[85] The possibilities for the "leasing" of tax breaks are unlimited.

By 1986, when Congress eliminated safe-harbor leasing, corporate attitudes toward the income tax had changed. Many corporate managers had come to regard their tax departments as another potential profit center. They could increase returns to shareholders by producing a better product, selling more goods or services, or by saving taxes. Often tax savings were easier. The government has been trying to halt corporate tax-shelter transactions ever since.

Since finding a solution to corporate tax shelters became a prime target of the Clinton Administration, numerous proposals have been advanced to address this problem. Most seek greater disclosure of tax-shelter transactions and greater penalties on those who enter into them.[86] But these ideas are unlikely to stem the tide. It is easy to define a tax shelter for the press or the layman: Tax shelters are "deal[s] done by very smart people that, absent tax considerations, would be very stupid."[87] But translating this definition into legislative language to defeat tax-shelter transactions and to justify enhanced penalties is another matter altogether. Both the Treasury and the Joint Committee on Taxation have advanced definitional tests of corporate tax shelters, but Congress has been cautious about embracing them.[88]

To be effective, any attack on corporate tax shelters must substantially change the incentives for corporate management to enter into such transactions. Now the incentives favor companies taking a chance that tax shelter transactions will not be discovered by the IRS or that, if discovered, a court will uphold the taxpayer's view of the facts and the law. There is no natural counterforce to offset the potential benefits for a company playing the tax audit lottery. This is because corporate tax-shelter deductions, credits, and losses reduce tax liability but do not also reduce the income

84. Art Buchwald, *The High Tax Racket*, WASH. POST, Dec. 3, 1989, at D1.

85. Timothy B. Clark, *Selling Tax Breaks–If Both Parties Benefit, Then Why Is Congress Unhappy?*, 13 NAT'L J. 2238 (1981).

86. *See* H.R. 2520; *see also* Long-Term Care and Retirement Security Act of 2001, H.R. 831, 107th Cong.

87. Tom Herman, *Tax Report*, WALL ST. J., Feb. 10, 1999, at A1 (quoting Michael J. Graetz).

88. STAFF OF THE JOINT COMM. ON TAXATION, PUB. NO. JCX-84-99, APPENDIX II TO JCX-82-99: DESCRIPTION AND ANALYSIS OF PRESENT-LAW TAX RULES AND RECENT PROPOSALS RELATING TO CORPORATE TAX SHELTERS (1999).

reported on the company's financial statements to shareholders.[89] Thus, the company gets the best of both worlds: Lower taxes are paid to the government while higher profits are reported to shareholders.

In my view, a stable solution to the corporate tax-shelter problem will require greater conformity between book and tax accounting for large publicly traded companies. Only then will economically unsound, tax-motivated transactions decrease the company's earnings reported to investors. When that happens, the pressures to engage in transactions to reduce taxable income will be counterbalanced by pressures to report higher earnings to shareholders.[90] Before engaging in tax shelter transactions, corporate managers would have to decide to take a corresponding hit to earnings; this would greatly dampen their enthusiasm for tax shelters.

The 1986 Tax Reform Act halted the widespread use of tax shelters by individuals. But since then, corporate tax shelters and our two-tier system of tax enforcement[91] have eaten away at both the federal fisc and the public's sense of tax fairness. No matter what the data show about the amount of income taxes being paid by high-income taxpayers or about the relationship of corporate taxes to corporate profits, Joe Sixpack no longer believes he is getting a fair shake. Joe believes that wealthy people and large corporations have tax advisers—lawyers, accountants, investment bankers, magicians, and alchemists—to help them arrange their affairs to duck the taxes they should be paying, thereby avoiding their fair share of the tax burden.

Americans now regard the income tax as both unfair and unnecessarily complicated.[92] Not only has this phenomenon diminished popular support for the income tax, it has also threatened income tax compliance. Lou Harris, among others, has reported a growing sentiment—especially among the young—that there is nothing wrong with tax cheating.[93] In one episode of the 1970s comedy *All in the Family*, Archie told his wife and son-in-law

89. U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 12 (1999), *at* http://www.ustreas.gov/taxpolicy/library/ctswhite.pdf.

90. The Enron debacle has only strengthened this judgment. *See* George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. Rev. 209 (2001); George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405 (2002).

91. Low- and middle-income taxpayers who have income only from wages, interest, and dividends and who take the standard deduction or itemize only state and local taxes and home mortgage interest have virtually no opportunity to underreport income taxes. Conversely, taxpayers who are self-employed, run cash businesses, or have investment transactions not routinely reported to the IRS have considerable opportunities to cheat. *See* GRAETZ, *supra* note 49, at 93.

92. *See id.* chs. 5-6.

93. *Fraudulent Tax Schemes*: *Hearing Before the Senate Finance Comm.*, 107th Cong., 2002 WL 541924 (2002) (statement of David C. Williams, Treasury Inspector General for Tax Administration); Gary Rummler, *Litter Is Anathema to College Seniors*, MILWAUKEE J. SENTINEL, June 10, 2001, at 1A.

that he had no intention of paying taxes on his income from a second job for which he was paid in cash. Archie said, "All those rich guys have their tax shelters and this is my tax shelter." Twenty-five years later, *Forbes* magazine asked, "Are you a chump?" for paying the taxes you owe.[94] This Archie Bunker attitude poses a real threat to the income tax.

Congress creates the complexities in the tax law, often providing convoluted or inadequate statutory guidance, then blames the IRS for being unable to cope. More power and more discretion devolve to the IRS, and often to lower levels within the IRS. As Congress has delegated more power to the IRS, it has simultaneously introduced new penalties into the law in an effort to change the odds of the tax-planning lottery.[95]

In 1998, Congress enacted the IRS Restructuring and Reform Act, changing the governance and many of the operations of the IRS.[96] IRS officials now talk of a "customer-friendly" culture. The Treasury Department designed "customer satisfaction surveys" for people who undergo IRS audits or collection activities.[97] (Your tax dollars at work!) The architects of the IRS restructuring legislation and the IRS Commissioner all agree that the IRS must become a modern user-friendly financial services institution. And improvements have occurred. A recent University of Michigan survey showed that people now prefer dealing with the IRS to dealing with the airlines.[98] Talk about damning by faint praise.

While I am a great fan of IRS Commissioner Charles Rossotti and his efforts to reorganize the IRS, I remain wary when people talk about a customer-friendly IRS. To think that the IRS can become a modern financial services institution without a major overhaul of the tax law it administers is to believe that you can turn a Winnebago around without taking it out of its garage. When the IRS promises to become "customer" friendly, I am reminded of Emerson's comment about an acquaintance: "[T]he louder he talked of his honor, the faster we counted our spoons."[99]

The fundamental problem is that the IRS is being asked to do too much. Having to administer the Earned Income Tax Credit (EITC), the nation's wage subsidy for low-income workers, has diverted IRS audit resources

94. Janet Novack, *Are You a Chump?*, FORBES, Mar. 5, 2001, at 122.

95. *See* Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Changing Face of Tax Enforcement, 1978-1988*, 43 TAX LAW. 893 (1990).

96. Pub. L. No. 105-206, 112 Stat. 685 (1998) (codified in scattered sections of I.R.C.).

97. *Joint Review of the Strategic Plans and Budget of the Internal Revenue Service: Hearing Before the House Comm. on Ways and Means, House Comm. on Appropriations, House Comm. on Government Reform, Senate Comm. on Finance, Senate Comm. on Appropriations, and the Senate Comm. on Government Affairs*, 107th Cong. 143-44 (2001) (response to questions by Hon. Charles O. Rossotti, IRS Commissioner).

98. Patrick Barta, *FAA Trumps IRS as Agency Least Loved, Customer Satisfaction Index Suggests More Patience with U.S. Government*, WALL ST. J., Dec. 17, 2001, at A2; Amy Hamilton, *IRS Moves Past Airlines in Customer Satisfaction Survey*, TAX NOTES TODAY, Dec. 18, 2001, 2001 TNT 243-3 (LEXIS).

99. RALPH WALDO EMERSON, THE CONDUCT OF LIFE 211 (AMS Press 1968) (1860).

away from business and high-income individual returns, leading to headlines that the IRS is targeting the poor for audits.[100] The IRS also administers the programs providing employees their health insurance and pensions, as well as the nation's largest subsidy for childcare and the many income tax provisions to help families finance the costs of higher education. The IRS routinely processes more than 130 million individual and corporate tax returns and nearly 1.5 billion information documents each year.[101] We also expect the IRS promptly to issue regulations implementing frequent and massive legislative changes, to ferret out and deter corporate tax shelters, to halt tax evasion, and to bring the underground economy to the surface. The IRS cannot do all of these things well. Many it cannot do at all. We should not expect it to. A major simplification of the nation's tax law is necessary. In order to achieve that, we need a fundamental overhaul of our nation's tax system.

IV. A FRESH START FOR THE NATION'S TAX SYSTEM

The vast majority of American families should not have to file tax returns or deal with the IRS at all. In the current tax reform debate, only the proponents of a national sales tax seem committed to this result. Everyone else proposing tax reform—the flat-taxers, the income tax reformers, and those who favor progressive consumption taxes—would fail to remove the IRS from the lives of average Americans.

Flat tax advocates trumpet their claim that they would shrink the individual tax return to fit on a postcard.[102] But given Congress's propensity for enacting tax breaks to encourage this or that expenditure or activity, it is foolish to believe that a flat tax—which would require all wage earners to file tax returns—would stay flat or simple for very long. The political allure of giving Americans tax breaks for specific expenditures or investments is catnip to both Congress and the White House. And the flat tax's treatment of exports and imports makes it anathema to American businesses.[103]

100. David Cay Johnston, *Rate of All I.R.S. Audits Falls; Poor Face Particular Scrutiny*, N.Y. TIMES, Feb. 16, 2001, at A1.

101. IRS, DATA BOOK 2001, at 26 tbl.25; Frank Zaffino, *Projections of Returns To Be Filed in Calendar Years 2000-2007*, STAT. INCOME BULL., Winter 2000-2001, at 146, 146.

102. *See, e.g.*, Leslie Wayne, *Flat Tax Goes from "Snake Oil" to G.O.P. Tonic*, N.Y. TIMES, Nov. 14, 1999, at A1 (referring to a statement by Sen. John McCain). Careful analysis of the flat tax indicates that it would not be so simple as its proponents claim. *See* David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599, 599 (2000) (analyzing implementation issues of the flat tax, including financial and international transactions and business issues, and concluding that the regime will be "complex and difficult to implement, although somewhat simpler than current law" and will be "easily avoidable").

103. Most sales or value-added taxes are only levied on consumption that takes place within the country. Exported goods (and some nonresident use of services within the country) are exempted from the tax. These exemptions are not available under a flat tax, which would tax the entire value of goods manufactured in the United States whether sold here or abroad, but would

The proponents of replacing the income tax with a national sales tax have labeled their proposal the "fair tax" and are spending millions of dollars to build grass-roots public support.[104] Since all reporting of sales taxes would be done by retail businesses and no individual returns would be required, a national sales tax would offer a genuine and lasting simplification for American families. The rub, however, is that complete replacement of the income tax with a national sales tax would provide a large tax reduction for the country's wealthiest people. Neither a flat tax nor a national sales tax would be a fair replacement for the income tax.[105] Both would shift the nation's tax burden from high-income families to those with less income. The tax system can, and should, be fixed without such a shift in the nation's tax burdens. As the conservative *New York Times* columnist William Safire, who called the flat tax "draconian," has said, "Most of us accept as 'fair' this principle: The poor should pay nothing, the middlers something, the rich the highest percentage."[106] The current income tax is a horrible mess. But in the course of radically restructuring our tax system, we should not enact a massive tax reduction for the country's wealthiest people, those who least need such relief, while increasing taxes for those with less income or worth.

In discovering how we should move forward to a new tax regime, our nation's tax history offers a promising path. We can achieve low tax rates and a reasonably simple tax system by replacing most of the income tax with a tax on consumption. In the process, we should return the income tax to its pre-World War II status—a low-rate tax on a relatively thin slice of higher-income Americans. Whittling down the income tax could be financed by enacting a value-added tax (VAT), a consumption tax commonly used throughout the world.[107] A VAT imposed at a 10% to 15% rate could finance an exemption from income tax for families with $100,000 of income or less and would allow a vastly simpler income tax at a 25% rate to be applied to incomes over $100,000. In combination, these two taxes would produce revenues roughly equivalent to the current income tax.[108] Moreover, this proposal, unlike the "flat tax" and "fair tax"

tax only the U.S. markup of imported goods manufactured abroad. Economists do not regard this as significant because they expect exchange rates to adjust to compensate for this difference. Business owners, on the other hand, perceive a major competitive advantage for imports and will exert considerable political muscle to oppose such a regime. *See* GRAETZ, *supra* note 49, at 241.

104. *See, e.g.*, AFT Support Org., Form 990 (2000) (reporting that one fair tax organization spent over $1.5 million on "public education"), *at* http://www.guidestar.org/search.

105. For a discussion of this point, see GRAETZ, *supra* note 49, at 220-26.

106. William Safire, *The 25% Solution*, N.Y. TIMES, Apr. 20, 1995, at A23.

107. LIAM EBRILL ET AL., THE MODERN VAT 9-12 (2001).

108. For further detail, see *infra* Appendix. A scaled-down version of a similar idea was offered by the Honorable Nicholas F. Brady, Secretary of the Treasury. Nicholas F. Brady, *Remarks Before the Columbia University School of Business*, TAX NOTES TODAY, Dec. 11, 1992, 92 TNT 247-33 (LEXIS).

proposals, would not dramatically shift the tax burden away from high-income families to middle- and lower-income families.

This is a practical and workable plan, which distinguishes it from those ideas for restructuring the nation's tax system that have so far received the most attention in Congress. The "flat tax" and the "USA tax" are essentially theoretical constructs, ideas developed by academics but untested in practice.[109] Their proponents like to contrast our real income tax with all its barnacles to pure, but politically unrealistic, forms of consumption taxes that have been conjured in ivory towers. Sales taxes, in contrast, are real taxes, used by state governments throughout the United States.[110] Their difficulty is that no government has imposed a retail sales tax at the rate that would be required to fund replacement of the income tax or, as I am urging here, to cut it down to its pre-World War II status. Moreover, sales taxes are far easier to evade than a value-added tax, which is the form of consumption tax commonly used throughout the world.[111] The VAT is a revenue-producing mainstay in more than 120 countries on five continents, and is also now used in Michigan.[112] A VAT operates much like a national sales tax, but is collected at all stages of production rather than just from retailers.[113]

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109. These taxes are discussed in detail in GRAETZ, *supra* note 49, ch. 14. The USA tax—or "Unlimited Savings Allowance"—is an uncommon form of consumption tax developed by Senators Pete Domenici and Sam Nunn. This system, which includes an eleven percent VAT on businesses, would tax individuals at progressive rates on their total annual consumption (although some consumption financed by borrowing is omitted from the tax base). Households would calculate consumption by subtracting their net saving from total income. *Id.* at 214-15. For further description, see LAURENCE S. SEIDMAN, THE USA TAX: A PROGRESSIVE CONSUMPTION TAX (1997). *See also* Henry J. Aaron & William G. Gale, *Introduction* to ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, *supra* note 26, at 1, 4, 8-13.

Edward McCaffery has suggested modifications to the USA tax that would move it considerably closer to the proposal I am offering here. Professor McCaffery would impose a value-added tax in lieu of the income tax for persons with total consumption of $80,000 or less and a progressive rate tax on consumption above that level. EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER 26, 91, 100-02 (2002). McCaffery recognizes that taxing consumption financed by borrowing is crucial, something that Senators Nunn and Domenici regarded as politically infeasible. *Id.* at 98-99; *see also id.* at 92 ("Middle-class consumer debt will also be taxed the moment it is incurred."). McCaffery, however, allows a deduction for home mortgage interest. *Id.* at 89, 132-35. Professor McCaffery says little about the transition issues that bedeviled the Nunn-Domenici effort. *Id.* at 109-10. McCaffery's plan would have no special benefits for retirement savings, including pension plans, IRAs, and 401(k) accounts. *Id.* at 131-32. Rather than a payroll tax adjustment such as I offer here, McCaffery proposes a demogrant for low-income workers. *Id.* at 101. The main conceptual difference between the proposal advanced in this Essay and that of Professor McCaffery is that he would not tax wealth, transfers of wealth, or income from wealth not spent on personal consumption.

110. Forty-five states and the District of Columbia impose sales taxes. *Congress Will Allow Ban on Internet Taxes To Expire*, N.Y. TIMES, Oct. 19, 2001, at A16.

111. EBRILL ET AL., *supra* note 107, at 23-24.

112. *Id.* at 9-12.

113. *Id.* at 19, 23-24. The VAT is imposed at each stage in production that value is added to a product. The business adding value pays tax on the increase in the value, but not on the entire value of the item. Thus, the steel mill would pay VAT on the value of the steel it produces, minus the value of the ore it had to buy (and pay tax on). The automaker pays tax on the value of the

Here is how this new tax system would work: People freed from income taxation would pay their federal taxes when they purchase goods and services, as they now do with state sales taxes. They would not be required to file any tax returns. They would have no dealings at all with the IRS. The income tax that would remain for high-income taxpayers would be shrunken and simplified substantially. A low, flat rate of tax would be imposed on the taxable income of high-income individuals and corporations. The marriage penalties of the existing income tax would be eliminated.[114] Most of the special income tax credits and allowances that now crowd the tax code and complicate tax forms would be repealed.

This plan is designed to maintain current federal government revenues without substantially redistributing the current burdens of the tax system. Thus, unlike proposals to replace the income tax completely with either a "flat tax" or a national sales tax, this plan does not entail a substantial tax cut for high-income individuals or a tax increase for those below the top tier. And this new tax system would be considerably more favorable to savings than the current tax law. Most families would be able to save free of tax, and the tax burden on savings would be reduced for everyone.

Currently the United States taxes consumption considerably less than our trading partners. (See Figures 7 and 8.)

vehicle it produces, minus the value of the steel (and other materials) it purchased. Ultimately, the tax burden falls on retail customers, much like a sales tax.

114. *See* GRAETZ, *supra* note 49, ch. 2 (discussing the marriage penalties that exist under current law).

FIGURE 7. CONSUMPTION TAXES (INCLUDING VAT) AS PERCENTAGE OF GDP: 1999[115]

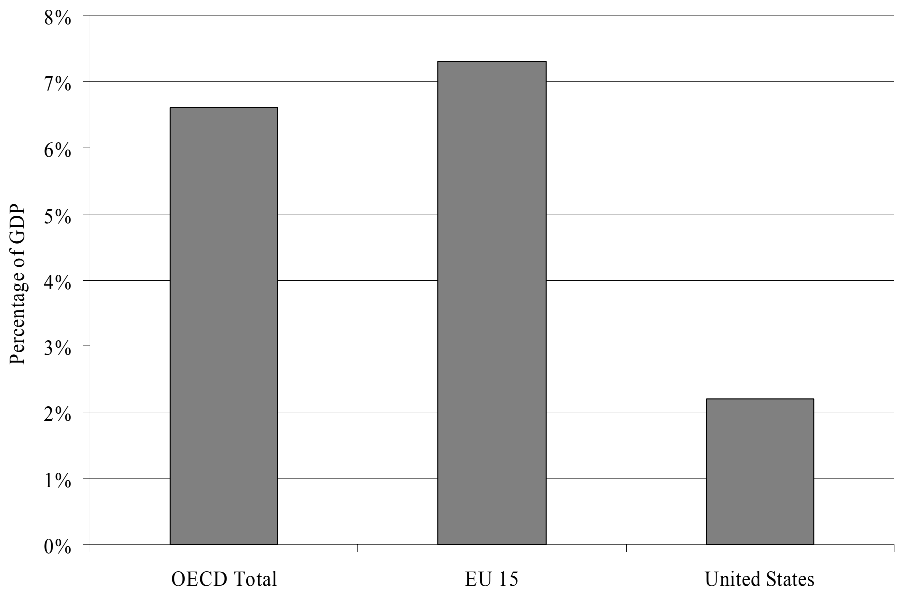
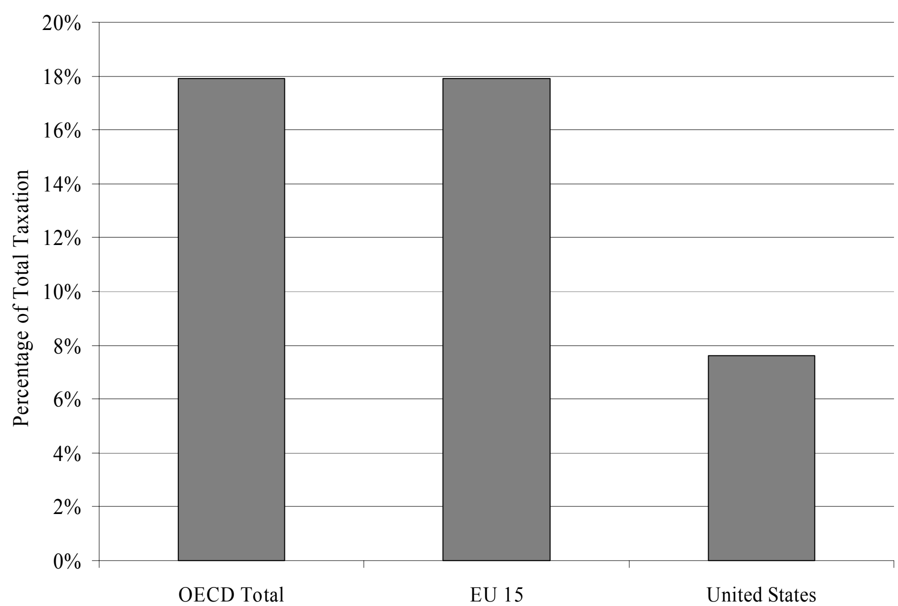


FIGURE 8. CONSUMPTION TAXES (INCLUDING VAT) AS PERCENTAGE OF TOTAL TAXATION: 1999[116]



115. ORG. FOR ECON. COOPERATION & DEV., CONSUMPTION TAX TRENDS tbl.3.1 (2001).
116. *Id.* tbl.3.2.

Reducing income taxes will make the U.S. tax system more favorable to investments by both U.S. residents and foreigners. Our income tax would be lower than that of most other nations, and our taxes on consumption would be comparable to those imposed elsewhere. This is a realistic and feasible plan for restructuring the tax system of the United States. It would be both much simpler and more conducive to economic growth than our current tax system. Next, I shall examine its contours in more detail.

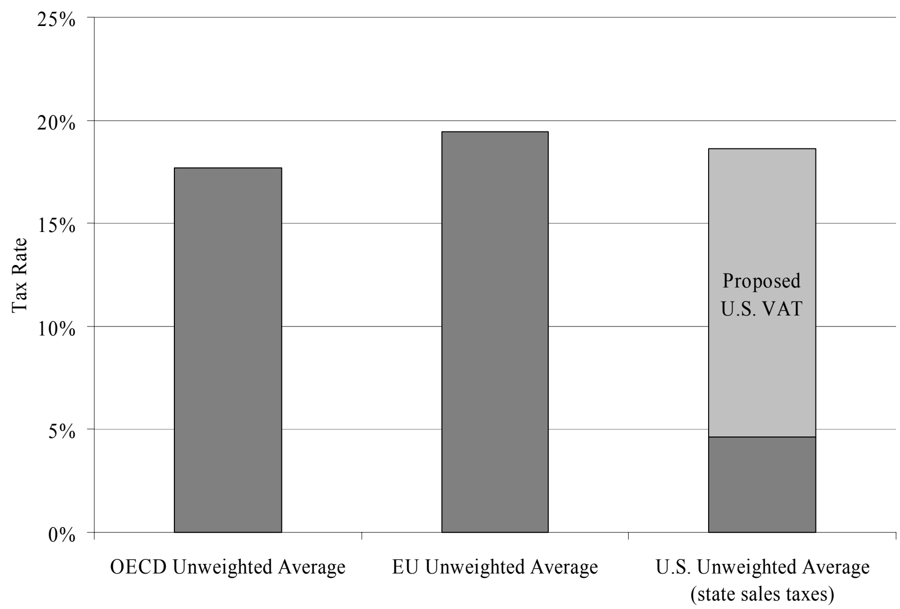
A. *The New Consumption Tax*

A new federal consumption tax, imposed at a rate of 10% to 15%, would finance the costs of eliminating more than 100 million American families—almost 90% of all filers—from the income tax rolls. With a family allowance level of $100,000 and individual and corporate income tax rates of 25%, as described above, a 14% or 15% consumption tax would be necessary to raise revenues roughly equal to those of current law.[117] Given existing state sales taxes, if the U.S. were to add a federal VAT of this rate, the total U.S. tax rate on consumption would approximately equal the average VAT rates in Europe.[118] (See Figure 9.)

117. For more detail, see *infra* Appendix.

118. The consumption tax rate required depends, of course, on the scope of income tax relief. For example, if the family allowance level were reduced to $75,000 or $80,000 for a married couple, the consumption tax rate could also be reduced. I do not recommend lowering the $100,000 income tax threshold.

FIGURE 9. CONSUMPTION TAX RATES (INCLUDING VAT): 2000[119]



In order to keep the tax rate as low as possible, the VAT tax base should be broad, covering virtually all goods and services.[120] A broad VAT tax base with a single tax rate would minimize its economic distortions,[121] and limiting tax exemptions would simplify compliance and administration. The VAT should, however, contain an exemption for small businesses, relieving them from the costs of compliance and the tax collector from chasing after small amounts of tax. If all businesses were required to collect VAT and file returns, about 25 million businesses would be required to file, but almost half that number would be eliminated if small businesses with less than $25,000 of annual gross receipts were exempt from tax.[122] An

119. ORG. FOR ECON. COOPERATION & DEV., *supra* note 115, tbl.3.5. For data for the U.S. computation, see SALES TAX INST., SALES TAX CONCEPTS MADE EASY FOR YOU, *at* http://salestaxinstitute.com/sales_tax_rates.html (last visited Jan. 10, 2002).

120. EBRILL ET AL., *supra* note 107, at 42-49. A consumption tax as described in the *Basic World Tax Code*, drafted by Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy under President Clinton, and Ward M. Hussey, formerly Legislative Counsel to the House of Representatives, provides a good starting point for this kind of tax. *See* WARD M. HUSSEY & DONALD C. LUBICK, BASIC WORLD TAX CODE AND COMMENTARY (1996).

121. A broad, but realistic, consumption tax base would include approximately half of the nation's gross domestic product, less than the percentage of consumption taxed in some nations, but higher than the OECD average, which is about forty percent of gross domestic product. *See* EBRILL ET AL., *supra* note 107, at 40-42, 43, 46.

122. *See* U.S. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: POTENTIAL IMPACT OF ALTERNATIVE TAXES ON TAXPAYERS AND ADMINISTRATORS 140 (1998).

exemption for businesses with gross receipts of $100,000 or less would reduce the number of VAT returns to about 5.5 million.

Expenditures on education and religion would be exempt from the consumption tax, as would most expenditures on health care. However, rather than exempting food or clothing, as many foreign VATs and state sales taxes do to reduce the tax burden on necessities, low-income people should be protected from tax increases through a reduction of payroll tax withholdings.[123] The VAT should be imposed on the value of new residential construction, but would not apply to the resale of existing homes.[124] Financial services should be included in the VAT base, although these are often excluded because they are difficult to measure.[125] And the value-added tax would be imposed only on consumption in the United States; it therefore would exempt exports from tax but would tax imports.[126]

There are a variety of methods for imposing and collecting such a consumption tax. The best alternative is a so-called credit- or invoice-method VAT of the sort used predominantly throughout OECD nations.[127] Experience demonstrates that such a tax works well. Sellers of goods and services collect taxes and receive credits for VAT paid on their purchases. This allows tax revenues to be collected regularly throughout the year from companies at all levels of production, rather than just from retailers, thereby easing enforcement.[128] A credit-method VAT also facilitates exemptions for small businesses (and for specified goods or services if such exemptions become politically necessary).[129] A credit-method VAT may also impose multiple tax rates on specified categories of goods and services. Multiple rates, however, should be avoided; they add both complexity and economic distortions.[130]

123. *See infra* Section IV.B.

124. Nor would it apply to the rental value of owner-occupied homes. For a more extensive discussion of the effect of VATs on owner-occupied housing, see EBRILL ET AL., *supra* note 107, at 98-99.

125. *See id.* at 90-91, 94-98; Alan J. Auerbach & Roger H. Gordon, *Taxation of Financial Services Under a VAT*, 92 AM. ECON. REV. 411 (2002) (arguing for the inclusion of financial services in a VAT base).

126. GRAETZ, *supra* note 49, at 241; *see also* EBRILL ET AL., *supra* note 107, at 176-96.

127. EBRILL ET AL., *supra* note 107, at 20. A "subtraction-method" VAT, in which value added by each firm is calculated by subtracting allowable purchases from receipts, has often been offered as an alternative. *See id*. In the United States, this may well be because a subtraction-method VAT looks more like an income tax.

128. *Id.* at 15-50.

129. *Id.* at 110-11, ch. 11.

130. *Id.* at 69-82. In some cases, multiple VAT rates may actually increase efficiency. An example would be taxing goods associated with the enjoyment of leisure (to reduce the distortion of the tax on the choice between paid work and leisure). Golf clubs might be an example. *Id.* at 71. Another example would be higher rates on environmentally disadvantaged products. However, specific excise taxes, such as that on alcohol, might be better used for these purposes. Multiple VAT rates generally tend to distort consumer choice among various low-taxed and high-taxed commodities.

While I favor the credit method of collecting consumption tax, principally for its compliance advantages, the form of consumption tax is not critical to the proposal I am offering here. The key points are these: The consumption tax should be collected only from businesses, and the tax should be imposed at a level sufficient to free the vast majority of Americans both from any income tax liability and from any requirement to file tax returns.[131]

Politicians who have proposed replacing the income tax with other forms of consumption taxes have been creative in the labeling and marketing of their plans, calling their proposals the "flat tax,"[132] the "USA tax,"[133] or the "fair tax."[134] In the past, the phrase "value-added tax" has sounded the political death knell for consumption tax proposals in the United States.[135] That label, therefore, should probably be avoided. The Japanese simply call their VAT a "consumption tax," and the Canadians impose a "goods and services tax." Either of these appellations or a new one, such as "business receipts" or "business sales" tax, might do.

Imposing a value-added tax at the level I have suggested here occurs commonly throughout the world, and generally would not be a difficult undertaking. But two features of the U.S. tax system pose unique challenges. First, the United States delivers substantial tax relief and, in some instances a direct wage subsidy, to low-wage workers through the current income tax in the form of earned income tax credits (EITC). Indeed, about 20 million workers file income tax returns principally to claim their earned income tax credits. If the income tax were eliminated for these workers, an alternative means for delivering these benefits would be necessary. Second, in our federal system of government, the states also impose income and sales taxes. Currently, 41 states impose income taxes and 45 impose sales taxes.[136] Fundamental restructuring of the nation's tax

131. If, for example, it were politically easier to coordinate a new national consumption tax with the sales taxes of states by choosing a different form of consumption tax, that might be a sound basis for preferring a different method of collecting the federal consumption tax. For a discussion of this issue, see Allen Schenk, *Radical Tax Reform for the 21st Century: The Role for a Consumption Tax*, 2 CHAP. L. REV. 133 (1999).

132. *See* GRAETZ, *supra* note 49, at 212-14.

133. *Id.* at 214-15.

134. *Id.* ch. 14.

135. Twelve-term Oregon Congressman Al Ullman lost his 1980 reelection bid after advocating a nationwide VAT. *See* David S. Cloud, *VAT Would Bring Big Revenue, but Prospects Slim on Hill*, CONG. Q. WKLY. REP., Apr. 24, 1993, at 1005-06 ("Ullman's defeat, which many contend had nothing to do with his position on VAT, remains a cautionary reminder for many politicians about the perils of advocating the tax.").

136. Forty-one states impose general personal income taxes. Tennessee and New Hampshire only tax income from dividends and interest. *See* Gary C. Cornia et al., *An Analysis of the Feasibility of Implementing a Single Rate Sales Tax*, 53 NAT'L TAX J. 1327, 1334 n.11 (2000); *States Rely More and More on Income Taxes*, ST. LEGISLATURES, Sept. 1, 1998, at 7. Forty-five states have sales taxes. *See Congress Will Allow Ban on Internet Taxes To Expire*, *supra* note 110.

system demands action by both the federal government and the states to achieve maximum benefits for taxpayers. I shall take up these issues in turn.

B. *Tax Relief for Low-Income Workers*

The earned income tax credit supplies indispensable wage subsidies to low-income workers and their children, but it is not working well. The IRS estimated in 2002 that almost one-half of these credits are being claimed by people not entitled to them, at a cost of $11 billion a year.[137] Moreover, the vast majority of workers entitled to the EITC receive their credit as a lump-sum refund after they file their tax returns. Thus, workers typically cannot use the EITC to fund their monthly expenditures.[138] Nevertheless, protecting low- and moderate-income workers from a tax increase or loss of the EITC wage subsidy without requiring them to file tax returns is probably the most challenging task for the new tax system I am urging here.

Under the proposed tax system, income tax withholding from wages would be eliminated for all low- and middle-income workers due to the new $100,000 per family income tax exemption. But Social Security payroll taxes would still be withheld from all employees, making possible new tax offsets that could both replace the EITC and, at the same time, protect low-wage workers from any tax increase that might otherwise result from the new VAT. Providing low-income workers tax offsets through the payroll tax withholding system would allow elimination of the tax return filing requirement for these workers without increasing their taxes or eliminating their wage subsidy. Moreover, payroll tax offsets would put money in low-income workers' pockets when their paychecks are earned (rather than through a lump-sum tax refund after year-end, as the EITC now does) and would not require workers to file any year-end tax return.

For several reasons, it is not appropriate that this tax relief correspond to that provided by the current earned income tax credit. The earned income tax credit now contains serious penalties on marriage, which should not be replicated in any new system.[139] Furthermore, for families with children,

137. Robert S. McIntyre, *Free Money: Take Some*, AM. PROSPECT, Apr. 8, 2002, at 21.

138. An advance-payment mechanism, which delivers these tax credits through employees' paychecks, has been part of the EITC law for more than two decades, but only a tiny percentage of eligible workers takes advantage of this option. The advance-payment option came into the law in 1978. Tax Counseling for the Elderly, Pub. L. No. 95-600, § 105, 92 Stat. 2763, 2773-76 (1978) (codified as amended at I.R.C. § 3507). Only about $160 million of the total $26 billion in refunded Earned Income Credits were refunded in advance in 2000. IRS, DATA BOOK 2001, at 14. There is much room for improving the delivery of this tax relief and wage subsidy to low-income workers. *See generally* EDMUND S. PHELPS, REWARDING WORK: HOW TO RESTORE PARTICIPATION AND SELF-SUPPORT TO FREE ENTERPRISE (1997) (proposing a system of graduated tax subsidies to employers of low-wage workers).

139. *See* GRAETZ, *supra* note 49, at 34-35. As I explain in my book, it is not possible in such a system for the tax law to be neutral with regard to marriage. *Id.* at 33 & n.6. Rather than

relief greater than that provided by existing earned income tax credits will be needed to offset any new tax burdens created by a consumption tax.

This tax relief and wage subsidy for low-income workers would be administered by having employers adjust their employees' paychecks to provide "negative withholding," or additional take-home pay. Individuals would be eligible for this benefit if they earn annual wages of $20,000 or less. An additional amount would be provided based upon the worker's number of children.[140] To avoid an abrupt termination of relief with attendant high marginal tax rates on wages, families with children might be eligible for some tax offset with wages up to about $50,000.[141]

Proponents of a national sales tax have proposed a different kind of payroll tax adjustment to offset the effects of a sales tax on low-income workers. They would provide each worker with a payroll tax offset equal to the sales tax times the federal poverty level (which varies with family size). This is designed, in effect, to provide all taxpayers with an exemption from sales taxes on an amount of spending equal to the poverty level. This payroll tax offset has been estimated to require more than an additional three percentage points in the sales tax rate.[142] Sales tax proponents have not offered any replacement for the earned income tax credit of current law, claiming that the earned income tax credit should be treated as any other government spending program.[143] Thus, while the payroll tax adjustment offered by sales tax advocates is easier to administer than the one I have offered, such an adjustment fails to match the protections accorded low-income workers under current law. By contrast, the payroll tax adjustment

imposing penalties on marriage similar to those of the current earned income tax credit, the system I am proposing would either be neutral or generate bonuses for marriage.

140. Under both the child credit and the EITC, there often has been difficulty and controversy over who is eligible to claim credits, because the claimant might be able to show that he or she has provided more than one-half of the child's financial support. *See* I.R.C. § 152(c) (2000). The EITC is now allowed to the parent who lives with the child. *See id.* § 32(c). Alternatively, it would be much simpler and, given the increasing efforts of enforcing child support obligations, perhaps equitable to allow payroll offsets for both parents.

141. For a discussion of the problems with such high margined rates from withdrawing benefits, see GRAETZ & MASHAW, *supra* note 37, at 296-99. The increase in take-home pay from this offset would grow with the number of children in the family. For example, families with earnings of $20,000 or less might receive an annual payroll tax reduction of $2,000 per child, families with earnings between $20,000 and $30,000 might receive $1,500 per child, and families with earnings between $30,000 and $50,000 might receive $1,000 per child. All workers with wages under $20,000 would receive a basic earned income offset to compensate for the loss of their earned income tax credits and to protect them against any tax increase. This tax relief for low-income workers would be quite expensive, requiring dedication not only of the full amount of revenues and outlays currently attributable to the earned income tax credit, but also an additional amount, which might be as much as two percentage points of total consumption tax revenues. GRAETZ, *supra* note 49, at 309-12. For more detail, see *infra* Appendix.

142. Fair Tax Act of 2001, H.R. 2525, 107th Cong.; *see also* DAVID R. BURTON & DAN R. MASTROMARCO, EMANCIPATING AMERICA FROM THE INCOME TAX: HOW A NATIONAL SALES TAX WOULD WORK tbl.3 (Cato Inst., Policy Analysis No. 272, 1997), *at* http://www.cato.org/pubs/pas/pa-272.html.

143. H.R. 2525.

proposed here is both better targeted and less expensive than the alternative being urged by sales tax advocates.

The exact structure of an appropriate progressivity adjustment along the lines described here would depend, of course, on the consumption tax rate ultimately enacted. The higher the tax rate, the larger the necessary payroll tax adjustment for low-income workers. The numbers used here and in the Appendix are intended merely to be illustrative.

Calculating this offset to payroll tax withholding would not burden employers; wage-withholding tables would be provided by the IRS showing the amounts of the payroll tax offsets at different wage levels and family sizes.[144] Employees whose payroll tax obligations are not sufficient to cover the adjustment would receive a direct increase in their take-home pay.[145]

Although this take-home pay increase for low-income workers takes the form of a reduction of payroll tax deposits, it would not affect employees' Social Security benefits or the amounts credited to the Social Security Trust Fund. It would be funded from general revenues.[146] Current earned income tax credits reduce general revenues and affect neither the amounts credited to the Social Security Trust Fund nor individual employees' Social Security accounts. These payroll tax offsets would serve merely as a mechanical device for transmitting wage subsidies and VAT tax offsets to low-wage workers. Each employee's wages would be reported to the Social Security Administration in full, thereby providing all necessary information to maintain every employee's full eligibility and credits for Social Security benefits.[147]

For retirees, any impact from the new VAT on their cost of living would be largely offset by automatic cost-of-living increases in their monthly Social Security benefits. In addition, retirees with less than

144. Obviously, this payroll withholding adjustment would be allowed based on less information than that currently required to claim the EITC, and therefore would provide rough justice. To avoid the problem of determining annual income, the allowance might be based on levels of hourly wages and the number of eligible children. This might allow offsets to some who do not deserve them—an investment banker's spouse who works at Wal-Mart, for example—but would be far simpler than the current system. Under such a system, employers would have to report employees' hourly wage rates to the IRS.

145. This is equivalent to the refundability feature of the EITC. It will not require additional funding by employers, since they would simply reduce their aggregate payroll tax deposits by the total adjustments for all employees. It would therefore be rare for an employer to have an overall negative withholding balance. In the handful of cases where the employer's total adjustments exceed its total payroll tax deposits, the employer could be provided a refundable credit against its income taxes. The Social Security Administration would reconcile each employer's withholding adjustments with wages reported at year-end as it now does with W-2 Forms for Social Security purposes.

146. This follows the current practice for the EITC, which was originally enacted to offset payroll tax burdens for low-income workers.

147. This payroll tax adjustment would be available only to workers. For low-income self-employed independent contractors, relief would have to be obtained through reduced estimated tax payments. This would require a year-end reconciliation through some form of tax return.

$100,000 of income would receive Social Security benefits, private pension, and IRA distributions free from the income taxes they now pay.

Many other federal programs are also indexed to reflect cost-of-living increases. For cash grant programs directed to low- and moderate-income individuals, which are not indexed for changes in prices, some increases in benefits would have to be legislated. Thus, for example, block grants to states, which now fund temporary assistance for needy families, should be increased to offset any additional tax burdens on these families resulting from the enactment of a consumption tax.

C. *Bringing the States Along*

Nearly all states impose an income tax, and although many state income taxes use federal income tax computations as a starting point, filing state income tax returns is a major source of compliance costs and complexity for many Americans. The 100 million families who would be freed from filing federal income tax returns under the plan I am advancing here would be substantially less blessed if they still had to file state income tax returns. Bringing the states into conformity with the new federal system is a major goal and would be a genuine challenge.

Simply eliminating the federal income tax for most Americans, however, would create substantial political pressures for the states to do the same. States might mimic the federal changes by financing their own $100,000 income tax exemption through an increase in sales or excise tax rates or through other sources. The federal government should give the states additional incentives to make such a change. For example, the federal government might speed the process of state conformity to the federal system by agreeing to collect and remit the states' remaining income taxes if they conform to the federal system. This would permit states to get out of the business of collecting income taxes altogether. This carrot could be accompanied by allowing federal deductions for state income taxes only for those state income taxes that conform to the federal tax.[148]

Harmonizing states' retail sales taxes and the federal consumption tax is far less important. State sales taxes and a federal value-added tax could readily coexist. But conformity, or at least coordination, of these taxes would greatly ease the burdens of compliance for businesses and reduce administrative costs for tax collectors. Even with such state conformity, the combined federal and state consumption tax rates would be no greater than value-added tax rates in Europe. (See Figure 9.) And U.S. income taxes would be much smaller.

148. For an illustration, see *infra* Appendix.

Moreover, substituting value-added taxes for state sales taxes has substantive advantages. State sales taxes are becoming more difficult to collect as Internet retail sales increase.[149] In addition, states now often impose multiple sales taxes on the same goods or services through a cascading of sales taxes that credit-method value-added taxes avoid.[150] As with the income tax, a duplication of state and federal tax collection processes should be avoided to the extent possible. Indeed, the expertise of state sales tax administrators argues for a substantial role at the state level for VAT administration, further easing demands on the IRS. And given the economic and compliance benefits of federal-state conformity in VAT tax bases, the federal government might supply additional financial incentives for state conformity when it institutes a federal consumption tax.

D. *The Individual Income Tax*

The federal income tax enacted in October 1913, following the ratification of the Sixteenth Amendment in February of that year, contained an exemption level, which limited its application to a relatively small group of the nation's highest-income taxpayers.[151] The tax was originally imposed at low rates and applied to fewer than two percent of American households.[152] The income tax did not become a tax on the masses until the federal government needed substantial new revenues to finance World War II.[153] Income tax rates reached their peak of 94% during the war, but the top rate has since declined substantially. (See Figure 10.)

149. Charles E. McLure, Jr., *Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?*, 2000 BYU L. REV. 77, 95 (asserting that e-commerce calls attention to the complexity of sales taxes).

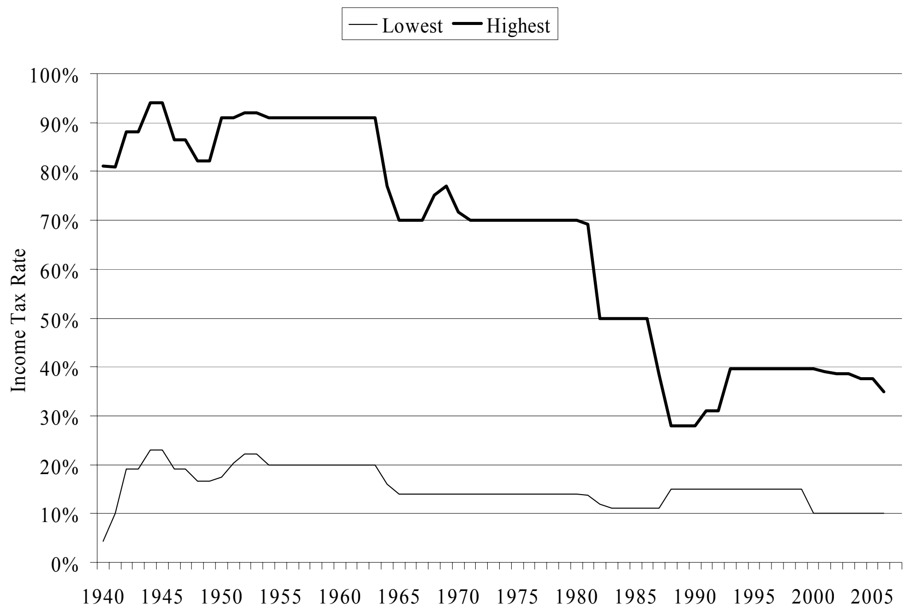
150. EBRILL ET AL., *supra* note 107, at 16-18.

151. *See* Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 166-81 (applying a "normal income tax" at a rate of 1% to all individual and corporate incomes exceeding $3000 and establishing a graduated surtax on incomes of more than $20,000).

152. *See* W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA 46 (1996). In 1910, the U.S. population was 92.2 million. U.S. CENSUS BUREAU, 1990 CENSUS OF POPULATION AND HOUSING tbl.2.

153. *See* GRAETZ, *supra* note 49, at 204.

FIGURE 10. LOWEST AND HIGHEST U.S. INCOME TAX RATES: 1940-2005[154]



Now more than 176 million people file more than 125 million tax returns annually.[155] The plan I am offering here would eliminate 100 million of these returns and restore the income tax to its pre-World War II status.

A new "family allowance" of $100,000 per family ($50,000 for unmarried taxpayers) would replace the current law's standard deductions, personal exemptions, and most personal tax credits, including child tax credits, education tax credits, and dependent care tax credits. This means that only about 25 million income tax returns would be filed each year.[156] The IRS's workload would be substantially reduced (even with the new VAT), and individuals' costs of tax compliance would be reduced dramatically. The family allowance would increase annually with inflation so that its value would remain stable when prices increase. Itemized deductions for charitable contributions, home mortgage interest, and

154. I.R.C. § 1 (1987-2001); JOSEPH A. PECHMAN, FEDERAL TAX POLICY 313-14 tbl.A-1 (5th ed. 1987).

155. Data based on 1999 Individual Income Tax Returns. *See* I.R.S. Pub. No. 1304, A Collection of 16 Tables, Plus the Introduction and Changes in Law, Description of the Sample, and Explanation of Terms Sections (Oct. 2001), *at* http://www.irs.gov/taxstats/article/0,,id=96586,00.html.

156. The IRS would continue to collect and match information on the payment of wages, dividends, interest, and proceeds from the sale of assets as a check on the accuracy of income tax filing and to enable it to inquire of taxpayers who fail to file required returns.

medical expenses would be retained.[157] Employees would be allowed to deduct their business expenses, but all other itemized deductions would be repealed.[158] Each family (which would include children under age 18) would deduct the greater of its family allowance or its itemized deductions. A flat rate tax of 25% would be imposed on income in excess of the greater of the family allowance or itemized deductions.[159] Alternatively, the family allowance might be phased out, for example, by $20 for each $100 of gross income above twice the family allowance amount. Thus, the family allowance for married taxpayers earning more than $200,000 would be reduced by $20 for each $100 of income above that amount. This means that the family allowance would be completely phased out for taxpayers earning more than $700,000. This phase-out would not, however, affect taxpayers' ability to claim itemized deductions; under this alternative, the full amount of itemized deductions would continue to be deductible. The Appendix illustrates the relative revenue effects of these two alternatives.

One straightforward way to think about this slimmed-down income tax is to consider three amendments to current law: (1) increasing the current exemption under the alternative minimum tax to the $100,000 level and indexing the exemption for inflation, (2) lowering the alternative minimum tax rate to 25%, and (3) repealing the regular income tax.[160] It would take a VAT of about 10% to fund these changes.[161] Additional simplification and broadening of this income tax base would be feasible. For example, with a 25% income tax rate, capital gains could be taxed at the same rate as ordinary income.[162] The special income tax advantages for employer-provided health insurance would be retained (at least until a better method

157. *See* I.R.C. §§ 170, 163, 213 (2000). This would mitigate substantially any adverse impact of the change on charitable contributions or the prices of owner-occupied homes.

158. *See id.* § 68. The two percent floor would also be eliminated. *Cf. id.* § 67.

159. For example, a married couple with deductions for mortgage interest, state and local taxes, and charitable contributions totaling $150,000 would be entitled to a family allowance of $100,000 and itemized deductions of $50,000. They would have no federal income tax at all imposed on the first $150,000 of income. Any additional income above that amount would be subjected to a tax of 25%. It would be feasible, of course, to have more than one income tax rate, but at this level of income, it does not seem necessary. The combined income and value-added taxes paid by high-income people would be roughly similar to that of income tax burdens under current law.

160. For an estimate of the revenue costs of these three steps, see *infra* Appendix. While this is a straightforward way to implement the income tax changes suggested here, it is not the only way. Daniel Halperin, for example, has suggested the need to consider more fundamental income tax reforms. *See* Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 TAX NOTES 967 (1997) (proposing major income tax changes). Also, it is not necessary that the income tax be imposed at a flat rate. Aligning the corporate and individual income taxes at one rate facilitates some simplification, but most of the complexity of the income tax is due to difficulties in defining the tax base, not multiple rates. Congress might, for example, deem an additional rate important for distributional reasons.

161. For more detail, see *infra* Appendix.

162. This would permit much simplification, and, unlike the 1986 Tax Reform, capital gains definitional rules and the rules for determining allowable capital losses would be streamlined.

of providing health insurance to employees is enacted) as would the tax benefits for employer-provided pension savings.[163] The current Social Security payroll tax advantages for these fringe benefits would also be retained. Thus, this tax regime—unlike proposals to replace the income tax completely with a flat tax, sales tax, or other consumption tax—should not produce any substantial decrease in employers' provision of these important protections for employees' medical expenses and retirement income.[164]

In an income tax limited to high-income individuals, further simplification should become politically possible. Most importantly, the political impetus for festooning the tax code with tax breaks for specified expenditures, which have proved so popular with Congress and recent presidents, would disappear since such income tax allowances would offer no benefits to the vast majority of Americans.[165]

E. *The Corporate Income Tax*

The corporate income tax rate would also be reduced to twenty-five percent, the same rate that would apply to the income of high-income individuals.[166] The computation of corporate income tax would be simplified substantially, and the corporate alternative minimum tax would be repealed.[167] By adopting identical tax rates (and depreciation allowances) under the individual and corporate income taxes, the income of small corporations could be taxed on a flow-through basis, thereby eliminating the separate corporate tax for many small businesses and taxing their income directly to their owners. This would allow small-business income to

163. Thus, payment of such benefits would continue to be deductible for employers, even though the receipt of such benefits would not be taxed as income to employees. Keeping the exclusion for health insurance and income-tax-favored treatment of private pensions should ensure the continuation of these important tax subsidized employer-provided benefits. For an evaluation of these programs and a discussion of policy, see GRAETZ & MASHAW, *supra* note 37, at 127-42, 163-87, 255-78.

164. GRAETZ, *supra* note 49, at 266. If, however, the $100,000 income tax exemption were to undermine employees' desire for these benefits somewhat, some additional allowance for employers might prove necessary. Both the sales tax and the flat tax would completely eliminate any benefit for employers provided by pensions or health insurance.

165. Many of these benefits are phased out for higher-income taxpayers under current law, and would automatically be eliminated with a $100,000 income tax threshold.

166. This cut in corporate tax rates need not be financed entirely by the new consumption tax. A number of possibilities exist for broadening the corporate tax base. For example, additional revenue would be provided and depreciation allowances for corporations would be simplified by requiring that plants and equipment be depreciated using a 150% declining balance method. If the additional level of corporate tax were eliminated through integration of the corporate and individual taxes, incentives under current law to use the noncorporate form of business would disappear in the new regime. *See infra* note 169.

167. For example, complex provisions for calculating credits for foreign taxes and for valuing inventories are prime candidates for simplification.

qualify for the $100,000 income tax family allowance and the corporate income tax to apply only to large publicly held companies.

In addition, the corporate income tax should require much greater conformity of tax and financial accounting rules for publicly traded corporations than the current income tax law. This convergence of tax and book accounting would greatly simplify corporate tax computations. Moreover, it offers real hope of a solution to the growing problem of corporate tax shelters, since it would make it impossible to concoct tax-reducing transactions without also reducing the company's earnings for financial reporting purposes.[168] Given companies' desire to report high earnings to shareholders, tax shelters might disappear for publicly held companies, which pay the lion's share of corporate taxes.

The corporate and individual income taxes could also be "integrated," through either an exclusion for dividends received or by allowing shareholders a credit for corporate taxes paid, thereby eliminating the double tax on corporate earnings.[169] And with a low corporate income tax rate, international business income taxation might be greatly simplified by moving to a "territorial" system of taxation.[170] Under this kind of tax system, which is used in about half of the OECD countries, the United States would collect tax on all business income earned in the United States, regardless of who owns the business, but the United States would not tax active business income earned abroad by corporations owned by Americans.[171]

F. *A Tax on Transfers of Large Amounts of Wealth*

As I have indicated, I regard the 2001 Act's repeal of the federal estate tax without any replacement as a mistake. I have also discussed the potential advantages of substituting an accessions or inheritance tax under

168. *See supra* text accompanying note 84.

169. *See supra* text accompanying note 84. A shareholder credit for corporate taxes paid is allowed in many European nations; integration might be accomplished by taxing corporate income only once at the corporate level. *See* MICHAEL J. GRAETZ & ALVIN C. WARREN, JR., INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS (1998). Notwithstanding its potential economic benefits, such integration is not an essential element of the restructuring of the nation's tax system that I am recommending.

170. Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771 (2001); *see also* Graetz, *supra* note 75, at 1432-35.

171. In order to make sure that the income excluded from U.S. tax is being taxed by the country where the income is earned and to avoid the ability of American multinational companies to eliminate tax altogether on foreign source income, a "white list" of countries in which business income would be exempt from U.S. tax might be appropriate. *See* Graetz, *supra* note 75, at 1433-34.

current law.[172] While such a tax would fit comfortably in the new tax system proposed here, no such separate tax is necessary. Much of the progressivity of the nation's tax system currently supplied by the estate tax could be maintained by treating large gifts and bequests as income to those families whose $100,000 family allowance does not exempt them from income tax. A flat tax of twenty-five percent would then apply to taxable transfers of large amounts of wealth.[173] The size of gifts or bequests required to be included in the recipient's income should be set at a level that maintains at least half the revenue that the estate tax would have produced.[174]

V. CONCLUSION

Restructuring the nation's tax system as I have described here would not entail any substantial shift in the distribution of tax burdens among American families at different income levels. Families who save more would fare better under the new consumption tax than under the existing income tax, but this is an intended consequence of replacing income taxes with taxes on consumption. Nor would this plan reduce overall federal revenues. The Appendix details estimates of the revenue effects of this plan. Estimates suggest that the individual income tax relief described above would reduce revenues by about $600 billion; that the adjustment for low- and moderate-income workers could cost roughly another $100 billion; and that, depending on how depreciation allowances are determined, reducing the corporate tax rate might reduce corporate tax revenues anywhere from zero to more than $100 billion. At a 14% rate, the new consumption tax is projected to increase revenues by the approximately $800 billion needed to fund these changes.

Thus, like the Tax Reform Act of 1986, the restructuring of our nation's tax system that I advocate here would be both revenue- and distributionally neutral.[175] Its principal advantage would be its major simplification of the tax lives of the American people. My plan would eliminate more than 80% of the income tax returns that currently are filed each year and would allow substantial simplification of the limited income tax that would remain. (See Figure 11.)

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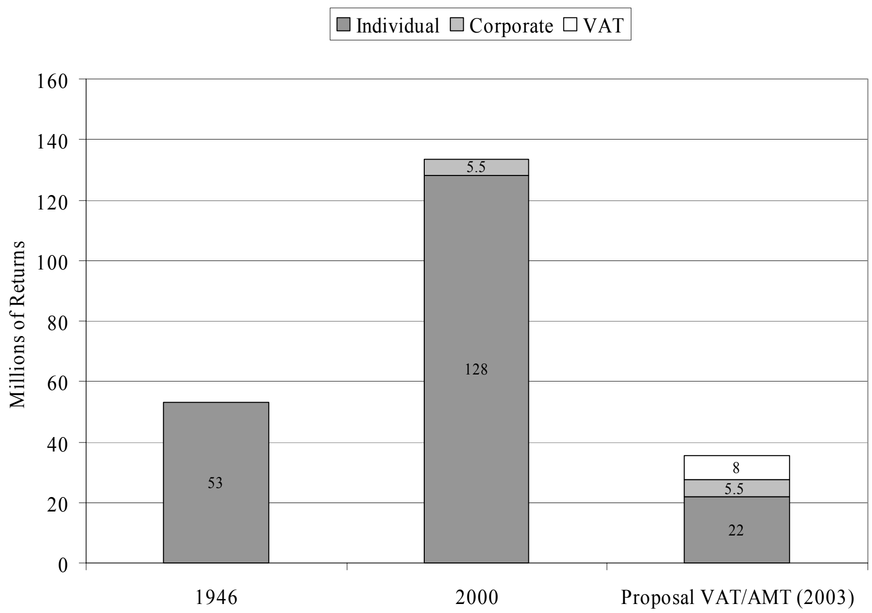
172. *See supra* text accompanying note 30.

173. Including such gifts and bequests in the recipient's income would be roughly the same as imposing a flat twenty-five percent accessions tax.

174. *See infra* Appendix.

175. These two conditions were extremely important in paving the way politically for the Tax Reform Act of 1986. *See* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 29-31, 59 (1987); Graetz, *supra* note 65, at 623-25. There is a major revenue gap in the years ahead under current law due to the import of the alternative minimum tax. *See* Tempalski, *supra* note 3.

FIGURE 11. TAX RETURNS FILED (MILLIONS)[176]



The IRS should then be fully capable of administering the nation's tax system, a task which it is unable to fulfill under the current tax law. As sales tax proponents are fond of saying, for the more than 150 million people from whom no income tax would be required, April 15th would be just another spring day.[177]

Revamping the nation's tax system should also produce positive economic benefits. The new tax system would be friendlier to savings and investment than the existing tax law. The tax burden on savings would be reduced for everyone, and people subject only to the new consumption tax would have no tax burden on their savings whatsoever. The corporate income tax would be reduced to a twenty-five percent rate, making the United States an extremely attractive nation for corporate investments for both U.S. citizens and foreigners. This tax system should stimulate

176. IRS, DATA BOOK 2000; U.S. GEN. ACCOUNTING OFFICE, *supra* note 122, at 140. GAO has estimated that an exemption for small businesses with gross receipts of $100,000 or less would reduce the required number of VAT returns from 24 million to 5.4 million. U.S. GEN. ACCOUNTING OFFICE, VALUE-ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES 62 (1993). We assume here that such a small business exemption would be included in a VAT and show 8 million VAT returns filed, since some small businesses will opt onto the VAT to obtain refunds and to account for growth since the GAO report was published.

177. Ann Reilly Dowd, *Get the Facts on Tax Reform*, MONEY, Jan. 1998, at 86-87 (quoting Rep. W.J. (Billy) Tauzin).

economic growth and create additional jobs for American workers, producing substantial long-term benefits for the American economy.[178]

When it first takes effect, the consumption tax might produce consumer price increases equal to the amount of the tax, but the Congressional Budget Office has predicted that no inflation should occur beyond that initial price jump.[179] For most families, the price increase could be offset by the increase in their weekly paychecks due to the elimination of the income tax. As I have discussed in detail, low- and moderate-income workers would be protected through payroll tax withholding adjustments and the elderly would largely be protected by increased Social Security benefits and the elimination of income taxes on their retirement income. Thus, for most Americans, this one-time price adjustment should have little adverse impact.

The most common objection to the tax system I have proposed here is grounded in fears that it would not prove stable: fear that the size of the family allowance would gradually creep downward, thereby ensnaring more and more Americans into the income tax, as well as fear that both income and consumption tax rates would creep upward over time. The 1990s unraveling of the low rates of the 1986 tax reform offers an unfortunate precedent fueling such fears. The proposal I have advanced here is structured to minimize the likelihood of such instability. The VAT rate necessary to fund the income tax changes described here (14% to 15%) is at a sufficiently high level that, taking state sales tax rates into account, it would be difficult to push the VAT rate much higher. Nevertheless, an upward creep in the VAT tax rate is a possibility if Congress should desire additional revenues.

On the other hand, reduction of the $100,000 income tax exemption seems extremely unlikely. A political speech urging restoration of income taxation to families with incomes below that level is difficult to imagine, regardless of the speaker's political party. Remember, it took the cataclysm of World War II to extend the income tax to the masses in the first instance.

178. Probably the most comprehensive effort to estimate the economic benefits from the tax reform alternative is David Altig et al., *Simulating Fundamental Tax Reform in the United States*, 91 AM. ECON. REV. 574 (2001). They estimate "significant long-run increases in output" from a proportional consumption tax, an increase of more than nine percent. *Id.* at 593. Because the proposal I advance here retains some income tax, the gains in output would be somewhat less, but still significant. Emmanuel Saez suggests that an income tax limited to high-income taxpayers, combined with a consumption tax on the masses, would have no adverse effect on the long-run capital stock. EMMANUEL SAEZ, OPTIMAL PROGRESSIVE CAPITAL INCOME TAXES IN THE INFINITE HORIZON MODEL (Nat'l Bureau of Econ. Research, Working Paper No. 9046, 2002). In addition to reducing the distortions caused by current law on choices to save or invest, this proposal would also reduce distortions between corporate and noncorporate forms and between housing and other investments.

179. CONG. BUDGET OFFICE, COMPARING INCOME AND CONSUMPTION TAX BASES 35 (1997). Whether price increases of even this magnitude would actually occur depends on monetary policies adopted by the Federal Reserve.

Moreover, there are substantive advantages to using two low-rate taxes on both consumption and income rather than relying solely on the income tax. Economic distortions should be smaller. Tax avoidance would be more difficult; those who are able to conceal their income would be taxed when they spend. Aggressive tax planning would reap smaller benefits. Thus, the system I advocate here should be more efficient, more equitable, and much simpler than the present income tax.

Nevertheless, for this plan to be viable politically, a supermajority voting requirement might become necessary—a requirement, for example, of a vote of sixty percent of both the House of Representatives and the Senate to raise either consumption or income tax rates or to lower the amount of the income tax family allowance.[180] Such a supermajority requirement would preclude this tax reform from becoming a first step toward both high income and high consumption taxes. With this protection, the American public could look forward to a fair, simple, and economically friendly tax system for the twenty-first century.

To be sure, today's political climate makes it difficult to see how we might muster the necessary bipartisan majority to achieve such a fundamental restructuring of the nation's tax law. It is difficult to be optimistic that we will move forward intelligently when, in our political discourse, ideology trumps ideas and demagoguery drowns out debate. But a political opportunity for major tax reform could occur at any time. The 1986 Tax Reform Act demonstrated that strong presidential leadership can overcome long odds against major change. When the political stars become aligned, the road forward must be well lit.

In the meanwhile, for the timid—those who insist on keeping the income tax the centerpiece of our nation's tax system—I close by offering a related alternative: A consensus has apparently emerged for repeal of the alternative minimum tax (AMT) because of the 2001 Act's failure to avoid the massive increase in the number of taxpayers the AMT will affect when the 2001 Act's rate reductions are fully phased in.[181] But instead, we should repeal the regular income tax. If the 2001 Act does not sunset in 2010 and

180. GRAETZ, *supra* note 49, at 286-88 (describing a House rule that, beginning in 1995, required a supermajority to raise taxes). House Rule XXI(5)(c) required a three-fifths majority of those voting to pass an increase in tax rates. Rules of the House of Representatives, H.R. DOC. NO. 103-432, R. XXI(5)(c), at 658 (1995). Shortly thereafter, seventeen law professors asserted that the rule was unconstitutional. *See* Bruce Ackerman et al., *An Open Letter to Congressman Gingrich*, 104 YALE L.J. 1539 (1995). For a defense of the constitutionality of the House rule, see John O. McGinnis & Michael B. Rappaport, *The Constitutionality of Legislative Supermajority Requirements: A Defense*, 105 YALE L.J. 483 (1995). *See also* Eric A. Posner & Adrian Vermeule, *Legislative Entrenchment: A Reappraisal*, 111 YALE L.J. 1665, 1683-87 (2002); *id.* at 1690 ("Critics of entrenchment must show that good use of entrenchment is outweighed by abuse, and that entrenchment lends itself to abuse more than other legislative powers do.").

181. *See* BURMAN ET AL., *supra* note 3, tbl.8 (estimating that repealing the AMT after 2002 would cost $788 billion in lost revenues over the next decade); *supra* text accompanying note 3.

the AMT remains unchanged, more revenue would be produced in 2008 by the AMT standing alone than by the regular tax.[182] If the regular tax were then repealed, about forty million fewer families would have to file tax returns, eliminating about one-third of all filers from the rolls. People who applauded the 1986 Act's approach to tax reform—lower rates and a broader tax base—should stop complaining about the AMT and start campaigning for repeal of the regular tax. Such a half-loaf would be better than nothing at all if the political landscape in the decade ahead does not become congenial to a tax restructuring plan along the lines I have advocated here. And it may set the stage for enactment of the whole loaf. Continuing with the current tax law portends ever greater complexity, rising dissatisfaction with the tax system, and a decreasing willingness of Americans to comply with tax requirements they cannot comprehend.

182. *See* Leonard E. Burman et al., *The AMT Will Cost More To Repeal Than the Regular Income Tax*, 96 TAX NOTES 1641 (2002); *see also* BURMAN ET AL., *supra* note 3, at 7.

APPENDIX: ESTIMATES FOR GRAETZ PROPOSAL[183]

TABLE 1. COSTS AND FUNDING (BILLIONS OF DOLLARS)

Calendar year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-12
$100,000 income tax exemption (AMT base, 25% rate)[1]	-577	-601	-640	-655	-694	-732	-779	-826	-878	-938	-7320
10% VAT[2]	565	596	628	661	696	731	768	807	848	891	7191
Net revenue	*-12*	*-5*	*-12*	*6*	*2*	*-1*	*-11*	*-19*	*-30*	*-47*	*-129*
Tax capital gains at 25%	17	17	17	19	19	20	21	22	23	25	200
Net revenue	*5*	*12*	*5*	*25*	*21*	*19*	*10*	*3*	*-7*	*-22*	*71*
Tax large gifts and bequests[3]	24	25	22	25	22	23	25	24	26	22	238
Net revenue	*29*	*37*	*27*	*50*	*43*	*42*	*35*	*27*	*19*	*0*	*309*

[1] The proposal would (1) repeal the regular individual income tax, (2) increase the AMT exemption to $50,000 (singles) and $100,000 (joint returns), (3) index the AMT exemption, (4) lower the AMT rate to a flat 25%, and (5) phase out the AMT exemption at $20 for every $100 in excess of $100,000 (singles) and $200,000 (joint returns). (The current AMT phase-out is $25 for every $100 over $112,000 (singles) and $150,000 (joint returns).) Further broadening the AMT base could reduce the revenue cost of this change. Taxing capital gains at the same 25% rate as ordinary income is one possibility.

[2] The VAT base is as described in the text.[184] This results in a VAT tax base equal to about 50% of GDP.

[3] These estimates are intended to illustrate revenues from recovering roughly one-half of the estate tax revenue loss projected from estate tax repeal by taxing recipients of large gifts and bequests or including them in income. These estimates are based upon Congressional Budget Office (CBO) projections of estate tax revenues. The amounts shown here for the years 2003-2009 are revenues anticipated under the 2001 Act. Beginning in 2010, when repeal is effective, the amounts are one-half the revenues projected prior to enactment of the 2001 Act.[185]

183. These estimates were prepared for a seminar delivered to the U.S. Treasury Office of Tax Policy in August 2002. The Treasury's Office of Tax Analysis assisted in the development of these estimates in connection with that seminar. The proposals are assumed to be effective January 1, 2003. The sunset of the 2001 Act, scheduled for 2011, is assumed to be repealed. These estimates do not include any potential interactions among the proposals.

184. *See supra* text accompanying note 120.

185. *See* CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2003-2012 tbl.3-3 (2002) [hereinafter CBO, FISCAL YEARS 2003-2012] (for years 2003-2009, 2012); CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2002-2011 tbl.3-2 (2001) [hereinafter CBO, FISCAL YEARS 2002-2011] (for years 2010-2011).

TABLE 2. COSTS AND FUNDING (BILLIONS OF DOLLARS): ALTERNATIVE

Calendar year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-12
$100,000 income tax exemption (AMT base, 25% rate)[1]	-546	-567	-604	-616	-653	-689	-733	-778	-828	-885	-6899
10% VAT[2]	565	596	628	661	696	731	768	807	848	891	7191
Net revenue	*19*	*29*	*24*	*45*	*43*	*42*	*35*	*29*	*20*	*6*	*292*
Tax capital gains at 25%	17	17	17	19	19	20	21	22	23	25	200
Net revenue	*36*	*46*	*41*	*64*	*62*	*62*	*56*	*51*	*43*	*31*	*492*
Tax large gifts and bequests[3]	24	25	22	25	22	23	25	24	26	22	238
Net revenue	*60*	*71*	*63*	*89*	*84*	*85*	*81*	*75*	*69*	*53*	*730*

[1] The proposal would (1) repeal the regular individual income tax, (2) increase the AMT exemption to $50,000 (singles) and $100,000 (joint returns), (3) index the AMT exemption, (4) lower the AMT rate to a flat 25%, and (5) allow AMT itemized deductions only to the extent that exceed the new exemption levels. (In this alternative, there is no phase-out of the exemption amount.) Further broadening the AMT base could reduce the revenue cost of this change. Taxing capital gains at the same 25% rate as ordinary income is one possibility.

[2] The VAT base is as described in the text.[186] This results in a VAT tax base equal to about 50% of GDP.

[3] These estimates are intended to illustrate revenues from recovering roughly one-half of the estate tax revenue loss projected from estate tax repeal by taxing recipients of large gifts and bequests or including them in income. These estimates are based upon CBO projections of estate tax revenues. The amounts shown here for the years 2003-2009 are revenues anticipated under the 2001 Act. Beginning in 2010, when repeal is effective, the amounts are one-half the revenues projected prior to enactment of the 2001 Act.[187]

186. *See supra* text accompanying note 120.

187. *See* CBO, FISCAL YEARS 2003-2012, *supra* note 185, tbl.3-3 (for years 2003-2009, 2012); CBO, FISCAL YEARS 2002-2011, *supra* note 185, tbl.3-2 (for years 2010-2011).

TABLE 3. TOTAL INCOME TAX FILINGS ELIMINATED (MILLIONS)

Calendar year		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-12
Returns filed under current law		136	138	140	143	145	147	150	152	155	158	1464
Returns eliminated under proposal	**Returns with liability under current law**	-83	-83	-83	-84	-84	-85	-85	-86	-86	-87	-846
	Returns with no liability under current law	-34	-35	-36	-36	-37	-37	-39	-40	-40	-41	-375
Estimated nontaxable returns still filed under proposal[1]		3	3	3	3	3	3	3	3	3	3	30
Net returns filed under proposal		*22*	*23*	*24*	*26*	*27*	*28*	*29*	*29*	*32*	*33*	*273*
Decrease in returns filed under proposal		84%	83%	83%	82%	82%	81%	81%	81%	79%	79%	81%

1 Some nonliability returns will continue (e.g., returns with business losses).

FIGURE 12. TAXABLE RETURNS

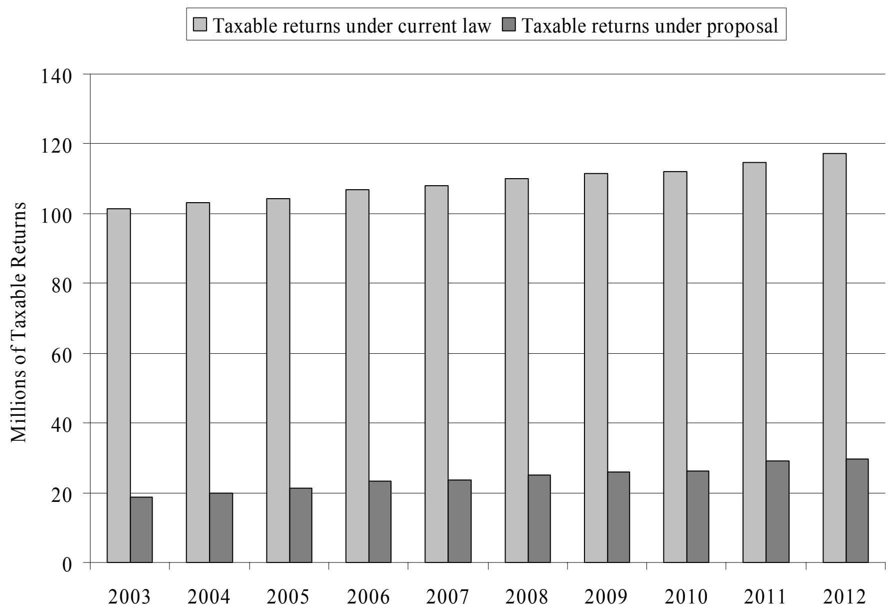


TABLE 4. REPLACEMENT OF EITC AND RELIEF FOR LOW- AND MODERATE-INCOME FAMILIES (BILLIONS OF DOLLARS)*

Calendar year	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2003-12**
EITC costs and outlays under current law	-36	-36	-37	-38	-39	-41	-42	-44	-44	-44	-401
Revenue generated by additional 2% VAT[1]	113	119	126	132	139	146	154	161	170	178	1438
Net additional revenue available for low- and moderate-income families' relief	*77*	*83*	*89*	*94*	*100*	*105*	*112*	*117*	*126*	*134*	*1037*

* EITC would be replaced and low- and moderate-tax relief would be provided through the payroll tax withholding system (trust funds would not be affected).[188]

[1] VAT base is as described in the text.[189] This results in a VAT tax base equal to about 50% of GDP. Two percent VAT is illustrative only.

188. *See supra* text accompanying note 139.
189. *See supra* text accompanying note 120.

TABLE 5. PROPOSED CORPORATE INCOME TAX REDUCTION AND INTEGRATION (BILLIONS OF DOLLARS)

Calendar year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-12
Reduce corporate tax rate to 25% flat rate	-88	-89	-117	-117	-113	-117	-118	-117	-117	-121	-1114
1% VAT to fund corporate relief	57	60	63	66	70	73	77	81	85	89	721
Exclude dividends from individual income tax	-27	-29	-29	-30	-32	-35	-37	-39	-42	-45	-345
***Net cost*[1]**	*-58*	*-58*	*-83*	*-81*	*-75*	*-79*	*-78*	*-75*	*-74*	*-77*	*-738*

[1] This net cost could be recouped by base broadening. Examples of potential base broadening include modification of depreciation to 150% declining balance, greater conformity between book and tax accounting, adopting a Comprehensive Business Income Tax (CBIT) as described by the Treasury Department in 1991,[190] and shifting to a territorial tax system.

TABLE 6. BRINGING THE STATES ALONG

Calendar year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-12
Allow state/local taxes as an income tax deduction	-50	-55	-60	-65	-70	-74	-79	-85	-91	-98	-727
1% VAT to fund state tax relief	57	60	63	66	70	73	77	81	85	89	719
***Net cost*[1]**	*7*	*5*	*3*	*1*	*0*	*-1*	*-2*	*-4*	*-6*	*-9*	*-8*

[1] This estimate illustrates the revenue cost from adding a state and local tax deduction for existing state and local taxes, which are not now deductible under the AMT. Under the proposal, any state income tax deductions would be conditioned on conformity with the new federal system. The revenue estimates shown here are intended only to suggest that the potential magnitude of an additional allowance for the states might require an additional one percentage point in the VAT rate.

190. *See* GRAETZ & WARREN, *supra* note 169, at 119-66.

TABLE 7. SUMMARY OF COSTS AND FUNDING:
14% VAT TOTAL RATE (BILLIONS OF DOLLARS)

Calendar year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-12
10% VAT	565	596	628	661	696	731	768	807	848	891	7191
Tax large gifts and bequests	24	25	22	25	22	23	25	24	26	22	238
Tax capital gains (25%)	17	17	17	19	19	20	21	22	23	25	200
$100,000 income tax exemption (AMT base, 25% rate)	-577	-601	-640	-655	-694	-732	-779	-826	-878	-938	-7320
2% VAT	113	119	126	132	139	146	154	161	170	178	1438
Replace EITC	-36	-36	-37	-38	-39	-41	-42	-44	-44	-44	-401
Additional funds for low- and moderate-income families' relief[1]	-77	-83	-89	-94	-100	-105	-112	-117	-126	-134	-1037
1% VAT	57	60	63	66	70	73	77	81	85	89	721
Base broadening	58	58	83	81	75	79	78	75	74	77	738
Corporate rate reduction to 25% and dividend exclusion[2]	-115	-118	-146	-147	-145	-152	-155	-156	-159	-166	-1459
1% VAT	57	60	63	66	70	73	77	81	85	89	721
State/local income tax deduction	-50	-55	-60	-65	-70	-74	-79	-85	-91	-98	-727
14% VAT total rate net	*36*	*42*	*30*	*51*	*43*	*41*	*33*	*23*	*13*	*-9*	*303*

1 Assumes two percentage points of VAT devoted to relief for low- and moderate-income families.
2 As indicated, a substantial portion of this cost might be funded by broadening the base of the corporate tax. Base broadening is discussed in note 1 of Table 5.

TABLE 8. SUMMARY OF COSTS AND FUNDING:
14% VAT TOTAL RATE (BILLIONS OF DOLLARS):
ALTERNATIVE

Calendar year	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2003-12**
10% VAT	565	596	628	661	696	731	768	807	848	891	7191
Tax large gifts and bequests	24	25	22	25	22	23	25	24	26	22	238
Tax capital gains (25%)	17	17	17	19	19	20	21	22	23	25	200
$100,000 income tax exemption (AMT base, 25% rate)	-546	-567	-604	-616	-653	-689	-733	-778	-828	-885	-6899
2% VAT	113	119	126	132	139	146	154	161	170	178	1438
Replace EITC	-36	-36	-37	-38	-39	-41	-42	-44	-44	-44	-401
Additional funds for low- and moderate-income families' relief[1]	-77	-83	-89	-94	-100	-105	-112	-117	-126	-134	-1037
1% VAT	57	60	63	66	70	73	77	81	85	89	721
Base broadening	58	58	83	81	75	79	78	75	74	77	738
Corporate rate reduction to 25% and dividend exclusion[2]	-115	-118	-146	-147	-145	-152	-155	-156	-159	-166	-1459
1% VAT	57	60	63	66	70	73	77	81	85	89	721
State/local income tax deduction	-81	-89	-96	-104	-111	-117	-125	-133	-141	-151	-1148
14% VAT total rate net	*36*	*42*	*30*	*51*	*43*	*41*	*33*	*23*	*13*	*-9*	*303*

1 Assumes two percentage points of VAT devoted to relief for low- and moderate-income families.
2 As indicated, a substantial portion of this cost might be funded by broadening the base of the corporate tax. Base broadening is described in note 1 of Table 5.