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Living With the Flat Tax

by

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LEADING IN THOUGHT AND ACTION

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Living with the Flat Tax

Alan L. Feld*

The flat tax replacement for the current Federal income tax -- proposed by Hall and Rabushka[1] and endorsed by House Majority Leader Dick Armey[2] and Senator and Presidential aspirant Arlen Specter[3] -- has attracted support from scholars and the general public alike. Many scholars believe the flat tax will reduce the inefficiencies of the income tax, increase incentives for productive behavior and promote savings.[4] Proponents add that the flat tax will produce adequate revenue without significantly increasing the tax burden currently imposed by the personal and corporate income taxes.[5]

For the general public, the most salient attraction of the flat tax lies in its promise of simplicity. The voluminous Internal Revenue Code would follow the dinosaurs into extinction, replaced by a short and easily comprehended statute.[6] Transactions motivated by tax reduction likewise would disappear, as would the complex forms of certain business transactions. Most particularly, the prospect of filing the annual income tax return on a form the size of a postcard has captured the popular imagination.[7]

The flat tax converts the income tax into a national tax on consumption, whose economic effects resemble those of a value added tax. It consists of two parts, a tax on individuals and a tax on businesses. The two taxes, taken together, create an "airtight" system for including income in the tax base once and only once, as

close to the source as possible.[8] The rate is the same for both taxes. It hovers around 20% and varies with the proposal.[9] The tax on individuals generally includes only wages and other compensation paid in cash and pensions.[10] (Correspondingly, business may deduct these payments.) Dividends, interest, rent, and capital gains are not taxed to individuals. Nor may individuals claim the personal deductions currently available for mortgage interest, state and local taxes, charitable gifts, medical expenses and the like.[11] The individual tax becomes progressive at the lower end through a personal allowance or standard deduction.[12] The earned income credit, however, would disappear.

The business tax is intended to act as a comprehensive withholding tax on all types of income other than wages.[13] The business tax covers all businesses, including partnerships and sole proprietorships. Accounting for business transactions is intended to follow cash receipts and disbursements. The tax base consists generally of gross receipts from the sale or exchange of property or services less the cost of business inputs, wages and retirement contributions.[14] The tax provides current expensing of all property purchased for a business; thus, if a corporation purchases a factory, it may deduct the cost of the land, buildings and equipment. The tax eliminates depreciation and inventory accounting, defers deductions until payment and repeals percentage depletion. The current deduction of all business inputs has the effect of exempting from tax the future income derived from business assets, calculated at a normal rate of return.[15] Current expensing of business investment essentially converts the business income tax base into a value-added

tax base. Businesses may claim no deduction for interest or dividends paid and do not include financial income when received. A special set of rules applies to banks and other financial institutions to tax income on services "bundled" with lending transactions.[16] Any excess of deductions over income carries over into the following year with interest added at the three-month Treasury bill rate.

As this brief description suggests, the flat tax would eliminate at least four features of the current income tax system that create statutory or transactional complexity. First, the single tax rate does away with bracket arbitrage, where taxpayers with different marginal rates seek to create or use deductions at high rates and include income at low rates.[17] Second, current expensing of investment obviates the need for the existing rules to recover investment over different time periods, such as depreciation and basis. Third, elimination of the capital gain-ordinary income distinction makes it unnecessary for tax planners to seek favorable characterization for transactions. Fourth, accounting for transactions on a cash basis eliminates arbitrage between different accounting systems. For taxpayers who keep their books on an accrual basis, however, the flat tax may require an extra set of accounting books, an increase in taxpayer compliance cost. As an additional feature, by reducing the marginal tax rate, a flat tax would reduce the incentive for taxpayers to complicate their transactions for tax savings. This benefit could be duplicated under the existing income tax by reducing marginal rates without conversion to a national consumption-based tax.

Unfortunately, despite the initial simplifying effects of a flat tax, other causes of complexity in the present income tax would remain. Many of the problems and tensions that have shaped the Internal Revenue Code will mar the anticipated simplicity of the ideal flat tax. New distinctions created under a flat tax will require new solutions, inevitably embodied in the statute, and altering its initial spare form.

This paper will discuss a few areas likely to be troublesome under a flat tax. I will not address directly the merits of an income tax versus a consumption tax. Nor will I discuss the important questions of economic efficiency in moving to a flat tax from the current system, nor those relating to the equitable distribution of the Federal tax burden. Nor will I dwell on issues arising out of the transition to a flat tax, a subject for an entirely separate paper.[18] Also, I leave to others the questions of how much record-keeping and audit activity will be required under a flat tax. Instead, the paper will assume the enactment of a flat tax in relatively pure form and will look at the choices that taxpayers and lawmakers will have to make in adapting to the flat tax. My claim is a modest one, that the flat tax cannot achieve all its goals of a simple statute and simple taxpayer reporting at a low uniform rate and raise the revenues produced under the current income tax regime.

I begin with an examination of questions under the business tax, partly because relatively little appears to have been written about its operation and partly because flat tax proponents look to the business tax to raise a significant part of the tax revenues under the new system. I turn next to the individual tax component of the flat

tax. Finally, I list a few of the groups disadvantaged by the change to a flat tax and which accordingly are most likely to press legislators for compensating benefits in the new law.

The Business Tax

The business tax applies to all forms of business, including partnerships and sole proprietorships. The number of businesses subject to this tax would far exceed the corporations taxable under the existing corporate income tax, but virtually all of these new taxpayers already file returns either as pass-through entities or on Schedule C of the individual return. The tax base starts with gross receipts. Deductions follow for wages, retirement contributions and the cost of business inputs. Businesses will claim no deductions for interest, fringe benefits, the employer's share of social security taxes or state and local taxes, including property taxes.

What counts as business inputs

Current law includes as taxable all of a person's income, whether derived from business or investment. It distinguishes between an individual's investment activity and business activity for deduction purposes, favoring the latter with more liberal deduction treatment.[19] On a sale of assets, the individual can obtain the generally more favorable capital gain treatment for investment property and for most kinds of business property[20] except inventory or property held primarily for sale to customers in the ordinary course of the trade or business.[21]

The flat tax enlarges the consequences of characterization of an activity as a business. It excludes altogether from the tax base the investment income of the individuals. It includes all business income

and business expenses under the business tax.[22] Individuals under the flat tax accordingly will have an incentive to characterize receipts as derived from investment, while treating expenditures as related to business. None of the proposals state how they will patrol the frontier between an individual's business and nonbusiness activity. Failure to do so will allow aggressive taxpayer reporting that will erode the business tax base.

Example 1

> Mary operates a sole proprietorship for the purchase and sale of widgets. She purchases for investment a piece of undeveloped land unrelated to the widget business. Mary receives nominal grazing fees on the land. May Mary deduct the cost of the land as an offset to the income from her widget business?

Hall and Rabushka's draft statute includes as a business each sole proprietorship, specifically including any individual with business receipts.[23] A business may file any number of business tax returns, provided all income is reported in the aggregate and that deductions are claimed only once. Mary thus may report the purchase of the land as a business input for a business of renting land for grazing purposes, and create a large first-year deduction. With the aggregate filing under the H-R proposal, the deduction will offset widget income. Mary can defer tax on income from the widget business virtually at will. The Armey and Specter bills both impose the business tax on every person engaged in a business activity, an

undefined term.[24] Their tax base begins with gross active income and perhaps the word "active" is intended to exclude from the business tax activities that produce relatively passive income, like rents.[25] All versions will require rules to distinguish business income (and therefore business assets) from investment income (and assets).

If grazing land reaches the necessary minimum of activity to count as a business under the Armey and Specter proposals, will purchase of the land offset income from the widget business? Aggregate filing at the taxpayer's election is not explicit in the Armey and Specter bills; but since Mary is the taxpayer for both the widget and the grazing land businesses, the statute presumably will require her to file only one return that includes her two businesses. If so, Mary will be able to defer tax on her widget business income.

Investment in land that produces nominal income thus produces deductions to offset other business income. Will investment in art serve the taxpayer as well? Suppose Mary buys an Old Master to hang on the office wall in order to impress customers. Will that expenditure count as a business input that gives rise to a deduction? If not, will occasional rental of the painting to others qualify its purchase for immediate deduction?

In both instances, the possibility for deferral arises because current deductibility diverges far more sharply than does current law from the measure of economic change in the value of the land or the art. These investments can serve a dual purpose, as business inputs and as a store of value for the owners of the business. If the investments reduce taxable business income, entrepreneurs will

shelter business income with investments by their business in order to store value until the individuals need them. The erosion of the business tax base will be substantial, inefficient and inequitable if businesses can obtain deductions by purchasing investment property from individuals who will not be required to take the gross proceeds into income. Lawmakers might seek to correct such activity by carving passive assets out of the business input definition. The current income tax has had to determine whether to characterize property as an investment or as part of a business under the capital gain and loss provisions. The return of such questions will add a level of unanticipated complexity to the flat tax. The passive activity loss rules, occasionally cited as an example of bad complexity under current law, may return in a new guise.

Which intangibles will qualify as business inputs under the flat tax? Businesses currently deduct or amortize the costs of creating or acquiring many intangibles, including goodwill.[26] The flat tax presumably would not distinguish between tangible and intangible business inputs for purposes of allowing deductions. But would it treat financial interests differently? For example, will the commodities futures transactions of an individual farmer constitute part of the business, producing gains and losses that enter the business tax computation, or will they fall under the investment category, with all gains and losses ignored? If farmers may deduct such hedging transactions, will individuals who take the other side of the contract be allowed to exclude the gross revenues as investment income? Complex rules for the identification of hedging transactions may be necessary to distinguish paper transactions related to a

business from those that are not. If deductibility also extends to notional principal contracts and other derivative financial instruments, businesses may be able, by employing such contracts, to deduct the equivalent of interest expense, which the flat tax purports to make nondeductible.[27] Further, if hedging through financial instruments can constitute deductible investments for a business, will hedging through stock ownership similarly qualify, as when a business purchases the stock of a captive supplier or customer or other business-related investment?[28]

Finally, consider individuals who make their living as traders in stocks, securities and other financial instruments. Under the H-R proposal, their income would constitute investment income unless the profits from their activities count as the sale or exchange of goods or services. The Armey and Specter bills would appear to treat traders as engaged in a business. Both define business taxable income as starting with gross active income. The Armey bill defines it as gross receipts from the sale or exchange of property or services in the United States, while the Specter bill defines the term as gross income other than investment income (which it leaves undefined). Both bills would have to sharpen the line between the receipts from active investment by individuals, exempt from tax, and trading.

Mixed Business and Personal Assets

How much may an individual deduct when an asset serves both business and consumption functions? Suppose Martin purchases a seaside home, occupying it part of the time and renting it out during the vacation season. May he deduct the full purchase price and set it

off against other business income? Current law has intricate rules to allocate expenses, including depreciation, between personal and rental use.[29] The law makes the determination on an annual basis, obviating the need to make an all-or-nothing or an intent-related decision at the time of purchase. Will the flat tax replicate the existing rules either on an initial or an annual basis?

Another common situation exemplifies other difficulties of mixed personal and business use assets.

Example 2

> Olivia purchases a house and uses it as a personal residence. In year 2 Olivia rents out one room to a tenant and continues to live in the rest of the house. In year 4 Olivia stops renting the room and resumes personal use of it.

Olivia presumably enters the rental business in year 2 and rental income should be taxed as gross receipts of a business. How much may Olivia deduct as the cost of the business inputs? The H-R proposal defines the cost of business inputs as the actual cost of purchases of goods, services and materials required for business purposes. Since Olivia incurred no actual cost in year 2, perhaps this language precludes any deduction for her house purchase. Alternatively, Olivia might be permitted to deduct some amount in year 2 for a deemed purchase of a business input, raising the further question of whether to base the deduction on her original cost or on the value of the rental unit in year 2. In either case, Olivia would have to make some allocation between the personal and business use

of the property. Olivia also would allocate common expenses for the property, such as property taxes. Similar results and questions would rise under the Armey and Specter proposals.

In year 4, termination of the business use of the property gives rise to business income to Olivia under the H-R proposal,[30] in an amount equal to the value of the rental unit at that time. If this activity is Olivia's only business transaction, the business income is reduced by any carryover remaining from the earlier deduction of cost (if any). The Armey and Specter bills contains no provision for inclusion in Olivia's income. But neither full inclusion of the value of the rental unit nor exclusion of all income in year 4 on conversion of the rental unit to personal use seems right, assuming Olivia enjoyed an earlier deduction. Exclusion would allow the deduction to offset the earlier business income without inclusion of any receipt on the sale of the property. Inclusion at current value offsets that earlier deduction but also recognizes as income any appreciation in value from the time of purchase, which may include investment income earned while the property was held for personal use. Moreover, inclusion requires payment of tax at a time when the business does not have cash.

<u>How will the flat tax treat in-kind transfers?</u>

Example 3

Suppose in Example 1 that Mary, in a subsequent year, transfers the land to a newly-formed corporation, Land, Inc. and later sells the stock to Norman. Norman uses the land for

recreational purposes. How will Mary, Norman and Land, Inc. be taxed?

(a) The transfer of the land to a corporation apparently does not give rise to tax to Mary under the H-R proposal. Receipt of the stock of Land, Inc. does not appear to fall literally within any of the subdivisions of the definition of business receipts. If it did, simple adjustments in business form that do not change beneficial ownership, exempt from tax currently, would become taxable under the flat tax. For other exchanges of land for stock, however, the H-R proposal may need to create a form of constructive receipt of cash. Thus, under the rule that only cash and not stock gives rise to business income, if Mary transferred the land to Boise-Cascade, a publicly traded company, for a small amount of its stock, the tax result under the current draft would be the same as in the example, no taxable inclusion to Mary. Yet Mary now would have a liquid financial investment, sale of which would not give rise to tax to Mary. A flat tax advocate might argue that no undue benefit has accrued in this example so long as Boise-Cascade claimed no deduction for its acquisition of land for stock.

The Armey bill includes as gross active income (the minuend for determining business taxable income) the gross receipts from exchanges of property, defined in the case of an exchange as the fair market value of the property received.[31] The language thus would treat Mary's transfer to Land, Inc. as a taxable exchange, valued at fair market value. For the Armey bill (or for the H-R proposal if a constructive receipt of cash idea is introduced) some of the

exceptions under current law for transfers to controlled corporations, reorganizations or like kind exchanges may be needed to prevent interference with simple changes in form undertaken for good business reasons.

(b) Land, Inc. presumably would recognize no income under the H-R proposal on receipt of the land in exchange for its own stock, as the transaction does not fall within the business receipts definition. Under the Armey bill, it is not clear whether the sale or exchange by a corporation of its own stock produces gross active income as gross receipts from the sale or exchange of property in connection with a business activity.

As noted, Land, Inc. probably may not claim deductions with respect to the land acquired for stock, even when it uses the land in its own business. The H-R proposal defines the cost of business inputs as the actual cost of purchases, including the actual amount paid for goods, services and materials.[32] Stock in the acquiring corporation issued as payment probably will not be treated as an "amount paid" by the corporation, unless a constructive issuance for cash followed by a constructive purchase for cash is implied. The Armey bill also uses the phrase "amount paid", but treats as an amount paid the fair market value of property in an exchange.[33] This broad language may include a corporation's issuance of its own stock in payment. If the cost of business inputs includes payment in stock, Land, Inc. perhaps could claim deductions for the land and both Mary and Land, Inc. would do so without any inclusion in income. In the absence of a concept of basis or basis carryover

under the flat tax, Mary's prior claim of a deduction may not prevent the corporation from claiming one as well.[34]

(c) Mary's sale of stock to Norman presumably would not be taxed to Mary. Thus, from her perspective, incorporation of an expensed asset followed by a sale of the stock provides a simple way to avoid income recognition on disposition of the asset.

(d) If, after the sale of stock, Land, Inc. distributed the land to Norman, the H-R proposal would require the corporation to include the value of the land in income. The H-R proposal requires businesses to include the market value of goods and services provided to owners or employees. It is unclear, however, whether Land, Inc. must make an inclusion for Norman's use of the land; if it must, is the amount of the inclusion the entire value of the land, as a constructive distribution of the land to Norman, or its annual rental value, as the provision of "services" to Norman.

Neither the Armey nor the Specter proposal contains a comparable provision and no inclusion to Land, Inc. apparently would be required under either. Presumably, even if Mary had simply converted the property in Example 1 from business to personal use neither the Armey nor the Specter proposal would require the business to include anything in income. The absence of a recapture mechanism when property moves from business use to personal use by the owner creates opportunities for claiming deductions on property applied to personal consumption. If the flat tax does not tax property in kind when it leaves a business, corporations could substitute tangible property for cash in their dividend policy. Imagine how General Electric would behave if it had

to pay tax on the sale of toasters but not on their distribution to shareholders, to whom all dividends came free of tax in any case. Some kind of recapture or constructive receipt by the business on a distribution of property will have to supplement the simple cash accounting the flat tax contemplates.

Who is the taxpayer-business?

Who must file the business tax return and pay the tax? All three versions of the flat tax seek to impose the tax on business activity, without regard to the legal form in which it operates. Apart from the personal consumption-business boundaries, explored elsewhere, the question of defining the taxpayer becomes material for a variety of purposes, including apportionment of the liability for the tax and the obligation to file a tax return. Most importantly, it can alter the amount of the tax liability, notwithstanding that all businesses are subject to the same tax rate.

Taxpayers under a flat tax generally will find it advantageous to aggregate their businesses. They can use losses currently to offset income, while they will suffer no penalty for adding two incomes together, given the absence of graduation in the tax rate. Consider the following example:

Example 4

Joan owns all the stock of Corporation A, which operates at a profit of $4,000 for the year. Joan also owns 50% of the stock of Corporation B, which invested in expensive equipment and has a loss of $5,000 for the year. Paul owns the other 50%

of the stock of Corporation B. If the tax law treats the two corporations as separate businesses, Corporation A will incur a tax of $800 on its income and Corporation B will have a carryover of $5,000. If the law aggregates the two, Corporation A will pay no tax currently and Corporation B will have a carryover of $1,000. If the law splits the deduction between Joan and Paul, Corporation A will pay tax on $1,500 of income.

Joan generally will prefer aggregation and an immediate tax saving of $200. While the carryover will earn interest at the 3-month federal rate, and would offset a larger amount of income in the future, that rate almost certainly will understate Joan's internal rate of interest for the enterprises as well as the interest a bank would charge for lending Corporation A $800.

Current law imposes strict limits on sharing of tax attributes among different taxpayers. The consolidated return regulations,[35] the S corporation restrictions,[36] and the partnership allocation rules[37] all provide complex systems for dividing income and loss among joint owners. Since all taxpayers would be subject to a single rate, flat tax advocates may advocate elimination of restrictions on the allocation of deductions, leaving the parties free to negotiate their own arrangements.

At a minimum the law will have to specify default rules for use of deductions. Assume that some part of B's deduction is absorbed by Corporation A in Example 4. What tax result follows if the stock ownership of Corporation B changes? Suppose for example that Joan uses $4,000 of deduction and then sells her B stock interest to

Stephanie. Who becomes entitled to the remaining $1,000 carryover (plus interest)? Suppose B claims the full $5,000 carryover in the next year. What default rule will determine which of Joan or B was properly entitled to the deduction? How will carryovers of deductions be accounted for? Must businesses keep records of their use of deductions so that after several ownership changes the entitlement to an original purchase can be traced?

The logical conclusion of unregulated allocation of deductions would allow free transferability of losses. Historically, however, the outcry against the opportunity by wealthy businesses to purchase exemption from income tax has produced the existing restrictions on the transfer of loss corporations[38] and repeal in 1982 of the finance lease provisions of the 1981 tax act.[39]

Cash accounting

If all business taxpayers report on the cash basis, accounting arbitrage disappears, but only if both parties report all transactions consistently. A number of common transactions raise the consistency question. At a minimum, each requires specification in the statute or regulations of default rules to govern in the absence of agreement by the parties. Failure to specify such rules allows taxpayers to report inconsistently and erode the business tax base.

(a) A purchaser mails a check at the end of year 1 that is not received by the vendor until the beginning of year 2. When may the purchaser deduct the payment and when must the vendor include it in income?

Under current practice, a deductible payment occurs when the purchaser puts the check in the mail if it clears the sender's account in the ordinary course: the purchaser claims a deduction in year 1 in the example. On the other hand, the vendor includes it in income when received, in year 2. Current law, however, limits the opportunity to reduce tax in this simple way. The widespread use of accrual accounting (generally mandated for taxpayers who have inventories[40]), inventory accounting and capitalization requirements for durable goods and long-lived intangibles all restrict deductions for year-end payments.

But under the flat tax the moment of payment determines the timing of deductions for business inputs. A rule like the existing one could allow a business to wipe out annual income with a large year-end payment to a supplier, who would not take the matching amount into income until year 2. While only one year's income could be deferred in this way, repetition of the year-end payment would defer the income indefinitely. The purchaser could enlarge the payment in subsequent years to take account of new increments in income.

It is not clear how the result would change under the flat tax if the vendor is a related party. Existing law tries to regulate certain related party transactions, including certain accounting-related deferrals.[41] Will the flat tax include special related-party rules?

(b) How should purchasers and sellers treat deposits made before taking possession of a business input? Are they like loans, neither deducted nor included until something more happens? If the deposit is not taken into account when made, and the purchaser loses

the deposit, does the vendor have an inclusion in gross receipts for not selling the business input, does the depositor have a deduction for not purchasing a business input or does the transaction have no tax effect? If the flat tax instead treats deposits as deductible and includible when made, some sort of recapture rule is needed if the deposit is returned in a later year.

(c) Are prepayments distinguishable from deposits or loans? Before delivery of the goods, should cash prepayments constitute gross receipts from the sale or exchange of property, includible by the vendor, and a cost of business inputs, deductible by the purchaser?

(d) How should contingent payments like options be treated?

(e) Suppose a purchaser buys a machine for 50 in year 1 and 55 in year 2. When will the purchaser deduct the cost of the machine? If the deduction matches cash payments, the purchaser will deduct the equivalent of interest, otherwise impermissible under the flat tax. Will some allocation be required in the manner of section 483? In this situation, so long as the vendor must include in income the same amount the purchaser deducts in each year, the consistency requirement of the business tax would be met.

International transactions

The H-R proposal curtails the present world-wide jurisdiction for U.S. taxation (with complex foreign tax credit provisions and a web of treaty adjustments). It substitutes simple source-based rules under which the market value of goods and services delivered from the United States to points outside the United States is included in

business receipts, the market value of business inputs brought into the United States is deducted and income on activities abroad are excluded from the tax base.

Current law prescribes complex source rules for determining whether or not income and deductions should be attributed to the United States.[42] While many of the issues taken up in these rules concern interest and dividends, other jurisdiction-allocating rules doubtless will be needed. Moreover, rules similar to those under current section 482 for determining the arms length price of goods and services will become even more important under the H-R proposal. A full elaboration of the possible transactions to test these simple parameters is beyond the scope of this paper.

Summary

When put in place, the business tax will have to deal with a number of unresolved questions. The responses to them will create statutory complication and in some cases will challenge the premises of the business flat tax. The need to assure consistency of treatment, simultaneous inclusion in income and deduction of the same amounts, between parties to transactions will produce further rules and add complexity. Some of these will seem unfair when judged by traditional standards.

The Individual Tax

Income

The individual tax counts only wages and retirement payments and permits no deductions other than a substantial standard deduction. The restrictive character of the tax base causes it to diverge from cash flows that enrich individuals. Apart from business income, taxed separately under the business tax, individuals will enjoy enrichment and suffer expenses not taken into account under this plan. The omissions may produce surprising results.

(a) Just after Arthur cashes his weekly paycheck, Betty robs him of the money at gun point. Under the flat tax, presumably Arthur includes the wages in income and has no offsetting deduction. Betty, on the other hand, probably has no income to tax unless she makes a practice of larceny, in which event she is in a business and should be taxed on the proceeds under the business tax. Present law, by contrast, would tax Betty and allow Arthur a deduction for theft loss, subject to certain limitations. Taxing Arthur and not Betty will be viewed as anomalous at best.

(b) Donald makes alimony payments to Charlene. Under current law, Donald deducts the payments and Charlene includes them in income. Under the flat tax Donald has no deduction and Charlene no inclusion in income. While the flat tax reaches a proper result in the aggregate, the parties would regard it as anomalous. Even without consideration of the transitional problems created by

existing arrangements, negotiations after the flat tax is operative may fail to adjust fully for the tax differential.

(c) Fern borrows money from Euphoria Investing Co. Fern later runs into financial difficulties and, after negotiations, Euphoria reduces the amount of the loan. Under current law, Fern will have discharge of indebtedness income, unless one of several exceptions applies.[43] Euphoria would claim a bad debt deduction.[44] Under the flat tax, Fern has no income and Euphoria no deduction.

(d) Geraldine wins a prize on a quiz show. The business that operates the show deducts the amount paid as an expense of the business. Geraldine, however, would not include the amount in income because it is not wages or retirement benefits. The income accordingly would escape taxation. Under current law, Geraldine would include the prize in income.

The first three examples simply shift the obligation to pay tax away from the party who receives cash and who is liable for the tax under current law. They raise questions of liquidity and perceived fairness: the taxpayer who pays out cash nevertheless incurs the tax liability and must find additional cash to pay the tax. Negotiations between parties in some but not all the cases can ameliorate these concerns. The fourth case provides an example of "leakage" from the business tax in providing deductible but nonincludible payments to individuals. The structure of the law will encourage businesses to find and exploit similar opportunities.[45]

Consumption

The current income tax has wrestled with the tax treatment of a range of business expenditures that confer consumption benefits on

owners or employees of a business. The H-R proposal attempts to deal with the question on the business side by excluding any deduction for purchases of goods or services provided to employees or owners unless included in business receipts. Business receipts includes the market value of goods, services and other property provided to owners or employees. The H-R proposal, however, also allows as a deductible cost of business inputs the actual cost, if reasonable, of travel and entertainment expenses for the business. The Specter bill allows deductibility of reasonable travel and entertainment expenses, using the same language as the H-R proposal, but contains no limitation on deductions for goods or services provided to owners or employees. The Armey bill contains neither provision but makes nondeductible items for personal use not in connection with any trade or business.

Example 5

> Harmless Insurance Agency, Inc. employs Ivan as an insurance broker. It provides Ivan with an automobile, which he uses to commute to and from work, to meet clients and potential clients and for personal matters. Harmless provides lunch without charge to employees on the business premises each day. Ivan occasionally takes potential clients to dinner and Harmless reimburses Ivan for the cost of some of these dinners. Clients sometimes take Ivan to dinner.

The automobile use and the meals all present different combinations of personal and business use. As an employee of

Harmless, Ivan will include only the cash wages he receives and none of the consumption items Harmless otherwise makes available to him. Ivan will not deduct the cost of meals for potential clients because Ivan is not in a business. Harmless, on the other hand, will deduct all of the expenses as the cost of business inputs unless some specific restriction applies. It is not clear from the H-R proposal which of its two principles should prevail: deductibility of reasonable expenses or nondeductibiliy of benefits to employees. Under the Armey and Specter bills, Harmless apparently could deduct all the expenses.

Current law contains a web of restrictions on the deductibility of expenditures for meals, entertainment, luxury automobiles, club dues and similar items.[46] Many of these restrictions are ineffective or redundant. Others, however, such as the limitation of deductions to half the amount spent on meals and entertainment, seem appropriate.[47] If the flat tax provides a deduction for the business and an exemption from tax to the employee for any kind of consumption, it will push businesses to compensate employees in that tax-favored form. The result will be both inefficient and inequitable.

<u>The taxable unit</u>

The flat tax provides progressivity through substantial personal allowances, referred to as a standard deduction in the Armey and Specter proposals. All three proposals reduce significantly the so-called marriage tax penalty by reason of the

single tax rate bracket. The Armey proposal also enlarges the standard deduction for a joint return to double the amount for an individual, eliminating this source of marriage tax penalty as well, but creating the potential for increased marriage benefit.

Children likewise will be entitled to a personal allowance or standard deduction. The potential exists for "kiddie tax shelters" to return, by paying children salaries out of family businesses. The salary payments would create deductions for the business while the income would generate no tax because covered by the personal allowance. The Armey proposal addresses this potential difficulty in two ways. First, it requires that taxable income of each dependent child under 14 be taxed to the parent. Second, it conditions any additional standard deduction for dependents on their not being required to file a return, a requirement that presumably would attach whenever salary income of a child exceeds the exempt amount.

Pressures for Change

The effect of a revenue-neutral tax change that increases a person's tax bill resembles that of taking candy from a child. Some children suffer in silence while others express their wrath and often get compensated for the lost sweet. We should expect pressures for change in the flat tax to come from taxpayers who lose current benefits and are unaccustomed to legislative defeat. A partial list follows:

1. Businesses that benefit from current special deductions. The timber and mineral extraction industries present two examples of businesses that receive substantial benefits under current law and would lose their relative advantage under a flat tax.[48]

2. Labor and labor-intensive businesses. The flat tax influences the business decision at the margin of whether to produce goods or services using labor inputs or machinery inputs. It favors the latter, as compared with current law, in at least three ways. It provides for current deductibility of capital investment. It eliminates the deductibility under current law of the employer's share of social security tax. Certain fringe benefits, currently deductible, become nondeductible under the flat tax. All three changes make the use of labor more expensive as compared with machinery and equipment.

3. Home owners and home builders. Elimination of deductions for mortgage interest and real property taxes will adversely affect home owners. Estimates of the impact vary, with one industry source concluding that home owners will suffer a one-time loss in property values of $500 billion. For home builders, some predict a decline in single-family home building, which might be offset at least in part by an increase in multiple-dwelling construction. The Specter bill provides restricted deductibility of mortgage interest.

4. Charities and other nonprofits. The H-R proposal eliminates current deductibility of charitable gifts and tax exemption for certain nonprofits that are not charities or community service organizations. The Armey bill retains the current tax exemptions but repeals the charitable contribution deduction. The Specter bill retains the

deduction, with a ceiling of $2,500 and a limitation to cash or equivalent gifts. Charities will fear the loss of major gifts, especially of appreciated property, under all three proposals.[49]

5. State and local governments. The flat tax effectively eliminates the comparative advantage states and local governments currently enjoy in obtaining financing. Municipal bonds will enjoy no special market niche when all interest is exempt from tax. Further, nondeductibility of state and local taxes will increase their real impact and make revenue-raising more difficult. If charitable gifts become deductible, it will seem anomalous to disallow deductions for taxes to pay for services similar to those provided by charities.

If these groups and others are "compensated" under the flat tax with new tax favors, the rate will have to rise to make up the lost revenue. An increase of only a few points, however, could materially alter the attractiveness of the tax.

Conclusion

This brief survey of the business and individual tax portions of the flat tax points to a number of unresolved questions. Something will give way in their resolution: the revenue yield, the simplicity of the tax or the simplicity of the business transactions that will take place. The imagination of practitioners and the need by government to preserve its chief revenue source will pull the statute in different directions and inevitably create complexity.

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[1]Robert E. Hall and Alvin Rabushka, The Flat Tax (Hoover Institution Press 1985) (hereinafter "Hall and Rabushka, Flat Tax"). The authors made similar proposals in an earlier book, Low Tax, Simple Tax, Flat Tax (McGraw-Hill 1983). References to the draft statute the authors propose will be identified as "H-R proposal".

[2]Rep. Armey introduced his latest flat tax proposal as Title I, Subtitle A of the "Freedom and Fairness Restoration Act of 1995" on July 19, 1995 (the "Armey bill"). A companion measure, S. 1050, was introduced in the Senate by Senator Richard Shelby.

[3]Sen Specter introduced his flat tax proposal as S. 488 on March 2, 1995 (the "Specter bill").

[4]See Doernberg (1985); U.S. Dept. of Treas., Blueprints for Basic Tax Reform 113 - 15 (1977).

[5]Hall and Rabushka note that high-salaried executives would pay far less tax under the individual flat tax than under the current personal income tax, but argue that, as an offset, wealthy people would incur a higher tax on business income. Any shift from wage taxation to business taxation would be progressive. Hall and Rabushka, Flat Tax, 76 - 79.

[6]Hall and Rabushka's draft statute runs to five pages, including a table of contents. Hall and Rabushka, Flat Tax, 123 -127. The first individual income tax statute after the Sixteenth Amendment covered 15 pages, including all the administrative material not included in the Hall and Rabushka draft, 63 Stat. 166 -181.

[7]Many individuals already file returns on Forms 1040A or 1040-EZE with as few lines as the Hall and Rabushka postcard.

[8]Hall and Rabushka, Flat Tax, 38 - 41.

[9]Hall and Rabushka proposed a 19% rate. Armey has advocated a 17% rate, intended to reflect some reduction in total government expenditures; the Armey bill now proposes a 20% rate for the first two years. The Specter bill proposes a rate of 20%.

[10]The Armey bill also includes unemployment compensation. The H-R proposal does not include it and unemployment compensation appears to fall outside its general definition of included compensation. The H-R proposal does include workman's compensation and other payments for injury, which the Armey bill does not. The Specter bill excludes all of these payments. All three exclude payments for services performed outside the United States.

[11]The Specter bill would allow a deduction for charitable contributions and for mortgage interest, but with more severe limits than under current law.

[12]Hall and Rabushka proposed a personal allowance in 1985 of $9,000 for a married couple filing jointly and an additional $1,800 for each dependent, defined more narrowly than under current law. The Armey bill proposes a standard deduction of $21,400 for joint filers and an additional standard deduction of $5,000 for each dependent not required to file a return for the year. (The dependent must also be described in section 151(c)(1), a reference

to the current requirement that the dependent have gross income of less than the exemption amount or be a child of the taxpayer either under age 19 or a full-time student under age 24. It is not clear under what circumstances someone who will not be required to file a return for the year nevertheless could have income over the exemption amount.) The Specter bill allows a basic standard deduction of $16,500 for joint filers and an additional standard deduction of $4,500 for each dependent, defined as in the Armey bill. Unlike the other two proposals, the Specter bill does not peg the basic standard deduction for a single individual at half the joint return amount, but at $9,500.

[13]Flat Tax, p. 47.

[14]The H-R proposal imposes the tax on business taxable income, defined as business receipts less the cost of business inputs, compensation and the cost of capital equipment. The Armey bill defines business taxable income as the gross active income less similar deductions. Gross active income means gross receipts from the sale or exchange of property or services in the United States in connection with a business activity and certain export receipts. Hall and Rabushka and the Specter bill allow a deduction for the actual cost, if reasonable, of travel and entertainment expenses for business purposes, but specifically exclude from "business inputs" purchases of goods and services provided to employees or owners (unless included in business receipts). The Armey bill excludes items for personal use not in connection with any business activity. The Armey bill expressly allows a deduction for excise and sales taxes on property used in a business activity.

[15]Businesses whose income exceeds the normal rate of return would pay tax on the excess.

[16]The H-R proposal, section 102(8), includes as business receipts the market value of goods and services provided to depositors. The Armey bill, section 102(e), includes as business income the value of financial intermediation services. The Specter bill contains no such provision.

[17]Tax rate arbitrage with a zero-bracket taxpayer continues to be possible.

[18]Compare the discussion of transition problems in Kaplow (1995).

[19]Compare section 162 (trade or business deductions) with the more restricted deductions under section 212 (expenses for the production or collection of income). The latter cannot be claimed by nonitemizers and are subject to a two percent floor, section 67.

[20]Code section 1231.

[21]Code section 1221(1). See e.g. Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976)(real estate); Hollis v. United States, 121 Fed. Supp. 191 (N.D. Ohio 1954) (art objects).

[22]It also requires characterization of the property at an earlier time, in the year of purchase rather than the year of sale.

[23] H-R proposal, Section 203(a).

[24]Section 102(a) of the Armey proposal and Section 11(B) of the Specter bill.

[25]The Specter bill simply defines gross active income as income other than investment income, without specifying how to tell them apart.

[26]Code section 197 allows amortization of purchased intangibles over a fifteen year period.

[27]For a discussion of the impact of innovative capital market contracts on income tax policy, see Warren (1993).

[28]See Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988).

[29]Code sections 280A and 183 and regulations.

[30]The H-R proposal includes as a business receipt the market value of property provided to the owners or employees of a business.

[31]The Specter bill defines gross active income as income other than investment income.

[32]The cost of business inputs is defined as the actual cost of purchases of goods, services and materials required for business purposes. It includes the actual amount paid for them.

[33]The Specter proposal does not contain similar language.

[34]In its provision on filing units, the H-R proposal allows any number of business tax returns provided that each expenditure for business inputs is reported on no more than one return. The issue then is whether Mary's purchase of the land and the corporation's later issuance of stock for it represent one or two separate expenditures.

[35]Treas. Reg. sec. 1.1502-1, et. seq.

[36]Code sections 1361 - 1379.

[37]Treas. Reg. sec. 1.704.

[38]See Code sections 269 and 382.

[39] P.L. 97-248, section 209, 96 Stat. 324, 442 - 447.

[40]Reg. sec. 1.446-1(c)(2).

[41]Code section 267(a)(2).

[42]See Code sections 861-865 and regulations.

[43]See generally Code section 108.

[44]Code section 166.

[45]Structured settlements in tort provide an example under current law of the exploitation of forms of payment that allow deductions to one party and noninclusion in the income of the other.

[46]Code sections 274 and 280F.

[47]Code section 274(n).

[48]For a comparison of tax liability under the flat tax and under current law by sector, see Peter Merrill, Ken Wertz and Shvetank Shah, Corporate Tax Liability Under the USA and Flat Taxes, 68 Tax Notes 741 (1995).

[49]Compare, as to the USA tax, Feld (1995).