A Supplemental Expenditure Tax

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U.S. tax reform is challenged by a basic dilemma: top rates need to be reduced to encourage savings and investment and to enable more equal treatment of different forms of income. But if top rates are reduced substantially, progressivity is undermined and substantial revenue needs to be made up. To some extent, the problem can be dealt with by eliminating or scaling back tax preferences, but this is politically difficult to do.

The Supplemental Expenditure Tax (SET) provides a solution. It restores progressivity to the desired level. It makes up needed revenue. And it makes the tax system more friendly to business, investment, and savings. By taxing consumption, it provides a break to entrepreneurs who reinvest in the business. By meeting these policy criteria, the SET can obtain bipartisan support.

1.0 INTRODUCTION

1. This paper discusses the pros and cons of a supplemental expenditure tax (SET). The specifics of how an SET might be drafted to fit in with the existing income tax are discussed for the United States, including by way of draft statutory language.

2.0 WHY AN SET?

2.01 Why a Consumed Income Tax?

2. Compared with the income tax, the SET is relatively nondistortionary. All income from capital is taxed in the same manner, i.e. on the basis of cash flow. Therefore, there is no distortion in favor of one kind of financing or investment or business arrangement. The SET is blind to the way that the taxpayer arranges his or her investments. It cares only when the taxpayer withdraws money for personal consumption. This is in contrast to the income tax, which applies differently depending on whether the taxpayer "realizes" gains or how the taxpayer finances investments (debt, equity, retained earnings, etc.). Thus in practice the SET could have a broader tax base than the income tax. Under current law, a significant portion of the income of the wealthy (unrealized capital gains) may go completely untaxed.

3. The main purpose of the SET is the same as that of the personal income tax, namely to increase the progressivity of the tax system. It might be difficult to reach the desired degree of progressivity in a tax reform that lowers income tax rates.

4. As explained below, the SET is not immune to tax fraud. Tax fraud can, however, be dealt with by robust enforcement. Moreover, as long as there is credible enforcement, only a small minority of individuals are willing to engage in substantial tax evasion. This is both because there is a threat of penalty and a reluctance to violate the law in such an overt way. The group interested in engaging in legal tax avoidance is much larger. The scope for avoidance is much narrower for the SET than for the income tax. Because the SET is based on cash flow, there is much less scope for characterizing a particular cash receipt or outlay in a tax-advantaged way than there is under the income tax. Moreover, many transactions that serve to reduce tax under the income tax simply do not work to reduce SET liability. For example, for income tax purposes if the taxpayer sells property at a loss and reinvests the proceeds, a loss is generated for tax purposes. The same transaction does not affect tax liability under the SET. Under the income tax, amounts can be invested in a trust, partnership, or corporation, in ways that reduce tax liability. How amounts are invested is irrelevant for the SET. If the taxpayer invests cash, the reduction of tax is the same no matter what the investment vehicle. And tax must be paid on the amount of cash withdrawn from an investment no matter what its nature. There is no scope under the SET to take advantage of leverage or recharacterization of transactions, since these do not affect SET liability. The only thing of relevance is whether cash moves into an investment (deductible) or is withdrawn (taxable).

2.02 Why a Supplemental Tax instead of replacing the income tax?

5. A long-range goal of reform for some might be for the entire income tax to be converted to a consumed-income tax. By contrast, the SET serves as a complement to the income tax rather than as a replacement. Replacing the income tax with a consumed-income tax would raise substantial additional issues, some of the more complex involving what happens to corporate taxation internationally. While one could replace the corporate income tax with a cash-flow distributions tax, this raises issues of coordination with other countries. While these issues could be worked out, the solution is not obvious, and it would require substantial international coordination, including revising the existing tax treaty network. The difficulties involved suggest to me that tax policy officials would be reluctant to tackle such a discontinuous change to the tax system, unless they were convinced that it was unavoidable or was highly preferable to current law.

6. Transition to a full-fledged consumed income tax that would replace the existing income tax would also be more difficult than that involved in applying the SET (see Section F below), most likely involving rules that preserved the value of existing tax basis, which would be complex to apply.

7. As a result, an SET looks like a more workable approach than replacing the income tax with a consumed-income tax. Moreover, the untested nature of a personal expenditure tax suggests that it might be foolhardy for a country to fully replace its income tax with an expenditure tax.

2.03 Tax Administration Considerations

8. Adoption of an SET would require a few changes in information reporting. Credit card issuers could be required to report total purchases charged by the taxpayer for the year, and total payments made by the taxpayer to the card issuer. Banks could be required to report total deposits made in the taxpayer's accounts during the year, as well as final account balances. These numbers could be added (backing out amounts paid to the card issuer), and would represent a ballpark estimate of total consumption by the taxpayer for the year in question. If the estimate differs substantially from the return as filed, an audit could be commenced.

9. The reports from credit card issuers would not be used for direct calculation of the SET base. The purpose of getting this information is to set up a cross-check against what is reported by the taxpayer as total consumption. If there is too large a discrepancy, there would be a reason for audit. Only an audit would allow the tax administration to determine whether an adjustment is appropriate, and how much that adjustment should be.

10. The SET could be evaded by using off-shore accounts that are not reported to the IRS. The SET would probably be more vulnerable than the income tax to this type of evasion. For example, tax could be evaded by selling an asset and depositing the proceeds in an offshore account. Asset sales are notoriously difficult to detect. In the case of the income tax, a taxpayer selling an asset and not reporting the sale would succeed in evading the tax on the capital gain from the sale. However, under an expenditure tax, the taxpayer reduces the tax base by the full amount of the sales proceeds, assuming that the offshore funds are eventually used to fund consumption expenditure. Historically, it has been difficult for the IRS to police the proper declaration of amounts held offshore. Recently, substantial progress has been made in this respect, and it looks like the ability of individuals to hide money offshore will have been significantly curtailed within the next few years.

3.00 SET Design Issues

3.01 In general

11. The SET would be a cash-flow tax (i.e. cash receipts, with a deduction allowed for net investments). Such a tax would be substantially simpler than the current income tax, although it does involve some design issues and new elements as outlined below.[1]

[1] Except as otherwise noted, I follow the design recommendations for the expenditure tax in Michael Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575 (1979).

12. In a broad sense, the SET is very similar to the income tax, except that includable receipts are defined more broadly than under the income tax and the SET does not tax income until the income is consumed (generally, investment is deductible).

13. Taxpayers would determine their SET liability using the same information as for the regular income tax, with a few modifications. The general approach is cash flow. Thus, items of income are taken into account when received. A deduction is allowed for any investments when made. This includes business investments. Borrowing would generally be included in taxable receipts, a deduction would be allowed for net savings, and includable receipts would be somewhat broader than under the income tax. Personal deductions would generally be the same as under the regular income tax.

14. Even though the tax base is personal expenditure, the base would be legally defined as income less specified deductions. This provides for a precise specification of how the tax base is determined.

15. Appropriate levels for the SET exemption, or for the rates, will depend on the whole tax policy picture. The SET rates and exemption can be determined at the end of the process of designing a tax reform bill so as to attain the desired distributional and revenue results. In very general terms, however, I would envisage setting the SET exemption at a rather high level, so that only a small percentage of taxpayers would pay this tax. This makes sense from the point of view of tax administration and simplification.

16. The SET would be a return-based tax that would be implemented with an additional schedule on Form 1040 and would be administered as part of the income tax.

3.02 Specific Design Elements

A. Jurisdictional basis.

17. As with the income tax, the SET would apply to individuals who are citizens. It would not apply to corporations or partnerships. Distributions from those entities would, however, be included in the SET tax base of the individual distributees. This would not require particularly complex calculations, since all that is needed is the amount of cash distributions, an amount that is relevant for income tax purposes as well.

B. Income.

18. Income would be defined much as under the regular income tax. Thus, income would include wages, interest, dividends, royalties, and the like. A major difference from the income tax is that the proceeds of sales are fully taxed when received, i.e. it is not just the gain that is includable in taxable receipts but the entire sales proceeds. These are accounted for on a cash basis, so, for example, installment sales would be taxed as cash is actually received, not at the time the sale takes place.

19. Fringe benefits present much the same issues under an expenditure tax as under the income tax. Accordingly, one could expect the same solutions, i.e. if a particular item is

taxed as a fringe benefit under the income tax, it would be taxed in the same way under the SET. An example would be use of an employer-provided automobile.

C. Deductions.

20. In general, allowable deductions would be the same as for the income tax. For example, if under the income tax a deduction is allowed for charitable contributions, the same would be allowed for the SET, with whatever limitations apply for purposes of the income tax. The same would be true for medical expenses, taxes, alimony, and other itemized deductions.

21. A deduction would be allowed for life insurance premiums, whether for term insurance or insurance that has an investment component. In other words, all life insurance would be treated like savings. The reason is to avoid having to make distinctions among different kinds of life insurance policies. (All life insurance has a certain degree of investment value.) Correspondingly, life insurance payouts would be taxable to the beneficiary of the policy when received.[2]

D. Treatment of debts.

22. As a general rule, all borrowing proceeds are included as taxable receipts and a deduction is allowed for interest and principal paid on loans. If the borrowing proceeds are used for investment, an offsetting deduction is allowed.

23. The only exception to the general rule is for home mortgages, auto loans, and loans for other consumer durable items, purchased with debt secured by the item. In these cases, the taxpayer will be taxed on amounts used to pay off the loan, because no deduction would be allowed for principal or interest payments made. This approach times taxation closer to actual consumption of the consumer durable.

24. Forgiveness of loans the proceeds of which were included in taxable receipts would not be taxed. On the other hand, forgiveness of mortgage debt, auto loans, and loans to acquire consumer durables would be taxed (since the loan proceeds were not taxed). Note, however, that there is unlikely to be much SET liability by reason of taxation of loan forgiveness, given the high threshold. Most people in a position to have their consumer debt forgiven will not be subject to the SET in the first place because of the threshold. To deal with cases where the amount of loan forgiven is large, provision could be made in the law for spreading the taxable amount over several years, in order to allow taxpayers to make use of the threshold. Otherwise, a taxpayer generally below the threshold might get bumped up into being taxable in the year when a large mortgage loan is forgiven.

E. Treatment of cash.

[2] See Graetz, supra note 2, at 1611-13.

25. In principle, cash could be tracked, but the simpler approach is not to do so. This means, for example, that when an investment asset is liquidated and cash proceeds are obtained, the cash is included in the SET base at the time of receipt as personal expenditure. The particular time that the taxpayer uses the cash to pay for consumption items is irrelevant.

26. The suggested treatment of cash will allow taxpayers to engage in a certain amount of self-help averaging. If a taxpayer wants to increase the SET base for a year, this can be done by liquidating an investment and receiving cash. By contrast, a transfer of cash into a checking account or other investment account will reduce the tax base for that year. In addition to this legitimate averaging opportunity, there is an opportunity to evade tax by failing to declare cash receipts and then transferring the cash into a bank account. The result would be a reduction of the tax base, beyond what could be accomplished under the income tax by failing to declare the cash income. Manoevres like this should raise a red flag for audit, but highlight that audit capacity does need to be there in order for the tax to succeed.

F. Housing.

27. To understand the treatment of owner-occupied housing under the SET, consider first the typical case of a home that is mortgage-financed. A purchase money mortgage used to buy a residence[3] would be left out of debt account (in other words, the borrowing proceeds are not taxable and repayments are not deductible). In the case of someone buying a home with cash or putting up a substantial down payment, it would be unfair to treat the entire amount as expenditure for SET purposes in the year that the house is purchased. (Bunching all this expenditure into one year would tend to place the taxpayer into a higher tax bracket than usual.) The remedy is to allow the taxpayer to amortize the expenditure over some lengthy period, say 20-30 years (interest should be charged on the outstanding balance; in effect, the taxpayer would be put on the same footing as if a mortgage had been used.). The taxpayer should be allowed to notionally pay off all or part of the outstanding balance at any time, thereby including this amount in the SET base. This would put the taxpayer on a similar footing to someone who financed with a mortgage, who could achieve this tax result by paying off all or part of the mortgage. It would be advantageous for a taxpayer to do this in any year where there is an unused exemption amount under the SET.

G. Other consumer durables.

If a taxpayer purchases a consumer durable, the transaction does not lead to a substantial amount of consumption for the year in an economic sense, given that annual consumption should include only the value of use of the durable for the year in question, not the entire value of the durable. However, from a legal point of view, absent a special rule, the entire purchase price is part of taxable expenditure for the year, because the SET treats the entire

[3] Including a second home, as well as collectibles and the like described in para. 45 below.

consumption as occurring in the year of purchase.[4] As with housing, the case of consumer durables purchased with debt can be dealt with by ignoring the debt-financed part of the transaction. The debt could be excluded from receipts, with no deduction allowed for loan repayments. The result will be that loan repayments will be taxed as consumption as they are made. This is the same rule as applies for debt-financed owner occupied housing. As with housing, one could also amortize the cost of consumer durables purchased with cash over a period of years.

H. Averaging.

28. An argument can be made for averaging under an SET. In a number of situations the taxpayer may incur substantial expenses for reasons largely beyond the taxpayer's control. These may be items such as medical expenses, legal fees, or tuition. If these expenses cause taxable expenditure to be higher than normal, the tax consequence may be considered unfair. An averaging rule could address this concern. Such a rule would, however, introduce complexity to the system. The complexity would involve both definitional issues as well as administrative burdens for both taxpayers and the tax administration in keeping track of carryovers from one year to the next. The added complexity of an averaging rule could be minimized by limiting the rule to expenditures that are quite large as a portion of taxable expenditure. The simplest approach would be to include no averaging rule.

I. Carryover of exemption.

29. The specific form of SET proposed raises an averaging problem that is somewhat different from that under a broader consumed-income tax. The large annual threshold means that taxpayers with relatively low amounts of consumption in a given year "waste" that year's exemption. This could be dealt with by allowing taxpayers to file the information on expenditure with their return even if they are not subject to the SET for the year in question, and carry over the unused exemption. Although this would involve a recordkeeping burden, it is not major, particularly for taxpayers with relatively simple financial affairs. If this option were not allowed, taxpayers would have the incentive to accelerate consumption into low-expenditure years (for example by purchasing consumer durables rather than investments), and this distortion would not make sense as a matter of policy. Administration of the rule might be simplified by limiting the amount that could be carried over, as well as limiting the period of time for the carryover (otherwise, returns that are many years old might have to be audited in the tax year when the carryover is used, at which point much of the applicable information might no longer be available).

J. International aspects.

30. Rules would be needed to avoid double taxation in the case of residents who earn amounts from foreign sources and pay foreign tax. This can be done either by allowing a credit against SET for foreign income tax paid, or exempting from the SET base amounts of consumption that are financed by foreign-source income. On introduction of the SET, for

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[4] The same approach is taken by the VAT.

purposes of the foreign tax credit, the SET should be considered as part of the income tax. In general terms, the foreign tax credit limitation formula is:

$$FT/FTI = DIT/TTI, \quad \text{or} \quad FT = DIT\ (FTI/TTI),$$

Where FT is the maximum creditable foreign tax, FTI is the amount of foreign taxable income, DIT is the domestic income tax on total taxable income (before credit), and TTI is total taxable income (i.e. both foreign and domestic). The only thing needed to accommodate the SET in this formula is to define DIT as including the amount of the SET. Under this approach, the foreign tax credit does not pose any difficulties for the SET. Admittedly, the result ends up being rough and ready, particularly where there is a substantial amount of taxable expenditure financed out of income of previous years. The formula proposed does not take into account whether that previous income was domestic or foreign source, and what tax rates it bore. Likewise, if the taxpayer incurs foreign income tax but saves a substantial portion of the current year's income, with the result that the current year's DIT is low, the formula reduces the foreign tax credit available. To calculate the foreign tax credit more precisely in a way that coordinated the different approaches of foreign and domestic tax law would, however, introduce needless complexity.

31. In respect of individuals who are noncitizens and nonresidents, the SET would simply not apply, since the jurisdictional scope of the tax extends only to citizens and residents.[5] Nonresidents would continue to be taxed under the income tax on their domestic-source income.

32. An individual subject to SET at a high marginal rate might have a tax incentive to retire abroad, if intending to continue at a high consumption level (or if the individual engaged in a high level of savings during the individual's earning years, which the individual intends to consume during retirement). It may be appropriate to provide rules requiring expatriating individuals to continue to pay SET for a period of years, particularly where the amounts involved are substantial. The policy issues are similar to those for an exit tax under the income tax, and one would expect the SET rules to track the exit tax rules for the income tax.

K. Family unit; gifts and bequests.

33. I assume that gifts and bequests will not be taxed to the donor. In other words, they will not be treated as part of the donor's consumption. The donor would accordingly receive a deduction for a cash gift. This – combined with a generous exemption – creates an obvious tax avoidance opportunity. A wealthy individual could transfer assets to his or her children, who could use them to purchase consumption goods and services. To cut off this

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[5] With the exception of the U.S., which also taxes nonresident citizens.

opportunity, it would make sense to include in the SET base of the parent any consumption by minor children. (The policy here is similar to that for rules under the income tax that tax income of minor children to the parents.) In most cases, there will not be anything to report, because most children typically do not liquidate financial assets in order to pay for their consumption. The proposed rule would not apply once the child attains majority. For this situation, an anti-avoidance rule would probably be needed providing that a purported gift will be disregarded to the extent that the gift is used to provide a consumption benefit to the donor.

34. If a deduction is allowed for gifts, rules will be needed to police the boundaries of this deduction. For example, gifts to corporations and other entities that do not qualify for the charitable deduction under the income tax should not be deductible. Importantly, this would include political contributions. These would be included in the donor's expenditure tax base. The only deductible gifts should be those made to individuals. Even these need to be restricted, since one would not want to allow deductions for gifts to a politician, or gifts to a person who provides services to the taxpayer.

L. Housing and other personal use property.

35. In the longer term, the principal residence, if purchased after the effective date, will be entirely tax-paid. To the extent purchased with cash, the cost will be included in the SET base in the year of expenditure (or would be spread over several years; see above discussion of averaging for special rules that might be provided). To the extent financed with debt, no SET deduction would be allowed for repayments of principal or interest. Upon sale, the entire proceeds should be exempted (see discussion of transition in section 5 below for treatment of housing purchased before the effective date). The same treatment should apply for sales of other personal-use property.

36. Rules will be needed to deal with property that is purchased with a mixed personal use and investment purpose. This kind of property consists of either immovable property or movable property such as antiques, collectibles, and art. A simple but tough rule would be to treat all such property as consumption expenditure. On disposition, the simplest rule would be to exempt the proceeds from tax. Alternatively the gain could be taxed, but an adjustment should be allowed for inflation (an exception to this rule could apply for the principal residence, on which no gain would be taxed). The administrative cost of calculating the inflation adjustment would be relatively small and such an adjustment should be allowed as a matter of fairness to taxpayers, because any tax on the gain is actually excessive as a matter of consumption tax principles (except to the extent attributable to sweat equity).

37. This approach will require treating as personal expenditure property any property that is in fact used for personal purposes, as well as property held for investment or used in a business if it constitutes fine art, a collectible, or an antique. Immovable property (such as a vacation home) that is available for use by the taxpayer or members of the immediate family (spouse or children 18 and under) would be treated in the same way as personal expenditure property. Proceeds from rental should be exempted. So, for example, if a vacation home is purchased partly with cash and partly with debt, the debt would be excluded (as consumption debt) and the cash payment for the home included in the SET base. Suppose that rental

income is used to pay interest on the debt, property taxes, repairs, and so forth. All of these amounts would simply be ignored for SET tax purposes. There would be no need for the taxpayer to keep track of the number of rental days or the amount of rental income received. In other words, there would be a (possibly modified[6]) yield exemption treatment for this kind of asset. (The same principle can be applied to artwork, a yacht, race horse, or other similar property which is treated as personal expenditure property: any income from renting the property can be ignored.)

M. Anti-abuse.

38. One fairly obvious anti-abuse rule would be to provide that a purported gift to a third party will be disregarded to the extent that the gift is used to provide a consumption benefit to the donor.

39. Another abuse situation would consist of the purchase of a yacht, car, airplane, real property, or similar item by a corporation, trust, or other entity. The corporation might be owned at least in part by the potential user of the property, who might then lease it from the corporation. If the user of the property had bought it himself, the expenditure would have been part of the SET base.[7] In principle, it would be possible to police the amount of rental charged, but this is unlikely to be effective because of potential disputes about the fair value of the rental, particularly in situations where the property is also rented to others for part of the time. A possible anti-abuse rule would impute to the user the purchase of personal-use property by a corporation or other entity (including an individual acting as an accommodation party). The purchase amount could be included in the expenditure tax base of the user in the year of purchase. An exception would be made for bona fide rentals by publicly held companies (for example, if someone rents a car from a company engaged in automobile leasing). While the suggested anti-abuse rule would be harsh, this would be justified because there would be little bona fide nontax reason for entering into such an arrangement. The existence of a tough anti-abuse rule of this kind should stamp out these kinds of transactions, with the result that it will not be necessary to actually apply the rule very often.

4.0 Transition.

40. If the existing income tax were completely replaced by an expenditure tax, there would be a need for transition relief. The classic case is that of the taxpayer who has saved up during a working life and is just about to retire when the expenditure tax is introduced. Suppose that the taxpayer's savings are in high-basis assets. If the income tax continued, the taxpayer could draw down these assets without additional tax. However, under an

[6] Modified if inflation-adjusted gains on disposition are taxed. (One reason for doing this is to capture any sweat equity by the taxpayer that results in increased value of the property.)

[7] See section g above.

expenditure tax, this taxpayer would face paying tax again. This situation would call for giving the taxpayer relief for consumption financed out of tax-paid assets.

41. In the case of the SET, however, the transition situation is somewhat different. The SET is designed to be an additional tax, imposed in addition to the regular income tax (hence it is called a *supplemental* expenditure tax). Its incidence is intended to fall partly on existing wealth, and partly on wealth accumulated after the effective date, to the extent that either is consumed. This seems fair. The income tax continues. Taxpayers holding wealth at the time of introduction of the SET will benefit from any reduction of income tax rates. The taxpayer in the above example would not pay any more income tax on assets that are liquidated to finance consumption. The SET payable would therefore not be in duplication of income tax already paid. Imposing a one-time tax burden on existing capital would, in other words, be part of the politically accepted strategy.

42. While general transition relief should therefore not be needed, a few specific transition rules will be required to avoid unfairness in particular cases.

43. One such rule involves consumer durables, particularly housing. In the case of someone buying a house after the effective date with borrowed funds, there would be no particular problem. Given that the loan would be kept out of account, the result is that interest and principal on the loan would be included in the tax base as the loan is repaid. This would provide an advantage to those who already own housing, but the advantage would be limited: no deduction for interest on existing housing would be available for SET purposes. The unfairness would apply to those who have saved up but not yet purchased a house as of the effective date. If no transition rule were provided, they would be seriously disadvantaged in comparison with someone who had purchased a house with cash just before the effective date of the SET. To address this, an exemption could be provided (subject to an appropriate limitation) for the purchase of a principal residence within a specified period (e.g. one year) after the effective date in the case of someone who does not own such a residence. (The exemption would apply only to amounts paid in cash. Any amounts in excess of the exemption limit would be eligible for averaging via amortization of the purchase price as explained above.)

44. A special rule will also be needed for disposals of the principal residence after the effective date, in the case of a residence purchased before the effective date. Assume that under current law, gain on the disposition of the principal residence is excluded. Suppose someone sells a principal residence qualifying for the gain exclusion after the effective date. This could apply for SET purposes as well. If there is a limit on the amount of gain excluded for income tax purposes, any excess of the sales proceeds over the exclusion amount should be included in taxable receipts for SET purposes.

45. Consideration should also be given to a transition rule for those who, before the effective date, purchased an unusually large house. Such individuals would be advantaged as compared with those who buy housing with income earned after the effective date, since the latter would be taxed on these amounts. If no account is taken of the existing asset as of the effective date, there will be an undue preference for these individuals. Accordingly it would make sense to include in the SET base an estimated rental value in the case of homes worth

more than a specified amount.[8] I recognize that this would involve some valuation issues, and it would be possible to get along without this rule, but some such rule would seem to be appropriate as a matter of fairness.

46. Apart from amounts invested in a principal residence (subject to a possible limitation as discussed above), the SET would constitute a levy on existing capital. The burden of this tax would, however, depend on the taxpayer's consumption choices: it would become due only for consumption at a luxury level. As long as the taxpayer (or the taxpayer's heirs) spent at or below a frugal level represented by the SET exemption, no tax would be due.

47. Initial cash balances as of the effective date would be taxed (with an appropriate de minimis exclusion).

48. Although not without difficulty, the above transition rules are far more modest than the transition rules that would likely be required if the existing income tax were completely replaced by a consumed-income tax. The difficulty of transition is often cited as one of the principal problems of a cash-flow tax.[9] The SET would largely avoid these problems.

Annex

[8] Compare Kaldor (1955) who proposed including in the expenditure tax base the annual rental charge on housing. The approach suggested here differs from Kaldor's in that it applies only to pre-effective-date housing, and applies with a threshold, so that only more expensive houses are affected.

[9] See Engler and Knoll, Simplifying the Transition to a (Progressive) Consumption Tax, 56 S.M.U.L. Rev. 53, 54 (2003).

This annex contains draft legislative language to implement an SET in the United States, followed by a technical explanation. References in this Bill are to the Internal Revenue Code of 1986 except as otherwise provided.

General Individual Income Tax Amendments

Subsections 1(a) through (e) are amended by striking out the lines relating to tax rates in excess of 28%.
Subsection 1(h) (maximum capital gains rate) is repealed.
Section 68 (overall limitation on itemized deductions) is repealed.
Section 151(d)(3) (phaseout of dependency exemptions) is repealed.
Section 1411 (unearned income medicare contribution) is repealed.

Replacement of Alternative Minimum Tax with Consumed-income Tax

Sections 55 through 59 are repealed and replaced by the following:

Part VI – Consumed-income Tax

Section 55. Consumed-income tax imposed.

(a) Married individuals filing joint returns and surviving spouses.
There is hereby imposed (in addition to any other tax imposed by this subtitle) on the consumed taxable income of –
(1) Every married individual (as defined in section 7703) who makes a joint return with the individual's spouse, and
(2) Every surviving spouse (as defined in section 2(a)),
a tax determined in accordance with the following table:

If consumed taxable income is:	The tax is:
Not over $x	y% of consumed taxable income.
Over $x but not over $(x + a)	$--,--- plus z% of the excess over $x.
Over $(x+a)	$--,--- plus w% of the excess over $(x+a).

(b) Heads of households.
There is hereby imposed (in addition to any other tax imposed by this subtitle) on the consumed taxable income of every head of a household (as defined in section 2(b))
a tax determined in accordance with the following table:

If consumed taxable income is:	The tax is:

Not over $p	y% of consumed taxable income.
Over $p but not over $(p + q)	$--,--- plus z% of the excess over $p.
Over $(p+q)	$--,--- plus w% of the excess over $(p+q).

(c) Unmarried individuals (other than surviving spouses and heads of households).
There is hereby imposed (in addition to any other tax imposed by this subtitle) on the consumed taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household (as defined in section 2(b)) who is not a married individual (as defined in section 7703)
a tax determined in accordance with the following table:

If consumed taxable income is:	The tax is:
Not over $m	y% of consumed taxable income.
Over $m but not over $(m + n)	$--,--- plus z% of the excess over $m.
Over $(m+n)	$--,--- plus w% of the excess over $(m+n).

(d) Married individuals filing separate returns.
There is hereby imposed (in addition to any other tax imposed by this subtitle) on the consumed taxable income of every married individual (as defined in section 7703) who does not make a joint return with the individual's spouse,
a tax determined in accordance with the following table:

If consumed taxable income is:	The tax is:
Not over $x/2	y% of consumed taxable income.
Over $x/2 but not over $(x + a)/2	$--,--- plus z% of the excess over $x/2.
Over $(x+a)/2	$--,--- plus w% of the excess over $(x+a)/2.

Section 56. Consumed taxable income.

(a) General rule.
The consumed taxable income for the taxable year is equal to gross income, reduced by the deductions allowable for purposes of determining the taxable

income for the taxable year, taking account of the adjustments and different treatment provided in this Part.

(b) Method of accounting.

The consumed taxable income is determined using the cash receipts and disbursements method of accounting.

(c) General rule for borrowing.

Except as otherwise provided in this Part, for purposes of determining the consumed taxable income, the proceeds of borrowing are included in gross income and a deduction is allowed for interest paid and repayments of principal.

(d) General rule for distributions and proceeds.

Except as otherwise provided in this Part, for purposes of determining the consumed taxable income, gross income includes any distribution (including a return of capital) from any person or the withdrawal of funds from an investment or trade or business of the taxpayer, as well as the proceeds derived from dealings in property.

(e) General rule for savings deduction.

Except as otherwise provided in this Part, for purposes of determining the consumed taxable income, a deduction is allowed for amounts saved (whether through an investment or a trade or business). No deduction is allowed for an amount that is excluded under subsection (f).

(f) Receipts of investment or business property excluded from gross income.

Notwithstanding provisions of this Part that include the value of property received in gross income, this value is excluded from gross income if, immediately after its receipt, the property is –

(i) held by the taxpayer as an investment;
(ii) held by the taxpayer as part of the taxpayer's trade or business; or
(iii) held by a trust, partnership, or corporation.

(g) Special rules.

For purposes of determining the consumed taxable income --

(1) Gross income includes an amount received under an annuity, endowment, or life insurance contract, and section 72 does not apply.
(2) Sections 75, 77, 83, and 88 do not apply.
(3) Gross income includes social security benefits received, and section 86 does not apply.
(4) Gross income includes amounts received under a life insurance contract by reason of the death of the insured, section 101 does not apply, and life

insurance premiums paid are considered amounts saved for purposes of subsection (e).

(5) Gross income includes interest or principal received on any bond or other indebtedness, and subsection 103 does not apply.

(6) Sections 107, 109, 110, 135, and 141 through 150 do not apply.

(7) Except as otherwise provided by paragraph 11, gross income does not include proceeds from the disposition of personal-use property.

(8) In applying section 162, a deduction is allowed for expenses paid regardless of whether they are of a capital nature.

(9) No deduction is allowed for charitable contributions of property (other than money or personal-use property).

(10) Gross income includes the proceeds derived from dealings in personal-use property acquired before the effective date, except that in the case of the taxpayer's principal residence acquired before the effective date, gross income includes the proceeds from disposition of the property, to the extent the proceeds exceed $250,000 ($500,000 in the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property). Section 121 does not apply.

(h) Exemptions for taxpayer and spouse.

(1) For purposes of determining the consumed taxable income, section 151(b) applies using an exemption amount of ---- for the taxpayer and ------- for the taxpayer's spouse.

(2) If the taxpayer's consumed taxable income is below the exemption amount specified in paragraph (1), then the excess of the exemption amount over the consumed taxable income (but not in excess of 30% of the exemption amount) is carried over to the next succeeding taxable year.

(3) The amount that is carried over from the preceding taxable year under this subsection is allowed as a deduction to the extent that the consumed taxable income (determined without regard to this paragraph) exceeds the exemption amount; and the remainder (if any) is carried over to the succeeding taxable year.

(4) A carryover is allowed under paragraph (2) or (3) for a taxable year only if the taxpayer timely files the appropriate schedule relating to the CIT on the taxpayer's return for the year.

Section 56A. Treatment of Borrowing

General rule.

(a) For purposes of determining the consumed taxable income –

(i) the general rule set forth in section 56(c) does not apply to excluded borrowing;

(ii) the proceeds of excluded borrowing are not included in gross income;

(iii) no deduction is allowed for interest paid and repayments of principal on excluded borrowing; and

(iv) no deduction for amounts saved under section 56(e) is allowed for amounts that are financed by excluded borrowing.

Excluded borrowing.

(b) Acquisition indebtedness for –

(i) a car;

(ii) another consumer durable the cost of which exceeds $25,000; or

(iii) real property,

that is personal-use property is excluded borrowing, but only if the indebtedness is secured by the property in question.

Credit cards.

(c) For purposes of section 56(c), the proceeds of borrowing in respect of a credit card are determined as the difference between the year-end balance on the card and the year-end balance for the previous year. If this difference is negative, the difference is treated as a repayment of principal. The year-end balance of a credit card is zero if the total amount due at year-end is paid within the grace period.

Section 56B. Purchase of Large Items

General rule.

(a) If the taxpayer acquires –

(i) a principal residence; or

(ii) a consumer durable that is personal-use property the cost of which exceeds $25,000,

the taxpayer may elect the benefits of this section in connection with the acquisition.

Spread over four years.

(b) If an election is made under subsection (a), a deduction is allowed for 80% of the difference between the cost of the item for which the election is made and the amount of excluded borrowing relating to the item, and 25% of the deducted amount (plus interest) is included in gross income for purposes of this Part for the 4 succeeding years.

Four-year spread for real property.

(c) In the case of real property, subsection (b) is applied by substituting 95% for 80% and 5% for 25%, and 19 years for 4 years.

Services.

(d) Under regulations prescribed by the Secretary, the treatment in subsection (b) extends to unusually large amounts of expenditure for services.

Regulations.

(e) Interest described in subsection (b) is determined under regulations. Regulations also specify how taxpayers may accelerate the inclusion in gross income.

Section 56C. Personal-use Property

Definition of personal-use property.

(a)Personal-use property is any tangible real or personal property that is –

(i) available for use by the taxpayer at any time during the taxable year, other than property used in a trade or business;

(ii) a collectible within the meaning of section 408(m); or

(iii)cash.

Exclusion from income.

(b) Income from the lease or rental of personal-use property is excluded from gross income for purposes of the CIT.

Section 56D. Business and Investment Property

General rule.

(a) Personal-use property is not considered to be held by the taxpayer for business or investment.

Change in use.

(b) If property held by the taxpayer for use in a business or as an investment becomes personal-use property, the property is considered to be disposed of at its fair market value, and the deemed proceeds are included in gross income.

Financial accounts.

(c) An account with a financial institution is investment property.

Section 56E. Bank and brokerage accounts

In the case of an account with a bank or other financial institution or a brokerage account,

(i) gross income includes only the net amount, if any, withdrawn from the account for the year; and

(ii) for purposes of section 56(e), the amount saved is the net amount, if any, added to the account for the year.

Section 56F. Gifts and Bequests

(a) General rule. -- Except as otherwise provided in this section or in section 56 (f), gross income includes amounts acquired by gift, bequest, devise, or inheritance, and section

102 does not apply. In the case of personal-use property acquired, no amount is included in gross income.

(b) Gifts.-- In the case of a transfer of money by gift, gross income does not include the amount of the transfer that is excluded under section 2503(b) from gifts made.

Transfer to individual.

(c) A transfer of property by gift to an individual is not taken into account in determining the transferor's consumed taxable income.

Deduction allowed.

(d) In the case of a gift made to an individual, a deduction is allowed to the transferor for amounts included in gross income of the transferee.

Section 56G. Transition rules

Cash.

(a) Amounts held by the taxpayer on the effective date as cash are included in gross income for CIT purposes for the taxable year that includes the effective date, but only if such amounts exceed $2,000.

Principal residence.

(b) In the case of a taxpayer who acquired a principal residence before the effective date, the greater of the following amounts is included in gross income:

(i) the excess of the fair rental value of the residence over ________; and

(ii) 3% of the excess of the fair market value of the residence over ------.

Second home.

(c) In the case of a taxpayer who acquired a second home (including more than one second home) before the effective date, the greater of the following amounts is included in gross income:

(i) the fair rental value of the second home; and

(ii) 3% of the fair market value of the second home.

Conforming amendments:

Section 871(b)(1). Delete "or 55".

Technical Explanation

Section 55 is the rate schedule for the consumed-income tax. There are three rates. The relative tax burdens on married vs. single taxpayers are roughly the same as for the regular income tax.
Section 56 defines consumed taxable income, which is the tax base for the consumed-income tax (CIT). The overall approach is to start with taxable income as determined for the regular income tax, and to make the adjustments spelled out in section 56. This means that in the absence of a specific rule for an item of income or deduction in this Part, the item will be treated the same as under the regular income tax.

Section 56(b) specifies that the consumed taxable income is determined using the cash method of accounting. So, for example, the rules on original issue discount are irrelevant. The determining factor is simply the time that an amount is paid.

Section 56(c) sets forth the general rule for borrowing for purposes of the CIT: the proceeds are included in gross income, and a deduction is allowed for interest and principal paid. This rule is subject to section 56A, which excludes certain borrowing from this rule. Excluded borrowing is effectively ignored: proceeds are not included in gross income and no deduction is allowed for loan repayments. The treatment of excluded borrowing is the same as that for consumer debt under current law. The main difference between the treatment of borrowing under the regular income tax and the consumed-income tax is that (1) for borrowing other than excluded borrowing, gross income for CIT purposes includes borrowing proceeds, and correspondingly a deduction is allowed for both interest and principal repaid, and (2) home mortgages are excluded borrowing, so that unlike current law no deduction is allowed for interest expense. On a home mortgage, the interest expense is still allowed as a deduction for regular income tax purposes.

Section 56(d) sets forth the general principle that gross income for CIT purposes includes the entire amount of distributions received from corporations, partnerships, and trusts. This is a simple rule looking to the amount of cash actually received. So for example in the case of a distribution from a corporation, the entire amount is taxable, regardless of the characterization for regular income tax purposes as ordinary income, capital gain, or return of capital.

Section 56(e) allows a deduction for purposes of the CIT for amounts saved, whether in the form of a business or an investment. Correspondingly, any withdrawal of funds from a business or investment is included in gross income for CIT purposes. Section 56D spells out what is meant by business and investment for CIT purposes.

Section 56(f) excludes from gross income for CIT purposes receipts in kind of business or investment property. The reason for this is to simplify tax reporting. For example, if one kind of security is exchanged for another security, there is no need to report the value of the security received, since a corresponding savings deduction would be allowed for the investment. To avoid this superfluous reporting of a receipt and an offsetting deduction, the value of the security received is simply excluded from gross income. This rule is broader than the rule of section 1031 for regular income tax purposes. Any exchange qualifying for nonrecognition treatment under section 1031 also results in exclusion from gross income under section 56(f), but section 56(f) is broader, in the sense that the property received in an exchange need not be of a like kind to the property disposed of, as long as the property received is business or investment property and not personal-use property. Any cash received in an exchange of business or investment property for other business or investment property would be included in gross income for CIT purposes.

Section 56(g) sets forth a number of special rules detailing the adjustments to be made to regular taxable income for purposes of determining consumed taxable income. By and large, these adjustments are by way of clarification, and implement the general principle that all amounts received are included in gross income for CIT purposes, and correspondingly any amounts saved are allowed as a deduction in determining consumed taxable income.

Under section 56(g)(1), the entire amount received in respect of an annuity, endowment, or life insurance contract is included in gross income for CIT purposes. This is simply the application of the general principle that all receipts are taxable regardless of their characterization as income or principal. Of course, for regular income tax purposes, the current law rules that tax only the income portion of amounts received in respect of an annuity continue to apply.

Under section 56(g)(2), sections 75, 77, 83, and 88 do not apply for CIT purposes. Section 75 is an accounting rule for dealers in tax-exempt securities. For CIT purposes, this rule does not apply and such dealers are taxed on amounts received. Section 77 is a special rule for proceeds of commodity credit loans. Instead of this rule, the general rule for borrowing in section 56(c) applies to such loans. Section 83 includes in income the value of property received in connection with the performance of services. For CIT purposes, such transactions are generally governed by section 56(f), which excludes from gross income property received if immediately after the receipt the property is held by the taxpayer as investment property. This will generally be the case for situations dealt with by section 83. Of course, when the taxpayer disposes of such property, the entire proceeds are included in gross income for CIT purposes. Section 88 is a special rule for nuclear decommissioning costs, which is simply not relevant for CIT purposes (because corporations are not subject to CIT, the rule would in any event come into play only in the event of a partnership; for CIT purposes, the general rule for partnerships is that what is included in the partner’s gross income is the amount of cash distributed by the partnership).

Section 56(g)(3) includes in gross income for CIT purposes the entire amount of social security payments. All retirement benefits, whether from government or private plans, and regardless of their characterization for regular income tax purposes, are included in gross income for CIT purposes.

Under section 56(g)(4), as a general principle, for CIT purposes gross income includes all amounts received under a life insurance contract. Correspondingly, life insurance is treated as an investment, so that any premiums paid are considered amounts saved for purposes of Section 56(e). This is an important difference from the rules under the regular income tax, which does not allow a deduction for an insurance premium, except for certain cases where the insurance premium is a business expense. The deduction for life insurance premiums under section 56(e) applies only to life insurance, and not to health insurance, auto insurance, homeowner’s insurance, and the like. However, insurance premiums that are deductible as a business expense for regular income tax purposes are also deductible for CIT purposes, because business expenses are deductible as savings under section 56(e).

Under section 56(g)(5), a gift of cash is included in the gross income of the donee and is deductible to the donor, except to the extent that the exclusion under 2503(b) applies. To the extent that a gift of cash is a taxable gift for gift tax purposes, the donor is allowed a deduction for CIT purposes and the donee includes the amount in gross income. In the case of a gift of personal-use property, no deduction is allowed to the donor and no amount is includible in gross income of the donee. (In such a case, the cost was included in the donor’s tax base at the time the donor purchased the personal-use property.) In the case of a gift of business or investment property, the value of the gift is excluded from the donee’s gross income under section 56(f), and no deduction is allowed to the donor (the donor is allowed a deduction at the time the donor acquired the business or investment property; this deduction would be allowed even if after acquiring business or investment property, the donor immediately transfers the property to the donee as a gift). The only time that the donor receives a deduction for making a gift is where the value of the gift is included in the donee’s income. This will only be the case in the event of a transfer of cash which is a taxable gift for gift tax purposes.

Section 56(g)(6) sets forth the general principle that all amounts received in respect of a debt claim – regardless of whether characterized for regular income tax purposes as income or capital – are included in gross income for CIT purposes. It also does not matter whether the interest is excludable for regular income tax purposes.

Section 56(g)(7) states that the following provisions do not apply for CIT purposes: sections 107, 109, 110, 135, and 141 through 150.

Section 107 excludes from gross income the rental value of a parsonage and a rental allowance paid. For CIT purposes, the general rule of 61 applies to these amounts, unless they are excluded under another provision, such as for example section 119 or 132.

Section 109 does not apply for CIT purposes, but amounts excluded under section 109 will generally qualify for exclusion under section 56(f). In case the property is personal-use property, the rental income, including amounts described in section 109, will be excluded under section 56C.

Section 110 excludes certain amounts of cash received by a lessee from a lessor. While this rule does not apply for CIT purposes, if the cash is used by the lessee for business purposes a deduction is allowed under section 56(e).

Section 135 excludes from gross income certain redemption proceeds of U.S. savings bonds used for education expenses. This provision does not apply for purposes of the CIT, since interest and principal on such bonds is included in gross income for CIT purposes.

Sections 141 through 150 deal with state and local bonds. These provisions do not apply for CIT purposes, since interest and principal on such bonds is included in gross income for CIT purposes.

Section 56(g)(8) provides that except as otherwise provided by paragraph 11, gross income does not include proceeds from the disposition of personal-use property. This is consistent with the rule that no deduction is allowed on the acquisition of personal-use property. However, the rule is subject to paragraph (11), which relates to property acquired before the effective of the SET.

Section 56(g)(9) is a clarification of the general rule in section 56(e), which allows a deduction for savings. Correspondingly, deductions are allowed under section 162 regardless of whether the expense is of a capital nature.

Section 56(g)(10) denies a charitable contribution deduction for gifts of property. This is because a deduction was already allowed to the taxpayer at the time the property was acquired. Consistently with section 56(g)(8), this deduction denial does not apply to personal-use property. Accordingly, the fair market value of such property donated to charity is deductible, as it is for the regular income tax. (This rule is significant for works of art and other collectibles.)

Section 56(g)(11) is a transition rule, under which proceeds from the disposition of personal-use property acquired before the effective date of the CIT are taxable. An exception is made for the taxpayer’s principal residence, up to the same limits applicable for the exclusion for regular income tax purposes.

Section 56(h) provides a substantial exemption for CIT purposes in lieu of the exemption for regular income tax purposes. Because the exemption is large, many taxpayers who are not subject to CIT will have a substantial unused exemption amount (the difference between the exemption and the consumed taxable income). Under subsection 56(h)(2), this unused exemption amount (limited to 30% of the exemption amount) may be carried over to future taxable years, but only if the taxpayer timely files an income tax return with the appropriate schedule for the CIT for the year from which the unused exemption amount is carried.

Section 56A provides exceptions to the general rule for borrowing in section 56(c), namely that the proceeds of borrowing are included in gross income, and a deduction is allowed for repayments of both interest and principal. This rule does not apply to the extent provided by section 56A for excluded borrowing. Excluded borrowing includes acquisition indebtedness for cars, other consumer durables, or real property used by the taxpayer as a residence or otherwise for personal purposes.

Section 56B allows the taxpayer to spread out the cost of acquiring relatively expensive items, so that expenditure is spread over a number of years. The spreading means that some taxpayers will not have to pay CIT (because of the large personal exemption), or will not fall into higher marginal rates of CIT. Under subsection (d), this treatment applies to items such as unusually large medical expenses or college tuition, as specified in regulations.

Section 56C provides a definition of personal-use property. This definition is relevant to the deduction allowed for savings. The concept of personal-use property is broad, including any property that is available for personal use by the taxpayer. For example, a vacation home that is used by the taxpayer only for a small portion of the taxable year (or in some years might not be visited at all by the taxpayer) will be personal-use property. Under subsection (b), rental income from such a vacation home is excluded from income. This is simpler treatment than under the regular income tax. The cost of acquiring a vacation home is fully included in the CIT base, since no deduction is allowed for its acquisition.

Section 56D treats bank accounts as investment property.

Section 56E simplifies accounting for bank and brokerage accounts. Interest, dividends, and proceeds of disposition of assets held in the account can all be ignored. The only amount that is relevant in determining consumed taxable income is either the net amount withdrawn from the account, which is included in gross income or the net amount contributed to the account, which is allowed as a deduction for saving.

Annex 2
Schedule ---, Form 1040.

Name(s) shown on form 1040 Social security number

1. Income amounts from Form 1040. ___________
2. Interest (not received from a financial institution or broker) ___________
3. Dividends (not received from a financial institution or broker) ___________
4. Net distributions from (contributions to) financial institutions and brokers. ___________
5. Net distributions from (contributions to) partnerships, trusts, S corporations etc. _______
6. Net withdrawals from (contributions to) a business. ___________
7. Net withdrawals from (contributions to) a farm. ___________
8. Net proceeds from borrowing (net repayments). ___________
9. Adjustments from Form 1040, line 36. ___________
10. Exemption amount ___________
11. Itemized deductions ___________
12. Combine lines 1 through 11. This is your consumed taxable income. ___________
13. Tax ___________

Instructions.

Line 1. Enter the total of the amounts on the following lines of Form 1040: line 7 (wages etc.), 10 (refunds), 11 (alimony), 15a (IRA distributions), 16a (pensions), 19 (unemployment benefits), 20a (social security), 21 (other income).
Line 2. Enter only the amounts from lines 8a and 8b, Form 1040, which you did not receive from a financial institution or brokerage. (Interest received from a financial institution or brokerage is taxable only insofar as it enters into amounts distributed to you, which are shown on line 4.)
Line 3. Enter only the amounts from Form 1040, line 8a, which you did not receive through a brokerage account. (Dividends credited to your brokerage account are taxable only insofar as they enter into amounts distributed to you, which are shown on line 4.)
Line 4. Enter amounts reported on Forms 1099 representing distributions from financial institutions and brokers. Subtract amounts representing net contributions. If the total is a negative number, enter in parentheses "( )".
Line 5. Enter net amounts distributed to you from partnerships, trusts, S corporations etc. (From line -- of Schedule E). . If the total is a negative number, enter in parentheses "( )".

Line 6. Enter net amounts you withdrew from businesses. This is the amount on line – of Schedule C. If you have more than one business, combine the amounts for each business. If the combined amount is a negative number, enter in parentheses "( )".
Line 7. Enter net amounts you withdrew from a farm. (From line -- of Schedule F). . If the total is a negative number, enter in parentheses "( )".
Line 8. Enter the total of amounts you borrowed during the course of the year. If for a particular loan you made repayments, then treat the amount of principal and interest paid as a negative number in calculating the total. In the case of credit cards, the net amount borrowed (repaid) is reported to you on Form ---. If the combined total of borrowings less repayments is a negative number, enter in parentheses "( )".
Line 9. Enter the amount from line 36 of Form 1040.
Line 10. Your exemption amount is $----- ($--------- if you are married filing jointly).
Line 11. Calculate your itemized deductions by subtracting the amount on line 15 (interest) of Schedule A from the amount on line 29 of Schedule A.
Line 12. Add the positive amounts and subtract amounts in parentheses.
Line 13. If the amount on line 12 is negative or is less than the amount for your filing status shown in the tax table, enter zero. Otherwise, enter the amount from the tax table.