A Roadmap to Income Tax Reform

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August 2011

The current Federal income tax system is a mess. It's enormously complicated. It's loaded with special provisions of questionable value. And it's rife with inconsistencies that are regularly used to create tax shelters. The sentiment is pretty much unanimous, on both sides of any political aisle: our income tax system needs fixed.

In part, these problems are a natural outgrowth of the Federal legislative process. Legislators tend to focus on their immediate issue, without always seeing how it relates to the overall plan. But the more serious problem is that our tax system really has no overall plan to begin with. Indeed, what we call an "income tax" is actually not all that close to what an income tax should be. Rather, it's a jumble of various taxes on various things, with various exemptions tossed in, with almost no rhyme nor reason whatsoever. No wonder it's a mess.

The purpose of this article is to lay out a consistent, coherent plan, not for an income tax, which our current "Income Tax" never quite was, but rather for a progressive consumption tax, which our current "Income Tax" kind of sort of is.

When most Americans hear the phrase "consumption tax", they think it means a sales tax or its European equivalent, a Value Added Tax. But since all of the income we don't save goes to buying consumption goods and services, a consumption tax is any tax that exempts saved income until those savings are spent. In particular, a progressive consumption tax can be structured very much like our current income tax, but as one redesigned to exempt all of our savings.

With only a moment's reflection, it has probably already occurred to you that our current "Income Tax" already sort of does that, through such provisions as IRAs and 401k savings plans. So changing to a progressive consumption tax would not be a radical departure from the status quo. However, dropping the pretense of income taxation and choosing instead to fully embrace the logic of a progressive consumption tax would substantially simplify the tax code. More importantly, choosing to fully implement a progressive consumption tax would make our tax system internally consistent with itself, far less open to tax shelters of questionable provenance, and probably far more widely perceived as fair.

Let me note at the outset that I make no claim about this plan leading to the best of all possible tax systems. What is really and truly best is difficult to determine, and subject to controversy. Rather, I will only claim that the plan I describe is both eminently doable, because most of the changes are relatively small adjustments to what we do now, and the plan is also a distinct improvement over the status quo. As the proverb goes, the perfect is the enemy of the good; I would hope that this good plan would not be rejected outright merely because it fails to achieve some notion of perfection.

I will begin by outlining some of the problems that necessarily arise with an income tax. I will then lay out the logic of a consumption tax, and then itemize the various changes needed to convert our tax system to a pure consumption tax. As you will hopefully see, the list of needed changes is neither long nor complicated. This is a tax reform that can be done.

The Difficulties of Income Taxation

Income is everything you earn, whether those earnings are used to buy the goods and services you consume, or whether those earnings are saved, adding to your net worth. In fact, this listing of the how you use your income leads to an alternative definition of income, widely used by economists: income is your consumption plus changes in your net worth.

Although we call the Federal tax we levy on individuals an income tax, it differs from a true income tax in a variety of ways, for two reasons. First, it turns out that levying a true income tax is extremely hard to do. And second, our elective representatives have included in the tax code provisions that make no sense under an income tax.

One example of the first is the tax treatment of pensions. Suppose I'm employed for a year, and part of my earnings come in the form of a future pension. That increases my net worth, so by the economists' definition, that's income. If the pension plan is of the "defined contribution" type – for example, my employer matches a part of my contributions to a 401K – measuring that income, by measuring the employer's match, is easy.

But suppose the pension plan is of the "defined benefits" type, where my future pension will be determined by some formula based on my years of service and other factors. Now, calculating my increase in net worth – how much more valuable my future pension is today than it was a year ago – is nearly impossible. So we don't even try, leaving this income entirely untaxed until the pension benefits are actually paid out.

An example of a provision that makes no sense whatsoever under an income tax is the individual retirement account, or IRA. These were created to mimic the tax treatment of pensions, which we just saw are extremely difficult to tax "correctly" under an income tax. Extending this tax treatment of pensions to IRAs, 401Ks, and other such retirement plans might be seen as only compounding the problem – and indeed should be seen that way, if our goal is to actually levy a true income tax.

A second example of the difficulty of taxing all income involves capital gains. A capital gain is the increase in the value of an asset you own, so again it's an increase in your net worth, hence income. Technically, all real capital gains should be taxed annually under an income tax. So, if our goal is to levy a true income tax, any real increase in the market value of the stocks and bonds you held all year should be listed as income on your annual form 1040.

There are two problems with actually doing this. One involves inflation. Part of your asset's increase in market value only reflects inflation; your real income would only be the "real" (inflation adjusted) capital gain. To handle this inflation problem, our Congress has sometimes allowed us to exclude a portion of our capital gain from taxation, and other times taxed those capital gains at a lower rate than other income. Both are rather crude adjustments, that don't even attempt to reflect the true inflation rate. Worse yet, our current tax code gives a similarly favorable tax treatment to dividend income, that has no inflationary component to it, but ignores entirely the inflation component in both interest income and interest payments on loans. This wildly inconsistent treatment of inflation is both patently unfair, it distorts investment decisions, and it opens the door to a variety of tax shelters.

The more difficult to address issue with capital gains involves liquidity. If you haven't sold any of your investment portfolio, you may not have the cash needed to pay the tax on this gain, forcing you to sell off some of the stock you own. To handle this problem, we don't tax capital gains until you sell the asset, "realizing" what had before been just a paper gain. But that again violates the logic of a true income tax.

The complexity of taxing capital gains as they occur is even greater when the asset is not something frequently traded. In 2007, if you were a homeowner, your home's value almost certainly increased by more than the inflation rate. Under the logic of an income tax, that real gain in net worth should have been reported on your form 1040, as part of your 2007 income.

My guess is though, you have no idea whatsoever how much your home's value went up that year. To even roughly estimate the increase, you would have needed to have had your home appraised in January of 2007, and again in January 2008, both at some expense. And again, this paper gain would not be particularly liquid – it wouldn't provide you with the cash to pay the tax bill, unless you sold your home. This would be a particular problem for the elderly, many of whom are house-rich but cash-poor.

There's another challenge to levying a true income tax that involves home ownership. Suppose you bought an asset – say, an ownership share in a restaurant – and because of that investment you earned a stream of consumption – say, one free meal per month at that restaurant. Under the logic of an income tax, that consumption stream should count as income, and be taxed. But when the asset that you buy is a house, you get a similar consumption stream – the shelter the house provides you. That consumption stream's market value is the rent you'd have to pay to live there, if someone else

were the owner. Economists call this "implicit rent". Under the logic of an income tax, implicit rent should be reported annually on your form 1040, and taxed.

Again however, we have a major measurement problem. What is the market rent for your home? What was it 5 years ago, and what will it be next year? You could hire a realtor to come in and annually give you an estimate, but again that would be cumbersome and costly. So our tax code ignores implicit rent, thereby once again falling short of a true income tax.

Interestingly, all of the problems listed above either disappear entirely or are easily addressed if we merely change our target. If we are trying to levy a true income tax, they are mostly insurmountable. But if our goal becomes levying a progressive consumption tax, they quickly disappear. We will turn to look at why that is.

The Logic of Consumption Taxation

Again, income is consumption (spending) plus changes in net worth (saving). So the difference between an income tax system and a consumption tax system is the treatment of savings. Under the logic of an income tax, your earnings are taxed whether they are saved or spent, and any earnings your savings bring in are also taxed. In contrast, under the logic of a consumption tax, only the portion of your earnings that you spend now are taxed now. The portion you save will for the most part also be taxed, but only later, when you actually spend those savings. A consumption tax is levied not on earnings, but on consumption.

Of course that sounds familiar to you, because our current "Income Tax" has many features of a true consumption tax. If part of your earnings go into a traditional pension plan, or into an IRA, or 401K, you right now are being taxed on those earnings only after you retire and begin to cash out those accounts. Converting our current "Income Tax" into a true progressive consumption tax would begin by expanding on those features of our tax code, and extending them in a variety of ways, as we will see.

Notice that although our current tax treatment of pension is altogether wrong under the logic of an income tax, it's exactly right under a consumption tax. I won't consume my pension until it's actually paid out to me, so under a consumption tax I shouldn't be taxed on it until my pension is paid to me. Similarly with the capital gains. If my stock portfolio has increased in value, but I haven't tapped any of it for spending, I have no consumption to tax. Waiting until I realize that gain by selling the stocks and bonds, although an anomaly under an income tax, makes perfect sense under a consumption tax.

The "implicit rent" problem at first glance seems like it would still be a problem under a consumption tax. After all, what isn't being taxed is a consumption stream, the shelter the home provides you and your family. As we'll see below however, addressing that problem is relatively easy under a consumption tax – and doesn't involve calling a realtor.

Besides being simpler to achieve than an income tax, a progressive consumption tax may be seen as fairer, and more consistent with some of our fundamental social principles. Taxing income means we are penalizing productive effort, be it working, saving, investing, or running a business (which generally combines the previous three activities).

Taxing consumption in contrast levies taxes according to one's lifestyle. A Warren Buffet who lives simply would be taxed simply; a Paris Hilton who lives lavishly would be taxed lavishly. As a society we are torn between the impulse to tax most those who can afford taxes most, and the impulse to relieve the tax burdens of those whose efforts spur economic growth. A progressive consumption tax retains the progressive impulse to tax the well off the most, but measures how well off you are not by the effort you contribute to the economic pie, but by the consumption you draw off from society. The entrepreneur who reinvests her earnings would be taxed relatively less; the socialite who spends profligately would be taxed relatively more.

The next several sections will lay out the details of a progressive consumption tax, and identify what in our current system would need to change – and what wouldn't.

The Tax Treatment of Savings

As noted already, our current tax system already treats a lot of savings as a consumption tax would prescribe; that is, earnings that are saved are exempt from taxation until they are spent. Thus, under a progressive consumption tax we would want to retain traditional IRAs, 401Ks, and similar "tax deferred" savings accounts. The primary changes would be to (a) substantially increase the amounts that can be contributed annually to these accounts; and (b) eliminate all penalties for early withdrawal.

There would only be one reason to have any limit on how much people could deposit in an IRA-type account under a progressive consumption tax – to prevent the wealthy from avoiding taxes indefinitely.[1] If there were no limit, a Paris Hilton could annually deposit just enough of her wealth into an IRA to cut her taxes to zero. A reasonable limit for most families would be a rather high fraction of "earned" (that is, wage or salary) income, say 25%.[2] Only a few families – perhaps professional athletes, who have a short but very high-paying career – would bump up against the limit. There would be a number of exceptions to the limit that would allow you to deposit more – to be discussed later.

There would no longer be a need to penalize "early" withdrawals, because the accounts would be for all savings, not just retirement savings. IRAs could be tapped for a new home down payment, or for college, or medical expenses, or a vacation, or whatever.[3] The withdrawals would be taxable, but there would be no additional penalty.

In concept, Roth IRAs are not consistent with a progressive consumption tax. Under a Roth IRA, contributions are not deductible, so the taxpayer would be paying taxes on income that isn't consumed. And withdrawals are not taxed, so that future consumption would go untaxed. However, you can think of the Roth as a way to "prepay" the tax on future consumption. That is, suppose I earn $100 today, "prepay" $20 in taxes, and save the remaining $80. That then grows by 10% to $88, which I consume next year without any additional taxes. If I hadn't had to prepay any taxes, my $100 would have grown to $110, which after the 20% tax would also have left me with $88 to spend. So the Roth IRA imposes a tax level equivalent to a same rate consumption tax.

The Roth IRA should be retained as part of a progressive consumption tax, but with one important modification, a limit on the types of assets held in a Roth IRA. In a traditional IRA, if you invest your funds in something very risky, say gold futures contracts, and you win and get a big payoff, you can then spend (consume) a lot, and pay a lot of taxes. If however your portfolio goes bust, you spend nothing, and pay no taxes.[4] Since your tax liability depends on your consumption level, it will vary with how your investments performed. But with a Roth IRA, since the taxes are "prepaid," you're taxed the same whether your investment pays off or not. To be consistent with the spirit of a progressive consumption tax therefore, Roth IRAs should only be allowed to hold low risk assets – savings accounts, CDs, money market funds, perhaps AAA rated bond funds.

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[1] Henceforth, by "IRA" I'll mean all such tax-deferred accounts, including 401Ks and similar accounts.

[2] Initially this limit should be kept well below 50%. A higher limit would allow high income individuals with large non-IRA investment portfolios to eliminate most of their tax liability just by shifting assets. The lower limit would slow that process.

Eventually, after the transition is nearly complete, the limit could be raised to above 50%. For the same reason, the top tier of tax rates should initially account for this sheltering process, to maintain the desired level of progressivity. A very gradual decline in the top tax rate could be programmed into the tax reform.

[3] For this reason, we would no longer need "special" tax deferred savings accounts, like Medical Savings Accounts and Education Savings Accounts. These should all be eliminated, with existing accounts rolled over into IRAs (for MSAs) or Roth IRAs (for ESAs). However, the tax code should continue to allow for both employer supported accounts like 401Ks and financial institution accounts like IRAs, to provide families with convenient options for automatic savings while retaining the option of employer matches.

[4] Economic theory suggests that this actually increases risk taking, since the government absorbs some of the investment risk through the tax code.

In summary, the tax code changes to savings accounts would be:

- **Raise the annual contribution limits on tax deferred savings accounts to 25% of earned income;**
- **Eliminate all penalties on early (i.e. pre-retirement) withdrawals;**
- **Limit Roth IRAs to holding low risk securities like money market funds;**
- **Eliminate redundant savings accounts (e.g. MSAs, ESAs).**

Consumer Borrowing and Consumer Durables

Under a consumption tax, any income that you don't spend (saving) goes untaxed. So conversely any spending that you didn't earn (unsaving) should be taxed. If that unsaving is a withdrawal from an IRA, that's already covered in the tax code. If however that extra spending is financed through borrowing, we need to take that into account.

The most straightforward treatment of borrowing would be as a reverse IRA. With an IRA, the savings that goes in is deductible, and the unsaving that comes out is taxed. A consumer loan would work the same, in reverse order: the unsaving (the amount of the loan you take out) would be taxed, while the repayments (paid back in) on the loan – both principal and interest – would be deducted. One advantage of this tax treatment is that those who default on their loans would get no tax break – if you borrow $10,000, blow it in Tahiti, and then go bankrupt, you'd still be taxed on the $10,000 you spent, but would get no deductions for the repayments you never made.

This would also be the appropriate tax treatment for personal loans used to purchase financial assets. Suppose someone borrows $10,000, and then deposits that money into an IRA. They haven't actually saved anything; if they got a deduction for the IRA deposit but weren't taxed on the loan proceeds, they'd have a tax shelter that might let them cut their taxes to zero. To prevent this, we would again need to treat the loan as a reverse IRA, with the loan proceeds taxed, and the interest and principal repayments deducted.

An alternative treatment of borrowing would be as a reverse Roth IRA. With a Roth IRA, the savings that goes in is not deductible, but the unsaving that comes out is not taxed. A "Roth" consumer loan would work the same, again in reverse order: the unsaving (the amount of the loan you take out) would not be taxed, while the repayments would not be deducted. This is how non-mortgage loans are currently treated. This tax treatment makes sense for secured consumer loans, like car loans and mortgages, where the loan finances a consumer durable good that will be repossessed if the consumer defaults on the loan.

Consumer durables are capital assets, like homes and cars and boats and TVs, that generate a "return" on the investment by providing consumption services – shelter, transportation, recreation, entertainment – over their lifetime. Technically, the logic of a consumption tax would suggest that the initial payment to purchase the asset (the deposit into the asset) should be deducted, and values of all the consumption services (the withdrawals out) should be taxed.

Measuring those withdrawals – in the case of a home, the "imputed rent" mentioned earlier – would however be hopelessly complex. So it's more appropriate to treat these as Roth-type assets: no deduction for the purchase, and no tax on the consumption service. Which is exactly how they are currently treated in our tax system.

Note that if you bought a $20,000 car, paying $2000 down and financing the rest over 5 years, (a) there would be no deduction for the $2000, so if you withdrew that money from a traditional IRA you'd be taxed on that $2000[5]; (b) since the car loan is secured, the $18,000 you borrow would not be taxed; and (c) correspondingly, your principal and interest payments would not be deductible. Again, this is how our tax code currently treats auto purchases, except that currently most people couldn't withdraw the down payment from an IRA without a penalty.

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[5] This is why a Roth IRA might be the preferred vehicle for those saving for a major capital purchase, like the down payment on their first house. Since this saving generally has a short time horizon, the low risk limitations for a Roth IRA would be appropriate.

This is not how we currently treat owner occupied housing. Home buyers currently get no deduction for their down payment, and pay no tax on the money they borrow, but they do get a deduction on their mortgage interest. This is not consistent with any type of either income or consumption tax. If we as a society want to encourage home ownership through our tax code, we could do it in a variety of ways – the simplest being some fixed amount tax credit for all home owners, unrelated to income, home size, or interest payments.[6] But the mortgage interest deduction should be eliminated.[7]

In summary, the tax code changes for consumer debt would be:

- **Tax all new borrowing, and allow a deduction for both principal and interest debt repayments, for all new unsecured consumer loans (e.g. credit card debt);**
- **Eliminate the mortgage interest deduction, perhaps replacing it with some fixed home-owner tax credit.**

The Tax Treatment of Small Business Income and Debt

Small businesses, whether sole proprietorships, partnerships, or so-called S corporations, are currently taxed at the individual level. That is, all of the business' income is attributed to its owners, whether the business actually pays that income out or not, and those owners then pay personal income taxes on that income.

That tax treatment makes no sense under a progressive consumption tax, since we want to tax individuals only on what they consume. And any income invested in the business is saved, not consumed. By that logic, a business should be treated as a traditional IRA: dollars that go in are deductible, earnings that come out are taxed (unless those earnings are then saved).[8]

Moving to a progressive consumption tax would only require two modifications to the status quo. First, under an income tax, deducting the gradual depreciation of capital equipment makes sense, but not under a consumption tax. Our consumption tax would treat new capital equipment purchases as if they were traditional IRAs: you get a full, immediate deduction for the dollars "put in" purchasing that equipment. This immediate tax write-off of the purchase price of capital equipment is often termed "asset expensing."

Second, as we saw with consumer debt, if the new equipment were financed by borrowing rather than saving, allowing a deduction for the purchase of an asset without taxing the loan proceeds would create a tax shelter. So the appropriate tax treatment of new debt would be again as a reverse IRA, where the principal borrowed would be taxed as revenue, and both principal and interest payments would be deductible.

Since current tax law treats business income as "earned" income, as long as the owners are actively engaged in running the business, they would again be allowed to deposit up to 25% of this income into a tax sheltered savings account.

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[6] A tax credit like this would avoid all three of the major flaws in our current home-ownership subsidy, the mortgage interest deduction, which (a) encourages people to buy excessively large houses, (b) encourages borrowing homeowner equity while discouraging paying off the mortgage, and (c) provides the greatest home ownership subsidy to high income families that need it the least.

[7] For pre-existing mortgages, if the deduction were not just eliminated, it should be converted into a mortgage tax credit, at a rate equal to the median tax bracket. There is no reason whatsoever to continue providing a generous home ownership subsidy to the well off. If the current deduction were replaced by a fixed credit as suggested in the text, this mortgage interest credit could be phased out over say 10 years.

[8] However, as with current tax law, those deductions should only be allowed to offset the business' income, with any excess losses carried forward. This "firewall" provision prevents "hobby" businesses that consistently lose money from receiving a tax subsidy.

In summary, the only tax code changes for business income would be:[9]

- **Allow new capital equipment to be immediately and fully expensed;**
- **Treat all business borrowing as revenue, and allow a deduction for all new business debt repayments (principal and interest).**

The Purchase or Sale of a Business

Other than delaying the deduction of "deposits" into the business until it begins to earn profits, a personal consumption tax treats a business just like a traditional IRA. But that means that, just like an IRA, anything withdrawn is taxable, unless rolled into another tax sheltered savings account.

Under current tax law, some of the proceeds of the sale of a business are taxed as ordinary income, and some are taxed as capital gains. Under a personal consumption tax, ***all*** of the proceeds would be taxable as ordinary income, that is, taxed if consumed, and not taxed if saved. Correspondingly, all of the purchase costs of the buyer would be deductible (by expensing all the business assets that were purchased), again subject to the limitation that the business would have to show a profit.

The primary difference is the treatment of capital gains. Suppose you purchase a non-depreciating asset – say, a moon rock – for $10,000, and use it to generate income (maybe by renting it to museums). Under our current income tax, you would get no deduction for the $10,000, but all your rental income would be taxable.

So you run this business for 10 years, and then decide to sell it. I pay you $15,000 for the rock and perhaps your list of museum contacts. You would only owe taxes on the $5000 capital gain, the increase in your business' value over the 10 year period.

Under the progressive consumption tax, the purchase of the moon rock would have been expensed, giving you a $10,000 deduction to offset your rental income for the first few years. So when you sell that rock, it is only appropriate that you untake that deduction. Now, the entire $15,000 would be taxable, not just the capital gain.

Now, this does create a problem for existing businesses, that didn't get to fully expense their business assets when they acquired them. Hence we will need some type of phase-in of this tax treatment, to be discussed below.

In summary, the tax code changes for business purchases and sales would be:

- **Allow the purchase of a business to be immediately and fully expensed, subject to loss carry forward provisions;**
- **Tax the entire sale proceeds as ordinary earned income, subject to phase-in conditions;**
- **Allow the entire portion of the sale proceeds that was taxed as ordinary earned income to be rolled over into an IRA.**

Inheritances and Bequests

One of the more controversial features of our current tax system is the estate tax, sometimes called the "death tax". As we'll see, switching from income tax logic to a consumption tax logic will not entirely eliminate this controversy. But it will clarify it, and give us a cleaner conceptual background for debating whether estates should or shouldn't be taxed.

The first observation however should not be controversial. If our goal is to tax consumption, and put the highest tax rates on those who consume most lavishly, then inheritances should be treated as taxable income. If my Uncle Larry leaves me $10 million, that I subsequently squander on babes, booze and bling, well, it's only fair that the tax man takes a big bite out of my windfall. On the other

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[9] Although this article focuses only on reforming the individual income tax, these same changes – expensing new investment, and taxing new debt – would also clean up many of the problems associated with the corporate income tax.

hand, if I deposit most of my windfall into an IRA and only consume a modest proportion of my inheritance each year, I should only be taxed modestly.

Notice that there would be no need to worry about the accumulated capital gain on inherited assets, as under the current tax law. It doesn't matter what grandpa paid for his stock portfolio. Any of it you inherit and then sell and spend would be taxed.

Notice also that if you inherit the family business, and you sell it, all the sale proceeds would be taxable. But if you continue to operate it, you would have no immediate tax liability. All of the assets you inherited were left in the business – effectively, in the IRA – and only your withdrawals will be taxable.[10]

So, inheritances should be treated as taxable income, with the entire inheritance eligible to be sheltered in an IRA. So what does that say about the bequest? Well, that depends upon how you look at it.

So Uncle Larry earned $50 million over his lifetime, and spent $40 million of it. Then he died, leaving me the rest, which I immediately blew. It's clear that he got consumption benefits from the $40 million he spent, and that I got consumption benefits from the $10 million I spent. So we should each be taxed on those amounts accordingly. The question however is, did Uncle Larry get consumption benefits from the $10 million he never got around to spending?

The simplest answer is no, he didn't. So he (or more exactly, his estate) should pay no taxes on that $10 million bequest he left me. I should pay taxes on it, but not his estate. That is the simple answer.

The more complex answer, which you may or may not agree to, is that yes, he got consumption benefits from that wealth, even though he never spent it. Warren Buffett is renowned for being enormously wealthy yet living a simple, almost spartan lifestyle. Is he better off that the guy down the street who can just barely afford that same simple lifestyle? Certainly Warren doesn't have to worry about ever outliving his wealth, the way his neighbor does. So perhaps yes, having exceptional wealth confers consumption benefits that should be taxed. And levying an estate tax, that only falls on exceptionally large estates, may be the logical way to do it.

Or maybe not. As you can hopefully see, having an estate tax is neither particularly consistent nor particularly inconsistent with the logic of a consumption tax. I would note that if we choose to maintain an estate tax, that would require maintaining the various rules regarding large gifts that are currently also part of our tax code.

Generally speaking, with respect to gifts, we could allow the giver to deduct the gift amount, and then tax the receiver on that same amount. Far simpler would be to do neither. So effectively if I gave you a sweater, that would be treated for tax purchases as my consumption not yours. Which I'm OK with – but I am expecting a nice gift from you next time around.

Incidentally, whether an estate tax is retained or not, there would be no need for Uncle Larry to empty his tax deferred savings accounts during his lifetime. The current tax provisions that require withdrawals from IRAs and similar accounts beginning at age 70 could be eliminated.

In summary, the tax code changes for inheritances and bequests would be:

- **Tax inheritances as income;**
- **Allow the full deductible deposit of an inheritance into an IRA;**
- **Treat the continued operation of an inherited business as a deductable deposit;**
- **Eliminate mandatory age-related withdrawals from IRAs and 401Ks;**

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[10] However, since the inheritance tax liability would in effect be cancelled out by expensing all of the inherited assets (including good will), the heirs would not be able to claim depreciation deductions on the business' assets. Conversely, since the expensing of the inherited assets would effectively cancel out the inheritance tax liability, they would be no need to apply carry forward rules on any "excess" expensing.

- **Modify the estate tax as deemed appropriate.**

Insurance

From a consumption tax perspective, there are two types of insurance. The first type is property loss insurance, like home owner's insurance, renter's insurance, auto insurance. This insurance covers losses on the consumer durables on which you would already have prepaid your consumption taxes, so it makes sense to treat this type of insurance like a Roth IRA.

The insurance premium would not be deductible; if your employer pays for the insurance, that "income" should be taxed. But if you incur a casualty loss, the money you get should be tax free. After all, you are just replacing the auto you lost with its cash market value. And since we're treating consumer durables as Roth IRAs – no deduction for deposits, no tax on withdrawals – this is just a nontaxable withdrawal from your consumer durables account.

Health insurance could also be put into this category, no deduction for the premiums, and no tax on the services. However, our society clearly thinks of health care consumption as different from other types of consumption, and we seem to want to encourage health insurance by subsidizing it. A deduction however provides the biggest subsidy to those with the highest standard of living, and encourages an excessively large amount of insurance. A refundable tax credit of some amount per person (or per family), perhaps skewed to provide the largest subsidy to low income households, would make more sense.

The second type of insurance replaces lost income, either due to death (life insurance) or some other catastrophe (disability or income replacement insurance), and everything else. Buying income insurance is really a kind of investment, whose "payoff" depends on what happens to you. So, like other IRA-type investments, the dollars put in (insurance premiums) should be deducted; if your employer pays for the insurance, that "income" should be tax exempt. Accordingly however, the dollars paid out should be taxed.

In summary, the tax code changes for insurance would be:

- **Tax the value of employer provided health insurance;**
- **Provide a refundable tax credit for the purchase of health insurance;**
- **Allow the full deduction (or exemption) of life and income replacement insurance premiums, but tax life and income replacement insurance payouts.**

Social Security

From society's perspective, the Social Security system is primarily a transfer of funds from the working age population to the elderly. From the individual's perspective however, it might be seen as a type of retirement savings account. While young, I deposit into the system; when old, I withdraw out of it. From the latter perspective, it could be interpreted as another form of IRA, so for tax purposes, it could be treated either as a traditional IRA or as a Roth IRA.

In fact, currently it's treated as both. The Social Security taxes that are withheld from your paycheck are not deductible, so that "contribution" into Social Security is given Roth IRA treatment. But you don't pay income taxes on the matching amount that is paid in your name by your employer. So that contribution into Social Security is treated the same as your employer's contribution into a pension fund, that is, as a traditional IRA.

Logically then, since exactly half your contribution into Social Security gets traditional IRA treatment, exactly one half of your withdrawal from the Social Security system should be taxed. Our current income tax doesn't tax any of those benefits for many people, half of those benefits for many others, and more than half for some, depending mostly on what non-Social Security income they have. Although not exactly consistent with a consumption tax, those provisions could reasonably be maintained under a progressive consumption tax.

Existing Deductions, Exemptions, and Tax Credits

Our current tax code is loaded with a wide variety of deductions, exemptions, and tax credits. This is not necessarily bad, since many of these provisions are designed to accomplish some clear public goal. But it is hard to justify many of them. I will only address a few of the more important ones.

The deduction of state and local income, sales, and property taxes should be ended. Mostly, these taxes pay for government provided consumption – police and fire protection, roads, parks, and schools. Measuring a person's consumption of these services by measuring their state and local tax payments is a reasonable approximation.[11] If our goal is to comprehensively tax all consumption, excluding this category makes no sense. Besides, our current system of measuring the appropriate deduction, especially for sales taxes, is crude at best. The cleanest option is to drop the entire deduction.

The charitable contribution deduction should be retained. For the most part, charitable contributions do not represent the donor's consumption. The contributions may represent consumption on the part of the recipient. But generally, that would be for medical or educational services that would be given favorable tax treatment, for religious services that most of us would probably not count as "consumption," or for social services provided to low income households that would be taxed at a zero rate.

Under current law, only medical expenses above 7.5% of income are deductible. As with health insurance, a deduction provides the greatest tax support to those with the highest standard of living. If our public policy goal is to assist those who encounter large, uninsured medical bills, a refundable tax credit similar to the one provided for health insurance would make more sense. This tax credit should still be only available for uninsured medical expenses that exceed 7.5% of other taxable consumption.

The existing tax credits for post-secondary education tuition should be retained. Education is an investment; since its payoff, higher future income, is taxed, a deduction or tax credit for its purchase is appropriate.

The exemption of municipal bond interest income should be ended. That income finances consumption as much as any other form of income, and should be treated accordingly.

In summary, the tax code changes for deductions, exemptions, and tax credits would be:

- **Eliminate the deduction of state and local income, sales, and property taxes;**
- **Change the medical expense deduction to a refundable tax credit;**
- **Eliminate the exemption of municipal bond interest income.**

Transition Issues

Any change in the tax system creates transition issues, where people are either suddenly confronted with a big tax increase, or suddenly receive a windfall tax break. One major advantage of this roadmap is that it holds the number of changes down to just those needed to rationalize our tax system, and so keeps those transition issues down to a minimum.

The primary transition issues that arise have to do with "old wealth" – wealth that has been accumulated before the tax code was changed, but not already deposited in an IRA type of account. On the one hand, a one-time-only tax on old wealth has none of the work or savings disincentive effects most taxes have, since all the working and saving has already been done. On the other hand though, if someone's retirement depends on that old wealth, which had already been taxed and then saved, taxing it again may be unfair.

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[11] State and local taxes can be thought of as the "dues" state residents pay into their "club", that then provides its members with various services. As with all clubs, some members actually receive more services than others. But without any good way to measure how those services are divided, the best reasonable approximation is to tax the dues paid.

Fortunately, most retirement savings is in pension plans, IRAs, 401Ks, and home equity, all of which would be unchanged by these reforms. And most old assets and old debts would be grandfathered – by for example allowing the continued deduction of the depreciation of pre-reform investments, and allowing only an interest deduction on pre-reform debts, while mostly continuing to tax old wealth held outside of IRAs under the old tax rules – so many other transition problems would be avoided.[12] The only old wealth that would have potential transition issues would involve the sale of a business, and the treatment of large investment portfolios outside of IRAs.

As noted above, under current tax law, some of the proceeds of the sale of a business are taxed as ordinary income, and some are taxed as capital gains. This proposal would tax the entire sale as ordinary income. This would impose a much heavier burden on someone who sold their business on the day after these changes were adopted, compared to someone else who sold a week earlier.

To soften this impact, I propose a 20 year phase in. During the first year, the sale would be taxed 100% under the old rules, and 0% under the new rules. The following year the split would be 95%/5%, and so on, with the fraction that falls under the full ordinary taxation rules rising 5% each year. This would take into account the fact that before these tax changes were adopted, businesses weren't allowed to immediately expense the assets that they'd now be selling.

Over time however, old assets wear out and are replaced, and an increasing share of assets would have gotten the more favorable expensing tax treatment when purchased. After 20 years, just about all assets would have been replaced under the more favorable consumption tax rules. So the entire sale of those assets should also follow the consumption tax rules. However, businesses that had been purchased under the new tax rules, for which the new owners would get a full deduction (by expensing the purchased assets), or which were inherited and given IRA status under the new tax rules, would be fully taxed under the new tax rules on sale.[13]

The owners of large investment portfolios are generally the well-to-do, for whom weathering a tax increase will be less of a problem. Much of this old wealth will have been inherited, and is fairly lightly taxed under current rules.

Old wealth should not be eligible for deposit into either type of IRA.[14] As already noted, without such a limitation, a Paris Hilton could annually deposit just enough of her wealth into an IRA to cut her taxes to zero. Rather, it makes sense to continue to treat the income from this wealth under the current rules, with just two changes.

The first change would be to eliminate the current tax law's lower tax rates on dividend and capital gain income. This income finances consumption, and should be taxed at the same rate as any other consumption. Paris Hilton should not be taxed less on her Dom Pérignon merely because she paid for it by selling her inherited stock.

The second change however would delay taxing those capital gains if they are reinvested, rather than consumed. By adding a "rollover" provision to the tax code, investors could sell shares and reinvest in other securities without being taxed. That currently occurs within IRAs – you can buy and sell shares

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[12] As businesses get sold, or estates passed on to heirs, this old wealth would automatically begin to fall under the new tax rules.

[13] However, the business seller would only be allowed to roll over into an IRA the share of the sale taxed as ordinary income. Since under the old rules the share given capital gains treatment is only taxed on the gain, allowing the basis to go untaxed, allowing this share to also roll over would again create a tax shelter. Sellers who wished to roll over a larger portion of the sale would be free to do so, but only by voluntarily having that larger portion taxed under the new rules.

[14] Therefore, small businesses would be given IRA treatment only if purchased solely using IRA-eligible sources: inheritance proceeds, IRA rollovers, IRA-eligible business sales proceeds, taxed debt, and 25% of earned income. For businesses purchased using old wealth, full expensing of new investments would be allowed, and new debt would be taxed, but the original business purchase would be treated under the old tax rules, and the sale of the business taxed under the phase-in rules.

within the IRA, and as long as nothing is withdrawn, you pay no tax. This change would extend that tax treatment to investments outside of IRAs.

One of the tax games that sophisticated investors currently play involves "realizing losses", that is sheltering income by selling assets that lose value, while holding onto assets that gain value. Rolling over gains without plugging this hole would create an even bigger loophole for avoiding taxes. So a new rule, allowing capital losses only to offset realized capital gains, would be needed.

In summary, the transition tax rules would be:

- **Phase in taxing the entire sale of a business as ordinary earned income over a 20 year period, by 5% each year;**
- **Tax dividends and capital gains held outside of tax deferred savings accounts at the same tax rate as other consumption;**
- **Allow capital gains to be rolled over into new investments, but only allow capital losses to offset realized capital gains.**

The Corporate Income Tax

This article's focus is primarily on reforming the personal income tax. The corporate income tax also needs reformed, but the reforms proposed here make sense no matter what happens to the corporate income tax. So there is no need to put off these changes, merely because of the complex issues that the corporate income tax reform raises.

Two notes however on the corporate income tax. First, it should not be eliminated. That would provide a windfall gain to shareholders. Secondly however, the same changes proposed for small businesses – expensing new investment, and taxing new debt – would also make sense for corporations. Adding them to the corporate income tax would effectively convert it to a tax on excess profits, or what economists term "economic rents." Of course, those changes, plus any other loophole-closing reforms that might be adopted, would require some appropriate adjustment of the corporate income tax rate.

Impact on Tax Shelters

The April 11, 2011 Edition of Bloomberg Businessweek described 11 ways that billionaires avoid paying taxes.[15] Three of them involved avoiding the estate tax, and wouldn't be affected by this proposal, unless the estate tax were either modified or eliminated. All the others would disappear. Mostly, these existing tax shelters don't eliminate tax liabilities, but rather delay them, which is in many cases almost as good. Those tax shelters, and the provisions eliminating them, are:

(1) **The "No-Sale" Sale**, in which an executive uses borrowing to avoid capital-gains taxes. Since all new borrowing would be fully taxed, this ploy would actually result in more taxes paid initially.

(2) **The Skyscraper Shuffle**, in which a business partner cashes out of the partnership, without triggering capital gains taxes. The roll over provision for capital gains taxes for old wealth, and otherwise the treatment of the entire sale, fully eligible for deposit into an IRA, would allow all investors, big or small, to get this same tax treatment without any complicated financial ploys.

(3) **The Estate Tax Eliminator** – not addressed.

(4) **The Trust Freeze** – not addressed.

(5) **The Option Option**, in which executives are paid in stock options that don't trigger taxes until years later. Under a consumption tax, this is OK, since the earnings are being saved but not consumed. The only issue would be that this might be used to avoid the 25% ceiling on contributions to IRAs. Some rule specifying how the receiving of stock options counts against the ceiling would be needed.

(6) **The Bountiful Loss**, in which an investor realizes capital losses to offset capital gains, without actually selling the assets that have lost value. Since under these new rules the sale of an asset would trigger a tax payment (unless the sale value were rolled over into another investment)

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[15] Jesse Drucker, "The More You Make, the Less You Pay", *Bloomberg Businessweek*,,April 11 – April 17, 2011, pp. 45-52.

whether the asset had gained or loss value, the game of realizing capital losses would no longer be worth playing. This game might still be played by those who hold old wealth, however.

(7) **The Friendly Partner**, in which an investor forms a partnership that borrows money that "loans" the investor the value of his original investment, all to avoid a capital gains tax. Since loans would now be taxed, this ploy would not change the investor's tax liability.

(8) **The Big Payback**, in which a billionaire who wants to avoid being taxed on his investments puts his money into various "permanent life insurance" contracts. Since all forms of investment would get this same tax treatment – no tax liability unless cashed in for consumption – everyone would get this same favorable tax treatment on all their investments, and the insurance industry would no longer receive an investment-distorting tax advantage.

(9) **IRA Monte Carlo**, in which investors choose to convert a traditional IRA into multiple Roth IRAs, and then undo the conversions on the ones that didn't increase in value. Under the proposed rules, Roth IRAs could only hold low-risk assets, so this type of conversion could no longer occur.

(10) **The Venti**, in which executives set aside large amounts of earnings in deferred compensation plans. As long as the amount set aside falls within 25% of earned income, this would be acceptable, but such deferred payment plans would have to meet the same rules as all other IRA-type of tax sheltered savings plans.

(11) **The Exit Strategy** – not addressed.

Recap

Hopefully you can see that moving to a consistent, coherent progressive consumption tax would not be particularly difficult. It would require a number of changes in our tax code, some of which might spur considerable controversy, but for most individuals, the changes would be well less than earth shattering. And since this proposal doesn't create any radically new tax structure, there would be no significant issues in administering the reformed tax code.

Some of the changes mentioned above are more critical than others to create a tax code that actually makes sense. The 16 changes that would be absolutely necessary for a coherent progressive consumption tax would be:

1. **Raise the annual contribution limits on tax deferred savings accounts, perhaps to 25% of earned income;**
2. **Eliminate all penalties on early (i.e. pre-retirement) withdrawals;**
3. **Tax all new borrowing, and allow a deduction for both principal and interest debt repayments, for all new unsecured consumer loans (e.g. credit card debt);**
4. **Eliminate the mortgage interest deduction, perhaps replacing it with some fixed home-owner tax credit;**
5. **Allow new business capital equipment to be immediately and fully expensed;**
6. **Treat all new business borrowing as revenue, and allow a deduction for all new business debt repayments (both principal and interest);**
7. **Allow the purchase of a business to be immediately and fully expensed, subject to loss carry forward provisions;**
8. **Tax the entire sale proceeds of a business as ordinary earned income, phased in over a 20 year period by 5% each year;**
9. **Allow the entire portion of the sale proceeds that was taxed as ordinary earned income to be rolled over into an IRA;**
10. **Tax inheritances as income;**
11. **Allow the full deductible deposit of an inheritance into an IRA;**
12. **Treat the continued operation of an inherited business as a deductable deposit;**
13. **Allow the full deduction (or exemption) of life and income replacement insurance premiums, but tax life and income replacement insurance payouts;**
14. **Eliminate the exemption of municipal bond interest income;**
15. **Tax dividends and capital gains held outside of tax deferred savings accounts at the same tax rate as other consumption;**

16. **Allow capital gains to be rolled over into new investments, but only allow capital losses to offset realized capital gains.**

These 16 changes alone would fully convert the personal "income" tax to a consistent consumption tax for almost everyone, and dramatically reduce the degree to which the tax code favors some taxpayers over others. However, all 16 would be needed. In particular, adopting the changes providing a more favorable treatment to saving and investing (#1, 2, 5, 7, 9, 11, and 16) without adopting the other changes would exacerbate the existing inefficiencies and inequalities within the tax code. This is not a menu to pick and choose from, it's an all-or-nothing package deal.

The other 8 proposed tax code changes would not be absolutely necessary, but are consistent with the logic of a progressive consumption tax. They would be:

17. **Eliminate redundant savings accounts (e.g. MSAs, ESAs);**
18. **Limit Roth IRAs to holding low risk securities like money market funds;**
19. **Eliminate mandatory age-related withdrawals from IRAs and 401Ks;**
20. **Modify the estate tax as deemed appropriate;**
21. **Tax the value of employer provided health insurance;**
22. **Provide a refundable tax credit for the purchase of health insurance;**
23. **Change the medical expense deduction to a refundable tax credit;**
24. **Eliminate the deduction of state and local income, sales, and property taxes.**

Finally, one additional change would be needed: adjusting tax rates. Mostly, the proposed changes would generate more tax revenue, so tax rates could be reduced substantially. My suggestion would be to adjust the tax rates to maintain roughly the current level of tax progressivity, while either maintaining current tax revenue, or increasing revenue somewhat as part of a comprehensive deficit reduction program:

25. **Adjust tax rates appropriately.**

Together, these 25 changes would greatly improve our tax code, reducing complexity, improving efficiency and fairness, and eliminating most tax shelters. This is a tax reform that could easily be done. And the best time to do it is now.