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Ironing Out the Flat Tax

David A. Weisbach*

This paper considers the design and implementation of the “Flat Tax” as proposed by Robert Hall and Alvin Rabushka and advocated by prominent policymakers. The purpose is to get a sense of the potential complexity and resulting compliance and administrative costs of the system.

Compliance and administrative costs are central to evaluating the Flat Tax. Much of its appeal lies in its alleged simplicity—the vaunted postcard returns resonate with many. If the claims of simplicity are not correct, proponents will have to make stronger arguments about its efficiency and fairness benefits. In fact, the benefits of the Flat Tax over other similar taxes, such as a VAT, may depend largely on claims of simplicity. If the claims of simplicity are not correct, the argument for the Flat Tax may fail. Moreover, if the claims of simplicity are not correct, there are likely to be gaps and loopholes that create adverse incentives and unfairness, weakening the efficiency and equity arguments. The devil might truly be in the details. To date, however, no details of the design of the Flat Tax have been offered.

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The term “flat tax” could mean any number of different things. Most generically, one might think it refers to any tax that has a proportional rather than progressive rate structure. As used in this paper, Flat Tax (capitalized to indicate the specificity of the reference) refers to the specific proposal set forth by Hall and Rabushka.

2 Hall and Rabushka have offered a broad outline of the proposal. The Flat Tax converts the current income tax into a national tax on consumption whose economic effects resemble those of a valued-added tax (VAT). It consists of two parts, a tax on individuals and a tax on businesses. Individuals are taxed on wages...
This paper will address only the design issues relating to the Flat Tax. It will not discuss the merits of an income tax versus a

and other employee compensation. Dividends, interest, rents, and capital gains are not taxed to individuals. No personal deductions, such as the deductions for mortgage interest or charitable donations, would be allowed. The individual tax is progressive at the lower end through a personal allowance or standard deduction, and flat thereafter.

The business tax is computed much like a VAT. Businesses are taxed on the difference between gross receipts from sales of property or services less the cost of business inputs, wages, and retirement contributions. The tax provides current expensing of all business purchases, and businesses may not deduct interest or dividends and do not include financial income when received.

The major difference between the Flat Tax and a VAT is that in a VAT, businesses do not deduct wages and individuals are not taxed on wages. VATs are collected entirely at the business level. In the Flat Tax, businesses get a deduction for and individuals are taxed on wages. The Flat Tax splits the collection of the tax between individuals and businesses but combined, the tax base is the same as the base of a VAT. The reason collection is split in the Flat Tax is so that individuals can be taxed on wages at a progressive rate.

From this basic outline, it is clear that the Flat Tax offers some simplification. Individuals may not claim personal deductions such as the medical expense or mortgage interest deductions, simplifying the law for many. In addition, individuals are not taxed on capital gains or interest. Businesses would no longer have to compute depreciation. These benefits alone may significantly reduce compliance costs.

But the proposal offered by Hall and Rabushka, and the legislation introduced based on their proposal, offers few additional details. We don't know, for example, the rules for such everyday transactions as the formation of a business, the liquidation of a business, or the sale of property on credit. Our economy is large and complex. The simple outline given by Hall and Rabushka does not come close to legislation that could actually be enacted. Without more detail, the benefits of the Flat Tax cannot be determined.

There have been several prior articles discussing design issues in the Flat Tax or similar taxes. The most comprehensive is Richard L. Doernberg, A Workable Flat Rate Consumption Tax, 70 Iowa L. Rev. 425 (1985). See also, Alan Feld, Living with the Flat Tax, __ National Tax J. 603 (199_); Ronald Pearlman, Fresh from the River Styx: The Achilles' Heels' of Tax Reform Proposals, 51 National Tax J. 569 (1998); Vernon Hoven, Flat Tax as Seen by a Tax Preparer, __ Tax Notes 747 (August 7, 1995); Michael Calegari, Flat Taxes and Effective Tax Planning, 51 National Tax J. 689 (1998); Joint Committee on Taxation, Discussion of Issues Relating to "Flat" Tax Rate Proposals (1995). See Alan Schenk, The Business Transfer Tax: The Value Added by Subtraction, __ Tax Notes 351 (January 27, 1986) for a discussion of subtraction method VATs which, as noted in the text, resemble the Flat Tax.
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consumption tax. Nor will it discuss important questions of economic efficiency or the equitable distribution of the tax burden under the Flat Tax, except as they arise from design problems. The transition to the Flat Tax will be discussed briefly, but only with respect to design issues, not efficiency or fairness concerns. In addition, the paper will assume that the Flat Tax is enacted in relatively pure form, so that political compromises that introduce additional complexity are not generally discussed. These issues are all important but are well covered in prior literature. The major hole remaining is the design of the system.

Although this paper is written at the level of implementation rather than theory, there is an important underlying theoretical problem. Suppose we identify an anomaly in the treatment of a transaction under the Flat Tax. Someone might be over or under-taxed or there may be an unintended incentive, maybe a loophole, that causes taxpayers to structure transactions inefficiently to avoid tax. The question is whether the tax should be amended to fix the anomaly or whether it should be left as is. This requires a trade-off between administrative costs of fixing the problem and the inefficiency, unfairness, and revenue effects of the leaving anomaly. How these trade-offs should be made is not fully resolved. Hall and Rabushka, for the issues they identified, had a strong preference for simplicity as witnessed by the proposed elimination of all personal deductions. But they failed to identify (or intentionally ignored) a large number of issues, and decisions must be made on these issues. The recommendations here are based on my judgment about the costs of complexity compared to the costs of a given anomaly. These judgments may be completely wrong (although I don’t think so), but the point of the paper is not to recommend final resolution of the issues but rather to identify the issues that must be dealt with in designing the Flat Tax and to evaluate the costs of solutions.

3 For a good introduction to the literature, see Economic Effects of Fundamental Tax Reform (Aaron and Gale, eds., 1996).
The Flat Tax proposed by Hall and Rabushka is a tax on consumption, not income. Section I of this paper, therefore, gives background on consumption taxes and the basic mechanics of the Flat Tax. It also considers several features unique to the Flat Tax that play a prominent role in its design. Section II considers six major design issues. Section III then gives a very brief discussion of other design issues that will have to be resolved to implement the Flat Tax. Section IV evaluates the design and provides a conclusion.

I. Background

A. Consumption Tax Basics

This section provides background on consumption taxes in general, not limited to the Flat Tax. This background is necessary for understanding the Flat Tax. All of the material provided in this section can be found in prior literature.5

The goal of a consumption tax is to capture all consumption in the economy. Instead of measuring consumption directly, say through a tax on consumption purchases, consumption can be derived from income. Income in a given period is equal to the sum of a taxpayer’s consumption and his change in savings during that period.6


6 As most of the conclusions of this section can be found in a variety of other sources, I will not explicitly footnote each conclusion. As stated in the text, all of the material in this section can easily be found in prior literature, including that listed above.
period. By simple algebra, then, consumption is equal to income less the change in savings.

Change in savings in a given period is equal to the difference between amounts saved and amounts withdrawn from savings to be used for consumption. We can measure this difference by measuring difference in receipts from the sale of investments and purchases of investments. Net receipts in a period means that the taxpayer withdrew savings to consume and net payments means the taxpayer saved. As a result, we can tax consumption by measuring cash flows, including receipts, and deducting outlays (other than consumption outlays). A tax following this pattern is called a personal cash-flow consumption tax.

One important consequence of this logic is that the major difference between an income tax and a consumption tax is the timing of basis recovery. In an income tax, there is no deduction for savings. Instead, investments are given tax basis which is recovered when the investment is recovered (e.g., through depreciation or on sale). In a cash-flow consumption tax, basis is recovered immediately through a deduction for outlays (i.e., investments are expensed).

A second consequence of this logic is that, under certain assumptions, a consumption tax does not tax (exempts) the yield on investments. The intuition is that the immediate deduction in the cash-flow consumption tax creates tax savings, which can be invested. When the investment is sold, the taxpayer must pay tax on the full amount realized, but the tax is exactly equal to the invested value of the original tax savings.

Example

Suppose a taxpayer earns $100 and wants to invest it. Assume the taxpayer has two choices: an investment that is immediately deductible but which is fully taxed on sale, and an investment that is not deductible but whose yield is exempt. Assume the tax rate is 40 percent and that the pre-tax return on investments during the relevant time period is 50 percent.

If the taxpayer invests in the asset with the exempt yield, the taxpayer must first pay tax on the $100 earnings. Thus, the taxpayer must pay a tax of $40 and has only $60 to invest. The $60 will earn a 50 percent return, or $30, which is not taxed.
Withdrawing the initial $60 invested is tax free, leaving the taxpayer with $90.

If the taxpayer invests in the deductible investment, the taxpayer will be able to invest the full $100. The $100 will earn a 50% return giving the taxpayer $150. When the cash is withdrawn from the investment, the taxpayer must pay a tax of 40% of $150, or $60, leaving the taxpayer with $90. Thus, the immediately deductible investment and the yield-exempt investment leave the taxpayer in the identical place, with $90.  

A cash-flow consumption tax allows immediate deductions for all investments and, therefore, under the assumptions, exempts the yield on investments. Therefore, we can replicate a cash-flow consumption tax by simply not taxing the yield on assets but also not allowing a deduction for purchases. This method of taxation is called “yield exemption.” The Flat Tax uses yield exemption for nonbusiness assets such as housing.  

6 Stated algebraically, a taxpayer earns $x and is subject to tax rate t. The return on investments is i. If the investment of $x is not deductible but the yield is exempt, taxpayer is subject to an immediate tax on $x leaving $x (1-t) to invest. The taxpayer's position after n years is:

$$x (1-t) (1+i)^n$$

If the taxpayer can deduct the investment, the taxpayer can invest the full amount and the pre-tax position after n years is $x (1+i)^n. The taxpayer is taxed on the return (and the withdrawal of the investment), leaving the taxpayer with:

$$x (1+i)^n (1-t)$$

These two expressions are equivalent.

The assumptions behind the equivalence are listed in Michael Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575 (1979). Other than the assumptions concerning inframarginal returns, discussed in the text below (i.e., that the taxpayer can immediately invest the tax savings at the same rate of return as the original investment), the most important assumption is that rates are not progressive (or, more narrowly, that the taxpayer stay in the same tax bracket) and stay the same during the term of the investment.  

7 As an aside, note that under a consumption tax and when the assumptions hold, the present value of the taxpayer's tax liability does not change regardless of when it is paid. Similarly, the present value of the taxpayer's consumption bundle is the
If this equivalence holds, the cash-flow consumption tax is just a tax on wages. The reason is there are only two sources of resources used for consumption, labor and capital. If the return to capital is exempt, only labor is taxed, effectively creating a wage tax (treating all returns to labor as wages). There are, however, two major exceptions to the cash-flow, yield-exemption equivalence.

First, a cash-flow tax taxes certain returns in excess of the market rate of return, known as inframarginal returns. An inframarginal return is the return from any investment opportunity in which one cannot invest additional cash at the same rate. For example, monopoly profits are inframarginal returns.

The intuition that a cash-flow tax taxes inframarginal returns is that taxpayers cannot fully “gross-up” their investments by the tax savings because the savings must be invested at a lower rate than the original investment. The return on their investment of the tax savings from a deduction earns only the marginal rate of return, not the inframarginal rate. These returns will not then be sufficient to pay the tax on the original investment (which will have grown more quickly) when the investment is sold.

Example

The facts are the same as above in which the taxpayer earns $100 and wants to invest it. Suppose, however, that the marginal rate for investments is 10% but the taxpayer has an opportunity to invest $60 at a 50% return. The remaining $40 (the tax savings from not paying immediate tax on the earnings) must be invested at 10%. After one year, the taxpayer has $90 from the 10% investment and $44 from the investment of the $40 of tax savings, for a total of $134. This is fully taxable, so the tax liability is $53.60, leaving the taxpayer with $80.40. A yield-exempt tax would leave the taxpayer with $90 (the $60 left after tax, invested at 50%). The difference between yield-exemption and cash-flow taxation is $9.60.

The $60 investment produced a return 40 percentage points greater than the market return, or $24 (the $90 super-return is same regardless of when he consumes. In this sense, the consumption tax is said not to distort the timing of consumption (and correspondingly, the decision to save). This is one reason for adoption of the consumption tax put forth by its advocates.
more than the $66 regular return on the same $60 investment by $24). A tax on this excess would be $9.60, which is difference between total exemption of the yield and cash flow taxation. Thus, cash flow taxation taxes the return in excess of the marginal return.8

It is not clear what portion of investments produce inframarginal returns.9 Inframarginal investments are not just investments that produce extraordinary returns. Instead, they are investments in which one cannot invest additional money at the same rate. So a risky start-up business may not produce inframarginal returns as additional cash would be welcome. Instead, they may produce large returns to human capital (i.e., talent or skill) and to risk. But if we cannot adequately police the border between

8 Note that another way to view the example is view the government as demanding a portion of the inframarginal investment (equal to the tax rate). This forces the investor to put less money into the inframarginal investment and more into marginal investments, which reduces the investor's returns. For example, using the numbers above, the investor would be viewed as investing $36 in the inframarginal investment, getting a deduction for this investment and grossing up the deduction for a total investment of $60, $24 of which is really the government's. When the investment is sold, the benefit of the deduction offsets the tax leaving the investor with the inframarginal 50% return on $36 (i.e., $54). The investor, however, has $60 to invest, so the investor invests the other $24 at the market rate of 10 percent, and deducts the investment and is taxed sale.

Under this view, no tax is imposed on any investment but the return is lower than in the yield exempt case because in the cash flow regime, the government gets a share of the inframarginal investment. One might argue, then, that it is inappropriate to say that the cash-flow tax “taxes” inframarginal returns. For purposes of this paper, it does not matter whether it is called a tax. All that matters is that the cash-flow regime the government gets some portion of inframarginal returns and does not under a yield-exempt regime.

9 The only estimates that I am aware of are in William M. Gentry & R. Glenn Hubbard, Distributional Implications of a Consumption Tax (1997). Unfortunately, Gentry and Hubbard based their conclusions on the fact that the ratio of fair market value to book value is higher for the wealthy. This measure—Tobin’s q—may indicate the presence of inframarginal returns but it may also reflect either a longer holding period and appreciation at the riskless rate or the return to risk. See Joseph Bankman & Barbara H. Fried, Winner and Losers in the Shift to a Consumption Tax, 86 Georgetown L.J. 539, 546 (1998) for a discussion.
wages and capital, so that entrepreneurs are likely to take some of their returns to human capital in the form of a return to capital, capture of these returns by the capital portion of the tax is important.\(^\text{10}\)

Second, depending on the particular transition rules that are adopted, a cash-flow consumption tax would tax all existing capital (old wealth) on a one-time (present value) basis. Consider a taxpayer who makes a $100 investment today under the income tax. She gets basis equal to $100. Suppose tomorrow we impose a cash-flow consumption tax, and the next day she sells the investment for $100. When she sells the investment, she receives $100, fully taxed under the cash-flow consumption tax. The effect is that wealth existing on the date the consumption tax is imposed gets taxed, regardless of whether it had previously been taxed (had tax basis) under the income tax.

Whether this happens depends on the transition rule for changing to a new system. For example, if we eliminated the income tax and imposed a broad-based retail sales tax (a type of consumption tax), all spending for consumption would be subject to the tax. In particular, there would be no recovery of existing income tax basis because all purchases would be subject to the retail sales tax, even if made out of cash from the sale assets with a high basis under the no-longer existent income tax. If we instead imposed a yield-exempt regime, there would be no tax on existing capital as all returns, such as our taxpayer's receipt of $100 on the sale of her investment, would be explicitly exempt.

While many economists treat consumption taxes as necessarily taxing existing wealth (and taxes that do not are different types of

\(^{10}\) As an aside, note that an income tax exempts returns to risk-bearing. The intuition is that taxpayers can adjust their portfolios to offset the tax. See Alvin C. Warren, Jr., How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax, 52 Tax L. Rev. 1 (1996). This return is also exempt under the consumption tax. Thus, the only component of the return on capital that is taxed under an income tax but not a consumption tax is the riskless return, making the distinction between the income tax and the consumption tax very small. See Joseph Bankman & Thomas Griffith, Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?, 47 Tax L. Rev. 377 (1992).
there is nothing inherent in the concept of consumption that prevents us from choosing any form of transition relief desired. For example, we can choose to allow recovery of existing income tax basis when we switch to a consumption tax, which would reduce the tax on existing capital to the extent it has been taxed under the income tax (i.e., to the extent of income tax basis less liabilities). The Flat Tax has no explicit transition rules and, therefore, will fully tax existing wealth.12

Transition effects raise important economic, fairness, and political issues which may cause us to allow or deny transition relief. The common assumption in the economic literature is that taxing old capital on transition is efficient as the tax cannot be avoided.13 As will be discussed in section __ below, however, under almost any feasible assumptions, the transition tax will be avoidable. Nevertheless, I will assume that the Flat Tax offers no transition relief, consistent with the Hall Rabushka plan. This simplifies much of the design as transition rules need not be considered.14 But given the likelihood of some transition relief, Section __ below will briefly discuss potential options and the pitfalls.

To summarize, a cash-flow consumption tax taxes wages, inframarginal returns to capital and, on a one-time basis, all existing capital. The two major differences between a cash-flow tax and a yield-exempt tax are the tax on inframarginal returns and the tax on

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11 See, for example, Jane G. Gravelle, The Flat Tax and Other Proposals: Who will Bear the Tax Burden, Tax Notes 1517, 1521 (December 18, 1995) (arguing that “provid[ing] relief to old capital is inconsistent with the fundamental nature of a consumption tax.”) See also Alan J. Auerbach & Laurence J. Kotlikoff, Dynamic Fiscal Policy. The best interpretation of their insistence that consumption tax taxes existing wealth is that it is an attempt to impose consistency of language within the community rather than an argument that there is something inherent in the words “consumption tax” that require such a result.


13 See, e.g., Alan J. Auerbach & Laurence J. Kotlikoff, Dynamic Fiscal Policy.

14 For example the transition rules are the reason for much of the complexity of the USA tax. See Louis Kaplow, Recovery of Pre-Enactment Basis Under A Consumption Tax: The USA Tax System __ Tax Notes 1109 (August 28, 1995); Alvin C. Warren Jr., The Proposal for an “Unlimited Savings Allowance,” __ Tax Notes __ (August 28, 1995).
existing capital. A yield-exempt tax would not to tax inframarginal returns as all returns from capital are explicitly exempt. Nor would a yield-exempt tax impose a tax on existing capital without a special rule doing so because the yield on all capital is explicitly exempt. Therefore, a yield-exempt tax taxes only wages.

B. The Flat Tax—General Background

This section will consider the general functioning of the Flat Tax as set forth in the Hall/Rabushka book. Three points will be made. First, the Flat Tax is a progressive consumption tax. Second, the business level tax in the Flat Tax (described below) would exist only to tax existing wealth and inframarginal returns. This second point is significant as most VATs collect value added at the business level while the Flat Tax does not. Third, the Flat Tax imposes multiple methods of taxing capital.

Begin by considering a retail sales tax. A retail sales tax is a direct tax on consumption purchases. If applied to all consumption purchases in the economy, it would be a consumption tax, equivalent in overall effect to the cash-flow tax discussed above.

The explanations of why the retail sales tax and the cash-flow tax are consumption taxes were quite different, but it is easy to see the connection. In a cash-flow consumption tax, the taxable amount for a given taxpayer is equal to his consumption purchases, as investments are deducted. Thus, the taxpayer effectively pays a tax if he purchases a good or service. The collection mechanism is for individual taxpayers to pay a tax on all of their consumption purchases during the year (or other accounting period) once, in a single tax filing. No special listing or tracking of each consumption purchase is required. In a retail sales tax, a tax is paid when a good or service is purchased for consumption. Businesses remit the tax, and

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15 This statement is true only in the most abstract sense on an economy wide basis. Actual transition to a yield-exempt tax might be complicated, for example, because long-term contracts and other relationships might not immediately adjust to the tax. For example, a yield exempt tax would probably eliminate the deduction for interest for the borrower and not tax interest to the lender. The burden on debt is not changed but absent immediate changes to interest rates, the switch would create windfall winners and losers.
the tax computed for each purchase rather than on an annual basis.

The overall effect, however, is the same.\(^{16}\)

Next consider a valued added tax, or VAT. A VAT is simply a complicated method of collecting a retail sales tax. A VAT collects the tax on each good at each stage of production rather than only at the retail level. The reason most nations impose a VAT rather than a retail sales tax is that avoidance of a VAT is more difficult.\(^{17}\)

**Example**

Suppose Bigco creates a good from scratch and sells it in the market. To impose a VAT or a retail sales tax, we tax the value of the good by requiring Bigco to pay tax equal to the value of the good times the tax rate. In this simple case, the VAT is identical to the retail sales tax.

Suppose Bigco purchases inputs from another company. In a VAT, the company selling the inputs would be taxed on the value of the goods sold. Bigco would then sell the finished good to the public and be taxed. If we taxed Bigco on the full sales price of the good, we would double tax the good simply because Bigco purchased its inputs from another company rather than making the product from scratch. To prevent this, we allow Bigco to deduct its purchases or claim a credit for the taxes paid on the purchase, and the tax savings from the deduction or credit offsets the tax on the seller of the input.

A deduction for purchases and an inclusion for sales means businesses are taxed on a cash-flow basis. A VAT that allows a deduction for purchases and an inclusion for sales is called a

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\(^{16}\) This leaves aside many differences between the two systems. In particular, a cash-flow tax is collected at the individual level so that taxes may be tailored to individual circumstances (for example, by allowing deductions for special consumption purchases such as medical services, or by imposing progressive tax rates). The text only attempts to show rough equivalences, so that design choices may be based on other considerations.

\(^{17}\) The reason that avoidance is more difficult in a VAT is that by collecting tax at each stage of production, avoidance at one stage only eliminates a portion of the tax. Avoidance at the retail level in a retail sales tax eliminates the entire tax. In addition, European VATs are designed so that business purchasers have an incentive to ensure that the seller has complied with the VAT, creating a self-policing mechanism. That Flat Tax would not have such a mechanism.
“subtraction method” VAT. Note that there is no deduction for wages and no direct tax to the workers on wages. Deductions are allowed to prevent duplication of the tax and, therefore, should only be allowed for goods or services purchased from a business that has already paid the tax. Workers are not taxed, so the purchase of their labor is not deductible. Like a retail sales tax, individuals pay the tax only on purchases.

European countries do not impose this method of VAT. Instead, they impose what is called a “credit-invoice” VAT. In a credit-invoice VAT, businesses get a credit against taxes for any taxes paid by the sellers of their inputs instead of a deduction. Conceptually, the credit and the deduction are the same—they both provide the same dollar offset against taxes for taxes paid by sellers of inputs. Both types of VAT use the same method to measure consumption. As will be discussed below, the real difference is the use of invoices.

The Flat Tax operates like the subtraction method VAT described above, except that it allows businesses a deduction for wages and taxes individuals on wages. Individuals are not taxed on investment income, just like in a VAT or sales tax. The benefit of the Flat Tax over a VAT is that in the Flat Tax, wages can be taxed at a progressive rate, but in a VAT they cannot because there is no tax at the individual level. The Flat Tax, then, is a progressive consumption tax.

Once again, the difference between a consumption tax and an income tax is the recovery of basis. If an income tax were collected at the business level, businesses would not get an immediate deduction for the costs of inputs. Instead they would recover the cost over time. The only difference between the discussion here and the discussion of individual consumption taxes above is that here we are imposing the tax at the business level rather than the individual level, but the principles for measuring (and taxing) consumption in the economy are the same regardless of where the tax is collected.

Thus, the crucial feature of the Flat Tax that makes it a tax on consumption is the immediate write-offs for expenditures. If the Flat Tax required businesses to depreciate assets based on their economic life, the Flat Tax would measure income. This type of tax has been labeled variously as an “income VAT” or, the Comprehensive
Business Income Tax (CBIT). Note also that one might be cautious in designing the Flat Tax around expensing as it would be an easy change in the future for Congress to require depreciation. The design should, if possible, be sufficiently robust to cover this possibility.

Given that the Flat Tax has an explicit wage tax, and that a consumption tax taxes wages, inframarginal returns and existing capital, the only reason for the business level tax must be to collect the tax on existing capital and inframarginal returns. This is significantly different than the European systems, in which the business level tax taxes valued added, and exemption from the business level tax has effects other than on transition or on inframarginal returns.

The business level tax does not apply to all capital. While the businesses are not defined by Hall and Rabushka or generally in the introduced bills, not all capital will be treated as held by a business in any likely definition. For example, personal residences, consumer durables, collectibles owned by individuals, and assets such as land or commodities held by individuals purely as investments are unlikely to be treated as part of a business. These assets represent a significant portion of capital in the United States. Personal residences alone are 22 percent of the capital stock. The return on these assets is explicitly exempt instead of being subject to the business cash-flow tax. Because these assets are exempt from the business tax, they are not subject to the transition tax or the tax on any inframarginal returns.

Having multiple methods of taxing capital creates distributional and efficiency issues. Not imposing the transition tax and the tax on inframarginal returns on capital held outside of a trade or business means the overall tax on capital is lower, and more of the tax burden

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18 Another possible reason for the business tax is to prevent shifting of wage income into business income. If only wages were taxed, individuals could have firms retain part of the wage income and pay it out as dividends or capital gains. Gordon and MacKie-Mason show that in the presence of shifting, the business rate and the individual rate ideally are the same. Gordon and MacKie-Mason, Why Is there Corporate Income Taxation in a Small Open Economy?, 67 The Effects of Taxation on Multinational Corporations (1994).

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will necessarily fall on labor. In addition, if the reason the transition tax is efficient is because it is unavoidable, not imposing the tax on all assets will reduce its efficiency because it will be avoidable.

To summarize, the Flat Tax is a progressive consumption tax, collected at the individual level for wages and at the business level for existing capital and inframarginal returns. The key to the Flat Tax taxing consumption is the cash-flow mechanism at the business level, which allows expensing rather than capitalization and depreciation. Progressivity is created through the progressive tax on wages. Non-business capital is taxed under the yield exempt method so the Flat Tax imposes multiple methods of taxing capital.

C. Some Important Details of the Flat Tax

There are several additional details of the Flat Tax necessary to understanding and designing the system. The most important of these is what I will call the "openness" of the Flat Tax. By openness, I mean that the Flat Tax allows deductions by businesses that are not necessarily offset by corresponding inclusions elsewhere. For example, a business may deduct the cost of land purchased from an individual, but the individual is not taxed on the sale.

Credit-invoice VATs, by contrast, are generally "closed," in the sense that credits are only allowed for purchases from taxpayers under the invoice mechanism. In a closed system, transactions generally have no net tax effect unless they are consumption purchases because businesses may claim credits only if there is an offsetting tax somewhere else in the system. This is consistent with the structure of a VAT which is designed so that credits or deductions offset tax liability at earlier stages in production. Only when the good or service is ultimately purchased to be consumed is there a net tax on a transaction.

The openness of the Flat Tax stems from two sources: the lack of invoices for domestic transactions and the treatment of international transactions, each of which is discussed below. In addition, the Flat Tax treatment of financial instruments, pensions, losses and several other items are briefly described.

1. Lack of Invoices

Recall that the Flat Tax has multiple regimes for taxing capital. The cash-flow regime applies to all assets used in a trade or business.
Assets not used in a trade or business, for example, land or durable assets held by individuals, are taxed under a yield-exempt method.

The openness of the Flat Tax comes from the interaction of these two regimes and, in particular, the lack of an invoice system governing the treatment of assets that switch between the regimes. Suppose an individual owns land worth $100 on the transition date. At some later date, a business buys the land for $100 and then resells it to a third party for $100. If the purchase is nondeductible (because the system is closed and a nontaxpayer was the seller), the business has gross receipts of $100 on the sale of the land and no deduction on the purchase, so its net receipts are $100 and it pays tax on $100. If the purchase is deductible (because the system is open), the business has no tax liability as the $100 deduction for the purchase offsets the $100 receipt on sale. Thus, the closed system taxes the full value of the land held by the individual while the open system exempts the value of the land held by the individual. The difference between the open and closed systems is the transition tax. Closed systems impose a transition tax on assets that switch from non-business to business use while open systems do not impose a tax on these assets.20

Realistically, the value of the land will vary between the transition date and the time the individual sells it to the business and between the time the business buys it and sells it. These fluctuations in value do not affect the conclusion. For example, if the land

20 There are some qualifications to this conclusion. For example, closed and open systems are different on the resale of used goods. Suppose a consumer purchases a car subject to the Flat Tax and then resells the car to a used car dealer. Tax was paid once by the individual. If the car dealer cannot deduct the purchase price of the used car, a double tax is imposed when the dealer sells the car. If the dealer can deduct the purchase price of the used car, only a single tax is imposed on the use (by two different individuals) of the car. To avoid the double tax created by a closed system, European VATs have special rules for used goods. An open system would require no special rules.

Similarly, an individual might create a capital asset after the transition tax and sell it to a business. Open and closed systems will tax the sale differently and the open system will allow the return to the individual's efforts, the labor earnings, go untaxed. The difference, however, depends entirely on whether the creation of the capital asset by the individual is treated as a business. The discussion in the text below highlights the problems with the definition of a business in an open system.
changes value while held by the individual, the expected present value of the land on the transition date will still be $100 and the expected present value of the tax in the closed system will be the tax on $100. If the land appreciates in value while held by the business, the appreciation is subject to the cash flow mechanism which will exempt normal returns and tax inframarginal returns. Thus, the net effect of the closed system as compared to the open system is to impose a transition tax on assets held by nontaxpayers on the transition date that are ultimately used in a trade or business.

The example above used an individual. But nontaxpayers potentially include foreigners (explored below), charities, governments, special classes of businesses such as small businesses, as well as individuals. In addition, most systems are not completely open or completely closed. European VAT's are generally closed but often have special classes of nontaxpaying businesses purchases from which are deductible.21 The Japanese consumption tax is open domestically but closed internationally. The Hall and Rabushka system is completely open but could be partially open instead. Note also that other literature, particularly that by Charles McLure, calls a closed VAT “sophisticated,” and an open VAT “naive.”22 I prefer the less weighted terms open and closed.

The decision to have an open tax will have distributional and efficiency effects. For example, if the tax is closed, assets that switch to business use after the transition date will be subject to the transition tax while if the tax is open, assets that switch regimes will not be affected. The additional transition tax imposed by a closed system may be inefficient because the tax is avoidable (it is based on a decision to shift assets from personal to business use). But an open system creates an incentive to shift assets to non-taxpayers immediately prior to transition and shift them back after transition and, therefore, makes the transition tax less efficient. It is not clear without more which system is more efficient. Similarly, reducing the size of the transition tax by having an open system will have

21 In VAT terminology, these businesses are known as “zero rated.” They are treated as paying tax at a zero rate so that they are taxpayers for purposes of the closed system.
22 Charles E. McLure, Jr., The Valued-Added Tax, Key to Deficit Reduction? (1987) at 71-79.
distributive effects as the transition tax falls on current wealth holders. Reducing the size of the tax means the tax burden necessarily falls more on labor.

The major advantage of an open system is that, at least at the surface level, it is cheaper to administer. In a closed system, each purchase has to be traced to a particular seller, and the business has to verify that the seller is a taxpayer. Effectively, invoices and tax registration are required in a closed system, exactly as in credit-invoice method VATs. Conceivably, the Flat Tax could be closed in which case many of the administrative and implementation issues would be similar to those of a European system. The Hall and Rabushka plan, however, is open and to highlight the administrative issues in the Hall and Rabushka plan, I will assume for the remainder of this paper that the system is open with respect to payments to domestic non-taxpayers.

Many of the implementation issues for the Flat Tax arise from its openness. While detailed examination of specific issues is left for Section __ below, some examples of how the open system affects design are useful here to show how pervasive the issue is.

Consider first the treatment of financial transactions. As discussed below, the Flat Tax does not allow deductions for payments on financial instruments and correspondingly, does not require an inclusion for receipts from financial instruments. For example, interest is not deductible by the payor and not includible by the recipient. Consider the treatment of a simple financial instrument, a contract to purchase fungible property in the future.

Example: Forward contracts

A business and an individual enter into a contract in which the business promises to purchase property for $100 in six months (a long forward contract). The forward can be settled in cash or property, at the election of the business. If the value of the property has gone up, the contract is settled in cash, creating no income to the business as the cash is from a financial transaction. If the value of the property has gone down, the contract is settled by delivery of the property (and subsequent resale by the business into the market), which produces a deduction for the business.
Half the time (when the value of the property has gone down), the business will have deductible loss. The other half of the time, the business will have exempt gain. Thus, a contract that has no expected economic value will generate expected tax losses. Moreover, the parties can take offsetting short and long positions in the same commodity (a straddle). The parties would then have no risk and the business would always end up with a deduction (on the long if the property value goes down and on the short if the property value goes up). Given that no risk is involved, businesses can use this transaction to eliminate business taxes at any time by simply doing it in greater size.

This transaction works because the Flat Tax is open (and ignores financial transactions). If the tax were closed, the purchase of the asset from the individual or other non-taxpayer would not be deductible, solving the problem. European VAT's, for example, do not have problems with this transaction as they are closed. Many other problems with the taxation of financial transactions are the result of the openness of the Flat Tax.

Second, consider valuation problems created by an open system. An individual who owns a profitable business could sell an asset to the business for a wildly inflated price (with payment made with funds loaned to the business by the individual). The business could claim a deduction and individual would have no corresponding inclusion. This means the government has to police the price of sales between businesses and owners in an open system. Effectively transfer pricing problems familiar in the international income tax context become prevalent domestically in the Flat Tax.

Third, consider the treatment of losses. European VAT's allow full refundability of losses. That is, the government makes a payment to businesses that have credits in excess of their tax liability. This is necessary to ensure that the net result of transactions between businesses is zero (with tax paid only on purchases by consumers from businesses). If the system is open so that invoices are meaningless, the possibility of losses being claimed improperly all but precludes full refundability of losses. The individual described above who mispriced an asset to offset taxes paid by the business could, if losses were refundable, require the government to write checks. This is generally viewed as intolerable, and Hall and
Rabushka therefore proposed that losses not be refundable. Instead, losses are carried forward increased each year by a very low interest rate.

Nonrefundability of losses, however, creates enormous administrative problems as transactions purely between businesses can generate tax. For example, suppose a business forms a subsidiary that will engage in a speculative research venture that will not produce profits until far into the future. If the business contributes assets to the subsidiary and the contribution is treated as a taxable sale or exchange, the business would have an inclusion equal to the value of the assets but the subsidiary would have nonrefundable losses. This means special rules, such as current law nonrecognition rules, will be needed to prevent mistaxation of these types of transactions. Effectively, large portions of the current corporate or partnership tax rules might have to be incorporated into the Flat Tax.

Finally, consider the treatment of small businesses. Suppose that for administrative reasons, small businesses are exempt from tax (discussed in Section _ below). Consider a small business that provides services to larger businesses, say a small law firm or computer support firm. That is, the small business operates at the wholesale rather than retail level. Suppose the price of the inputs (including wages) of the small firm is $100 and it charges $110 for the services. The small firm cannot deduct the cost of its inputs although the seller of the inputs will pay tax. Effectively, exemption from tax means the small business is treated as consumer of its inputs.

If the tax system is open, the purchasing businesses will deduct the $110 cost of the services. This deduction covers not only the $10 of value added by the small business but the $100 of deductions for inputs of the small business which the small business could not deduct because it was exempt. The net benefit of exemption in an open system is the tax on the value added by the exempt business.

If the tax system is closed, the large business gets no deduction for the $110 purchase. If it resells the product for $110, all $110 gross receipts are taxed. That is, the both $10 value added by the small business and the $100 of inputs used by the small business are taxed. But the $100 of inputs to the small business were already
taxed because the exempt small business could not deduct their costs on purchase (and the seller presumably had taxable receipts). This means the inputs of small businesses operating at the wholesale level are double taxed. This is why small business exemptions in the European system are used almost entirely by retail businesses, and other small businesses often elect to be taxed: for wholesale business, being taxed results in lower net tax payments than exemption!

These examples show that the openness of the system will affect many design decisions, making some, such as the treatment of financial instruments and losses, more difficult, and some, such as the treatment of small businesses, easier.

2. International Operation of the Flat Tax

The Flat Tax is unique in its treatment of international transactions because it taxes exports and exempts imports. As explained below, all other VATs exempt exports and tax imports. Although one might initially think that the difference is economically important because of the effects on imports and exports, it turns out, the most important implication is that this treatment makes the tax open internationally. This section describes the Flat Tax's international system and the economics behind it. Design issues are sketched in this section and are discussed in more detail in Section __ below.

a. Background

The Flat Tax, as described by Hall and Rabushka, is a territorial, origin-based consumption tax. A territorial tax does not tax foreign earnings, dividends, or interest of U.S. taxpayers. By contrast, the current income tax taxes worldwide income of U.S. taxpayers (although the taxation of the income is often deferred until repatriated). Territorial jurisdiction is typical of consumption taxes imposed throughout the world.

Under an origin-based consumption tax, a taxpayer gets a deduction for imports and pays tax on exports. This treatment applies whether there is a cross-border purchase or sale or the business simply ships the good across the border to a branch (in which case the deduction or income would be based on a

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23 Small businesses operating at the retail level do not have this problem in a closed system as there is no resale by the purchasing consumer.
hypothetical sale at fair market value at the border.) Effectively, the tax is imposed on domestic production, regardless where the product is consumed.

Example

Export. An automobile is produced domestically and sold to a retailer in Germany for resale and use in Germany. When the car is exported, a tax is imposed on the sale of the car just like any other sale by the business. The value of the production in the U.S. is taxed, but any value added in Germany, for example, through retailing, is not taxed by the U.S.

Import. A German automobile is purchased by a U.S. retailer for resale in the U.S. The retailer deducts the cost of the purchase, like any other business purchase. Only the value added in the U.S. by the retailer would be taxed (i.e., the difference between the price paid by the retailer and the sales price to the consumer).

The Flat Tax is open internationally because it is origin based. The German car maker is not subject to the Flat Tax when it sells the sale of the car to the U.S. retailer, so the retailer gets a deduction when there is no offsetting inclusion.

No existing VAT is origin-based. Instead, VATs are uniformly imposed on a destination basis. Under a destination-based tax, imports are not deductible and exports are not taxable. The tax base in a destination-based tax is domestic consumption.

Example

Export. Under a destination-based tax, the same car sold in Germany would bear no U.S. tax. Under a subtraction method tax, like the Flat Tax, no tax would be imposed on the sale but the selling business would still get a deduction for its inputs, effectively eliminating any tax imposed at prior levels of production.

Import. If a car is imported into the U.S., no deduction is allowed to the importer. When the importer sells the car, the

receipts are taxes, so that the full value of the consumption in the U.S. is taxed here.

In the above example, Germany will probably impose a destination-based consumption tax. Thus, if the U.S. imposes an origin-based tax and Germany imposes a destination-based tax, a car exported to Germany from the United States will bear U.S. tax and German tax. If the car were produced in Germany and sold in the U.S., then Germany would not impose a tax under its destination-based system and the U.S. would also not impose a tax under its origin-based system. U.S. exports, therefore, bear a double tax and imports bear no tax. (Note that this leaves aside questions about foreign income taxes.) This is obviously not the strongest political selling point of the Flat Tax.

Economists argue, however, that exchange rates will adjust to eliminate adverse effects (so long as the tax is imposed uniformly among all goods in the economy). This argument is summarized below. The major design issue created by an origin-based system is that the system is open and the problems created by an international open system are largely the same as those highlighted above domestically. The following sections discuss the basics of the economic analysis.

i. Destination-based consumption taxes do not alter international cash flows relative to a world with no taxes.

Consider the initial imposition of a uniform destination-based VAT. All prices in the economy would increase by the tax. There would, however, be no effect on trade flows. All taxes would be removed on export, so producers could export goods without tax, and exports would not be affected. Imports would bear a tax, but so would all competing goods, so relative prices would remain unchanged, and imports would not be affected either.

ii. Origin-based taxes are equivalent on the margin to destination-based taxes.

Suppose the destination-based consumption tax were replaced with an origin-based consumption tax. Now a tax is imposed on exports making the U.S. goods more expensive than other goods, and no tax is imposed on imports making foreign goods cheaper
than U.S. goods. This will mean there will be less demand for U.S. dollars by foreigners and more demand for foreign currency by U.S. nationals. Relative to other currencies, the dollar will weaken and, given consumers preferences for U.S. and foreign goods, the change in the value of the dollar will eliminate the effect of the tax.25

25 Al Warren gives the following example of switching from an origin to a destination based tax to illustrate the equivalence.

Suppose that the U.S. has an origin-based VAT of 10 percent with no border adjustments, and that a U.S. consumer product which costs $100 to produce will sell for $110, including the tax, whether sold in the U.S. or for export. Assume that a comparable product is produced in country Z and sells for 110Z in the local zed currency. Assume further that the exchange rate between the U.S. dollar and the Z zed is $1 = 1Z. Finally, for simplicity assume that there are no transportation costs for shipping the products.

Under these conditions, consumers in the U.S. and Z will choose between the two products on the assumption that they will sell for identical prices. Consumers in Z have the choice of buying the Z product for 110Z or buying the U.S. product for $110, which will require 110Z. Similarly, the U.S. consumers can buy either product for $110. A U.S. producer has the choice of selling in the U.S. market for $110 or exporting for 110Z, which will yield $110. In either case, the U.S. product will retain $100 after payment of taxes.

What will happen if the U.S. replaces its origin-based VAT with a destination- based VAT that exempts exports and taxes imports? Initially, the Z product appears more expensive to U.S. consumers than the U.S. product because the Z product will sell for $121 (the old price of $110 plus the new 10 percent tax) whereas the U.S. will still sell for $110. Similarly, the U.S. product now looks less expensive than the Z product to country Z consumers, because the tax rebate means that the U.S. product can now be exported from the U.S. for $100. The U.S. producer might therefore think it has an advantage in Z, where the comparable local product continues to sell for 110Z. Hence it is often argued that a destination-based VAT would stimulate exports and that an origin-based VAT would not.

Now consider what happens when the U.S. and Z consumers start to switch from Z products to U.S. products because the latter appear less expensive. That switch would mean that there would be less demand for the Z currency by U.S. nationals (who are reducing their imports of the Z products) and more demand for the U.S. currency by Z nationals (who are increasing their imports of the U.S. product). Given this change in demand, the value of the dollar will rise relative to the zed until there is no longer any advantage to switching from Z products to U.S. products, given consumer’s preferences relating to matters other than price, which preferences are
These currency adjustments are not intuitive to most people. The double taxation of exports and the zero taxation of imports will be immediately obvious to any observer but there will be no easy way to prove that currencies have adjusted. We will have to rely on the economists’ logic and, potentially, complex empirical studies. Thus, despite economist’s assurances, origin-based taxes like the Flat Tax are likely to face serious political problems.

Also note that the logic only applies to uniform taxes. Inevitably, some goods will not be taxed (e.g., goods sold by small businesses or any good given a special preference). Currency prices, however, will only adjust in the aggregate to the overall level of taxation. Thus, a sector of the economy that is taxed more heavily than the economy as a whole would be disadvantaged under the origin-based tax and a sector that is taxed more lightly would be at an advantage.

iii. Origin-based and destination-based taxes differ with respect to inframarginal returns and the transition tax.

An origin-based tax taxes inframarginal returns on inbound investments and imposes a transition tax on foreign investors in U.S. assets. A destination-based tax taxes inframarginal returns on independent of the tax law. In this simple example, the value of the dollar would rise until $1 could be exchanged for 1.1Z.

U.S. consumers would then have the choice between buying the U.S. product for $110 (including the tax) or the Z product for $100 (which would be exchanged for 110Z) plus the 10 percent tax on imports, for a total of $110. Z consumers would have the choice between buying the Z product for 110Z or the U.S. product for $100, which would require 110Z. Similarly, U.S. producers would be indifferent between selling in Z or domestically.

Taking into account the change in exchange rates brought about by the change in the relative prices of the U.S. and Z products due to the introduction of border adjustments, the destination-based VAT has no advantage over the origin-based VAT in terms of stimulating exports. One of the U.S. products exchanges for one of the Z products in both the U.S. and country Z under both taxes, and the U.S. producer earns the same amount from a sale at home and a sale abroad under either tax.

Michael Graetz attributes this example to Al Warren, but does not provide a citation. See Michael J. Graetz, International Aspects of Fundamental Tax Restructuring: Practice or Principle, 51 U. Miami L. Rev. 1093 (1997).
outbound investments and imposes a transition tax on U.S. taxpayers investing abroad.

Consider inframarginal returns first. Suppose that a U.S. corporation makes an investment abroad. Say it builds a plant abroad to produce goods sold here. Under a destination-based tax, any U.S. tax is rebated at the border and any import is taxed at the border. Effectively, the export of the plant is deducted and the import of the goods produced by the plant are taxed. Destination-based taxes give cash-flow treatment to foreign investments. An origin-based tax does not allow a deduction for exports and does not tax imports and, therefore, gives yield-exempt treatment. Following the usual difference between cash-flow and yield-exempt taxes, if there are inframarginal returns, the corporation bears a tax under the destination principle but not under the origin principle.

The same analysis, flipped, applies for inbound investments. Foreign businesses bear a tax on inframarginal returns on investments in the U.S. under an origin-based tax but not under a destination-based tax.

The transition effects are more complex because they depend on relative price changes. Grubert and Newlon argue that origin-based taxes impose a transition tax on foreign investments in the United States and destination-based taxes impose a transition tax on U.S. investments abroad. Their analysis, however, depends on adjustments in the domestic price level in response to the imposition of the tax. It is generally thought that the imposition of a VAT will cause an immediate increase in prices by the amount of the VAT, which means their analysis may be correct for VATs. But because the Flat Tax allows a deduction for wages, the price level change may not occur. Consequently, transition incidence may change.26

One can say much more about the international economic effects of the Flat Tax, but this is sufficient to consider design issues. One important question remaining is why the Flat Tax is origin-based if all other VATs are destination-based. The answer technically appears to be the GATT, although one suspects cosmetic issues of design also play a role.

26 See Jane Gravelle, The Flat Tax and Other Proposals: Who will Bear the Tax Burden, __ Tax Notes 1517 (December 18, 1995).
b. Why is the Flat Tax Origin-Based?

GATT 1994 imposes conditions on tax rebates on the export of goods to prevent nations from using tax rebates to create export subsidies. Generally, the GATT allows rebates for indirect taxes but prohibits rebates for direct taxes. The Flat Tax would probably be a direct tax because it taxes wages at the individual level. Thus, even though the Flat Tax is economically identical to a VAT (with a cash payment to individuals based on family size), which is an indirect tax, it is treated as a direct tax and may not grant border rebates under the GATT (i.e., it must be origin-based).

If the U.S. were truly serious about the Flat Tax and wanted it to be destination-based, one can imagine some accommodation at the international level. It would be difficult for other nations to insist on a distinction that makes no economic sense in the face of U.S. pressure. Another reason for the origin basis of the Flat Tax, however, is cosmetics. Hall and Rabushka have styled the Flat Tax as an income tax and frequently refer to it as an income tax, under the apparent assumption that this helps politically. Adopting an origin-based system makes it look like an income tax. Moreover, it means there are fewer changes from current law. The question is whether this cosmetic difference is worth the disadvantages: being inconsistent with other consumption taxes, relying on currency adjustments to avoid adverse effects on U.S. exports, and, being open internationally.

c. Effects on Design

The effects of the Flat Tax's international tax system on the design of the tax are discussed in Section ___ below. It is worth pointing out here that the most important implication of an origin-based tax on the design of the tax system is that it is open. The effects are similar to those of having an open system domestically: for example, an open system has transfer pricing issues, problems with losses, and difficulty taxing financial transactions. Allowing the system to be open internationally, however, compounds the effect because foreign businesses and their large, concentrated pools of capital are exempt. Problems with financial products and transfer

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27 See Shay and Summers, at 1054.
28 See Shay and Summers, at 1054.
pricing compound significantly merely because of the potential to increase their size and sophistication.

3. Additional Details of the Flat Tax

Hall and Rabushka provide a number of additional details for the Flat Tax. To give a more complete sense of the tax, the most important of these details are briefly described below, but further discussion will be taken up in the next or following sections.

- Interest is not deductible by borrowers and not taxed to lenders. More generally, financial transactions are ignored, generating neither deductions nor inclusions. Only real transactions are subject to the cash flow tax. The resulting system, used in all VATs, is known as an R-based system.
- Pensions are deducted by businesses when earned by an employee but not included by employees until paid (i.e., at retirement).
- Fringe benefits are not included by employees (as roughly true under current law and local governments and, roughly, charities as defined under current law, are exempt from tax.
- Businesses withhold taxes on wages.
- Losses are not refundable, but can be carried forward indefinitely with interest (i.e., unused losses increase each year by an interest rate).

II. Six Major Design Issues

The number of individual design issues presented by the Flat Tax is too vast to cover in a single paper of reasonable length. To get a sense of the overall system, this section considers six issues: (i) financial transactions; (ii) losses and structure of the business tax; (iii) accounting methods; (iv) international transactions; (v) small businesses; and (vi) the distinction between consumption and investment. The first four are chosen because they are the core of modern business tax planning and are responsible for much of the complexity of the current tax law. Because of the complexity of the issues raised by these transactions, the discussion here is necessarily an overview. Small businesses raise extremely difficult and somewhat
unique issues in the Flat Tax and are worth close examination. Finally, the distinction between consumption and investment is complex under current law and one would expect exactly the same issues to arise in a consumption tax as the same distinctions must be made. Hall and Rabushka claim a simple resolution of this distinction and it is worth seeing if their claim is correct. These six issues, therefore, should give a good sense of the overall administrative and compliance issues in the Flat Tax. Other issues, which may be equally important, are discussed much more briefly in the next section.

A. Financial Instruments

As noted above, the Flat Tax, like a VAT, is R-based, which means it does not allow deductions for payments on financial instruments and correspondingly, does not require an inclusion for receipts from financial instruments. Thus, interest and dividends are not deductible to payors and not includible to recipients. The nominal tax on a financial investment, therefore, is on the operating business rather than on the investor. For example, if an individual lends a business $100 at a 10 percent interest rate, the individual investor has no nominal tax liability but the business will not be able to deduct the interest and, therefore, will have nominal tax liability on the amounts it earns with the $100.

Because the Flat Tax is R-based, it must distinguish between payments on financial instruments and payments on other investments. If the Flat Tax does not properly distinguish between these two, taxpayers may be able to shift the tax on investments. For example, interest can be disguised as another type of cash flow that is deductible. This shifts the nominal tax on the interest to the investor contrary to the premise of the R-based system.

The ability to shift the tax on the return to an investment is a particular problem in an open system because a deduction to the business (for disguised interest) will not necessarily be offset by an inclusion to the lender. Thus, to the extent the Flat Tax imposes a tax on an investment (say because the return is inframarginal or on transition), shifting the nominal liability to a nontaxpayer avoids the tax. For example, in the case of disguised interest, the business will
be able to deduct the disguised interest but the lender will have no inclusion.  

The Flat Tax, therefore, will need a set of rules designed to distinguish the return on financial instruments from the return on goods and services. This distinction, however, is not coherent. Investments, whether financial or real, produce expected cash flows. There is little difference in theory in the two types of cash flows. Financial investments are ultimately (often through a series of intermediaries) investments in productive assets and the overall expected cash flows have to be the same. This means any set of rules in the Flat Tax that distinguish between financial and real returns will be manipulable.

The current income tax has some rules that distinguish financial returns from other others. For example, many rules apply only to positions in actively traded property, which, on a rough basis, describes many financial instruments. Moreover, current law attempts to identify disguised interest in some situations. But these rules are not complete and do not need to be because the current tax does not have the same dichotomy between the two types of payments. The Flat Tax, effectively, will need many of the current rules for identifying interest and other financial flows plus a host of additional rules to complete the regime. These rules would be complex, given the wide variety of ways financial and real flows can be intertwined. Given the lack of conceptual coherence, the Flat Tax is also likely to need anti-arbitrage rules. Similar types of cash flows can be created through financial and real assets. These cash flows will have different tax treatments which can be used in an arbitrage.

On the other hand, the timing of payments is less important in the Flat Tax so many of the current law rules on timing of income from financial instruments can be eliminated. (Section _ below

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29 Note that switching to an R-based tax from the current system will create dislocations even when the total tax on a transaction is the same. For example, under current law, interest is deductible to the borrower and includible by the lender and in an R-based tax, it is neither deductible nor includible. The total tax on a lending transaction remains the same. But a borrower with an existing, long-term obligation must pay interest based on a rate set under the prior regime. These dislocations are discussed in Section _ below.

30 See, e.g., sections 1092 and 1234A.

31 See, e.g., section 7872.
discusses accounting methods and discusses when timing can be important in the Flat Tax. Moreover, the capital gain and loss rules for financial instruments can be eliminated in the Flat Tax. There will clearly be some simplifications that can be made. The net effect is probably close to a wash—the Flat Tax rules will have to be about as complex as those of current law.

To make this discussion more concrete, this section will consider four examples which illustrate the problem of distinguishing financial from real flows. The first example given in Section above is illustrative of the problems with an R-Based, open system for financial instruments.

Example: Forward contracts

A business and an individual or foreigner enter into a contract in which the business promises to purchase property for $100 in six months (a long forward). The forward can be settled in cash or property, at the election of the business. If the value of the property has gone up, the contract is settled in cash, creating no income to the business because the cash is from a financial transaction. If the value of the property has gone down, the contract is settled by delivery of the property (and subsequent resale by the business into the market), which produces a deduction for the business.

Half the time (when the value of the property has gone down), the business will have deductible loss. The other half of the time, the business will have exempt gain. Thus, a contract that has no expected economic value will generate expected tax losses. Moreover, the transaction can be done as a straddle, so that the business is both long and short the same commodity. The parties would then have no risk and the business would always end up with a deduction (on the long if the property value goes down and on the short if the property value goes up). Given that no risk is involved, businesses can use this transaction to eliminate business taxes at any time by simply doing it in greater size.

This transaction works because the Flat Tax is R-based and open. If for example, the tax were not R-based, the transaction would be treated symmetrically regardless of whether the business settled with cash or with property. Businesses could no longer
generate exempt gain. (This is why the transaction is not a serious problem under current law.) Similarly, if the tax system were closed, the purchase of the asset from the individual or other non-taxpayer would not be deductible, again solving the problem. European VAT’s, for example, do not have problems with this transaction because they are closed.

The solution is to separate the payment into its financial and real elements. For example, the Flat Tax could treat assets as purchased for their fair market value on the purchase date, regardless of the price paid. Any difference between the fair market value of the asset and the price paid would be due to financial transactions and be nondeductible to the buyer and exempt to the seller. This approach solves the problem but requires valuation. In addition, it would be complex for everyday business transactions such as long-term fixed price contracts. Perhaps for certain contracts closely related to purchases of inventory, businesses could agree to treat all payments on the contract as payments for a physical good, which would eliminate the electively present in the example. One can imagine the details of this regime can be worked out but would be complex.

Example: Installment purchase by an individual from a business

An individual purchases a $100 good from a business by promising to pay $110 in one year. The transaction is documented as the purchase of a $90 good with $20 of interest.

By overstating interest on the sale, the business reduces its taxable receipts while not changing its cash flows. In the example, the business reduces taxable receipts by $10 as compared to a true statement of the interest in the transaction. The individual on the other side of the transaction is indifferent because no payment on the transaction is deductible. The parties, therefore, do not have adverse interests and there is a strong incentive to mischaracterize the transactions.

Correctly identifying the interest element in the transaction will not be easy because the parties often will have no incentive to negotiate a true interest rate. For example, in a typical retail installment sale (the purchase of furniture on credit), there is not likely to be a comparable, nondistorted price to use to determine the true price. Determining the true price would involve some measure
of profitability of sellers or the appropriate interest rate. One can imagine solutions that involve publishing maximum interest rates for various types of loans but any such solution would be complex.

In the next example, the cash flows are in the opposite direction—instead of a purchase by an individual from a business, there is a purchase by a business from an individual. The strategy, therefore, is to understate interest rather than overstate interest.

Example: Installment sale from individual to business

A business purchases property from an individual for use in a trade or business for immediate delivery. The property is worth $100 today and the business promises to pay the seller $110 next year. The transaction is documented as a purchase for $110 without any payment of interest.

This transaction involves an implicit loan. Effectively, the business borrowed $100 from the seller at a 10% interest rate. If we are to separate the interest element from the purchase of the physical property, we would give the business an immediate deduction for the $100 purchase and no deduction for the $10 of interest.

If we tax the business on a cash flow basis we produce the same present value result. The business would get no deduction for the purchase until it paid cash. But paying $110 next year is the same as paying $100 today, so the business is indifferent between the two methods and, therefore, documentation does not generally matter in this case.

The reason policymakers might care about this transaction is that it allows businesses effectively to elect to treat loans on a cash-flow basis. This allows businesses to shift the return to the financial investment to individuals contrary to the basic decision to have an R-based tax. Given the equivalence between yield-exempt and cash-flow taxes, policymakers should only care where the equivalence does not hold, namely in the presence of inframarginal returns. For example, if the interest rate were not just 10% interest, but instead was contingent on a return, allowing cash flow treatment would allow shifting of inframarginal returns to yield-exempt individuals. Note also that any problems presented here, such as non-taxation of inframarginal returns, would be eliminated if the tax system were closed.
Example: Arbitrage

Preliminary Example: Sale of property and repurchase

A business sells property to an individual for $100 and promises to repurchase the property next year for $110.32

Effectively, the business has borrowed $100 at 10% on a nonrecourse, collateralized basis. Because the loan is documented as two transactions in property, the business is taxed on a cash flow basis.

This transaction is similar to the first example of the forward contract—it involves a similar forward purchase of property for a fixed price. But the tax planning goals are different. In this transaction, the goal is to separate the interest element in the return to a physical investment from the risk element. By separating the interest element in a physical asset, this transaction allows interest to be taxed on a cash–flow basis. The proposed solution to forward contract above was to treatment the risk element in the financial contract as a financial return. This solution does not change the treatment of the interest element, which is the key here. This example more closely resembles the example of an installment sale from an individual to a business because it allows a loan to be treated on a cash–flow basis. The same concern is present, the shifting of inframarginal returns to non-taxpayers. And here again, this transaction is not a problem in a closed system.

Example: Arbitrage

A U.S. business enters into an arrangement with a shell corporation located in an offshore tax haven. In the arrangement, the shell borrows money from the business and promises to repay a contingent amount in the future. The shell then uses the money to purchase an asset from the business. In addition, the business agrees to repurchase the asset around the same time the

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32 Note that the property could be fungible property. There is some question of whether the business could use T-bills as the property, or whether, because they are financial instruments, the business would be denied a deduction. But the business could use gold or some other fungible, tradable, financial equivalent. If operating business property were used, the property could be leased back during the term of the loan.
loan is due for the same contingent purchase price. The contingency will be set so that it is very likely to go up at a very high rate.

The cash flows on the transaction wash out. The business can neither gain nor lose and at all times is in an identical position to doing nothing. The tax result for the business, however, is an immediate inclusion from the sale of the asset and a very large deduction when the asset is repurchased. The loan has no results under the Flat Tax. If the repurchase is set at high enough price, the business can simply manufacture deductions.

This example uses the ability to structure investment returns as either financial or real to create an arbitrage. The arbitrage puts the tax liability in a non-taxpaying entity and creates an offsetting deduction to a taxable business. Anti-arbitrage rules might prevent transactions as bald as this one, but either the rules will be overbroad or there will be some gaps.

The underlying problem behind all these examples is that there is no principled distinction between financial and real flows. For example, asset pricing models apply equally to financial and real returns. Economically, the two are simply not different and can, therefore, be intertwined in an indefinite number of ways. The transactions considered here are extremely simple, and I have no substantial economic incentive to find the really big holes. Taxpayers will have strong incentives to find others, and one can imagine that many more exist.

Switching to a closed system (i.e., using invoices and a destination basis) much like the European systems, would substantially reduce the problems. All of the problems illustrated above, except the problems in the retail installment sale example, would be eliminated under such a system. But this solution would effectively abandon the Flat Tax for a more traditional VAT.

If the basics of the Flat Tax are to be maintained, one place to start would be the various time value of money rules in current law.\(^{33}\) For example, the installment sale rules would reduce the problem

\(^{33}\) Note also that we cannot rely on capitalization of tax benefits into prices to reduce the problems presented here, as many of the transactions involve no net cash flows and can be done regardless of the price of the asset.
with understatement of interest in the sale from an individual to a business. New rules imposing maximum interest rates would reduce the problem of installment sales from businesses to individuals. Special rules for forward sales that allow deduction or require inclusion only of the fair market value of the underlying asset would help (treating the rest as a payment on a financial transaction). Integration rules or other anti-arbitrage rules would be needed to reduce the problems with creating loans through the sale and repurchase of property. The scope of these rules is likely to be broad and uncertain, and their application complex.

The Flat Tax, however, does offer some simplification in the financial products world. In particular, the character of gains and losses as ordinary or capital would no longer matter. In addition, timing would matter much less in the Flat Tax so many of the timing rules can be eliminated. Overall, the set of rules needed would be on the same order of magnitude in terms of complexity as the financial products rules under current law.

B. Losses and the Operation of the Business Tax in a Flat Tax World

This section considers two related subjects: (i) the treatment of net losses in a given year; and (ii) the rules governing business transactions such as formation, liquidations and mergers. These two topics are covered together because the treatment of losses is central to the design of the business level tax.

Hall and Rabushka propose not to allow refunds for losses (i.e., a cash payment from the government equal to losses in the accounting period multiplied by the tax rate), contrary to the uniform rule for VATs. While they do not clearly state their reasons, the apparent reason is the lack of invoices, which means the system is open.34 In an open system there is no necessary tension between a deduction (producing refundable losses) to one party and an inclusion at the same tax rate to another party. Without this tension,

34 They simply state that “whenever the government starts writing checks, clever people will abuse the opportunity through fraud and legal maneuvers.” Hall and Rabushka at 41. The lack of invoices is the primary reason why the opportunities for clever people will exist.
pricing problems and outright fraud become a significant concern.\textsuperscript{35} Instead of allowing refunds, Hall and Rabushka propose to allow losses to be carried forward (but not back) indefinitely, increased each year by the average daily yield on three-month Treasury bills during the first year.\textsuperscript{36}

The interest rate is set lower than the market rate. Although Hall and Rabushka do not give the reason why, presumably, if the interest rate were the market rate, a carryforward regime would create no fewer problems than a refund regime as the two would have the same present value. Thus, the low interest rate might be intended as an intermediate solution between full refundability or its equivalent and current law, which allows carryforwards without interest.

A low rate of interest on loss carryforwards will change some of the conclusions about the effects of the Flat Tax given in section \textsuperscript{2} above. To the extent the interest rate is lower than the cost of capital, the Flat Tax overtaxes some consumption. The value of the initial deduction for an investment that creates a loss will not be sufficient to offset the gain on the future sale because the deduction grows at a rate that is lower than the market rate. The greater the difference between the cost of capital and the carryforward rate, the higher the tax. The cost of capital will be higher for riskier projects but the refund rate will stay the same. Therefore, the analysis showing that a consumption tax does not tax the returns to risk would not apply: risky investments would be taxed at a higher rate than low risk investments. In essence the carryforward regime creates a sliding scale tax rate: goods and services produced by entities with high costs of capital are subject to a higher tax than goods and services produced by entities with lower costs of capital.

\textsuperscript{35} The Japanese consumption tax, however, is open (domestically) and allows refunds. One reason they can allow this is that their tax rate is only three percent reducing the incentive for evasion. Another reason is that they retained their income tax and there may often be tension between avoiding their consumption tax and creating income tax liability.

\textsuperscript{36} Apparently, the interest rate is determined based only on first year interest rates and does not thereafter adjust. It is not clear why it does not adjust, particularly as the rate is a short term rate. As discussed in the text below, this creates administrative problems.
While the nonrefundability of losses has economic consequences, the immediate implications for implementation are straightforward. Businesses would have to keep records of loss carryforwards, adjusting them by the interest rate and the government would have to publish the appropriate interest rates. Some complications could arise in the Hall and Rabushka proposal because carryforwards arising in different years would use different interest rates requiring complex calculations and stacking rules to determine which carryforwards are used first. Presumably, a single interest rate could be used instead. The main impact of nonrefundability, however, is in the design of the business tax.

To illustrate the connection between the treatment of losses and the business tax, consider the tax system if losses in a given year were refundable. Transactions between businesses would create no net tax as taxable receipts to one would produce deductible payments to the other, and the refund from the deduction would exactly equal the tax on the receipts. The treatment of transactions between businesses, therefore, would be relatively unimportant so long as businesses treat transactions the same. All transactions between businesses, therefore, could be treated as taxable. A voidance of taxable treatment would also have no net effect (as long as nothing left the business tax base, say as a distribution to shareholders, without tax). Few business tax rules would be needed. This is demonstrated by the European VATs which refund losses and have almost no special rules governing transactions between businesses.37

If losses are not refundable, transactions between businesses can have tax effects. Suppose losses were not refundable and could not be carried forward or back. That is, losses not used against receipts in the year incurred would be forfeited. In this case, a contribution of property by a business to a newly formed joint venture, if treated as a taxable transaction, may produce net tax—there would be an immediate tax to the contributor on the exchange and, if the joint venture does not immediately produce revenues, no offsetting

37 Some European VATs zero rate the sale of ongoing businesses, creating the equivalent of nonrecognition under a subtraction method tax or income tax. As zero rating grants relief only from administrative requirements and not from any tax liability that would otherwise be owed on the transaction, the zero rating rule creates little controversy.
deduction to the new venture. We would need nonrecognition rules for such formations. Similarly, a sale from a profit making company to a company with no net receipts (say a bankrupt company) would generate net tax revenues. The profit making company would have taxable receipts but the bankrupt company would get no deduction. There would be a strong incentive for profitable businesses to acquire money losing business and rules might needed to prevent distortions in the market for corporate control. The various nonrecognition regimes and the anti-loss trafficking rules are central elements of the current corporate tax regimes and will probably need to be duplicated in the Flat Tax because of the treatment of losses. Losses are the pivotal element in the design of the business tax.

The easiest place to begin exploring the business tax is with the formation of a business. There are two polar cases: the formation of a new company by an individual (or other nontaxpayer) and the formation subsidiary by a business. Suppose in both cases the contributor transfers property to the business in exchange for equity in the business.

The sensible rule for the formation of a business by an individual is to treat it as a taxable sale. Under current law, a formation is generally tax free to both the business and the individual. That is, neither the individual nor the business recognize gain or loss on the contribution. Because individuals would otherwise be taxed, they like this treatment and generally do not seek to avoid it. In the Flat Tax, however, nonrecognition would deny a deduction to the business with no offsetting benefit to the individual because individuals are not taxed on the sale of property anyway. That is, if the same transaction were structured as a sale, the business would get a deduction without offsetting gain to the individual. Nonrecognition, therefore, would be taxpayer adverse rather than taxpayer friendly and give individuals a strong incentive to structure contributions as sales. As such, it would require enforcement, such as a prophylactic rule treating all sales between any substantial owner of a business and the business as a tax-free contributions and rules preventing third parties from facilitating such sales. A good case can be made that the Flat Tax should instead simply treat all formations by individuals as sales.
Now consider the formation of a subsidiary (sub) by a parent corporation (parent). If the formation is treated as a sale, parent would have taxable receipts and sub would have deductible payments. But, as noted above, if sub is a new business that will not produce net receipts for a number of years, parent's tax would not be offset by sub's deduction. Each year the loss is carried forward it loses value because the carryforward interest rate is below the market rate, making the rule particularly punishing for long-term speculative or research ventures. A tax-free contribution regime is necessary for the formation of businesses by other businesses.\(^{38}\)

Coordinating the two regimes, taxable treatment for contributions by individuals and nonrecognition treatment for contributions by businesses might be complex. Rules will be needed much like current law to determine which contributions are tax-free and which are taxable.

The same problem might occur for distributions of property from a business. Again, consider individuals and businesses separately. If a business distributes property to an individual, the distribution must be taxable to the business. The business deducted the cost of the property when it was purchased. The distribution must be taxed to recapture the initial deduction. If not, business could purchase consumption goods, deducting the cost, and distribute them tax free to the owners of the business. Liquidating distributions would get the same treatment as operating distributions.

Suppose a subsidiary distributes property or liquidates into a parent business. If losses were refundable, the distribution would

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\(^{38}\) One question would be whether there should be a control requirement. The current law nonrecognition rule for partnership formations has no control requirement while the analogue for corporate formations requires the contributors to control the new venture. The best (and only?) argument for a control requirement would be that it limits loss trafficking: Without a control requirement, businesses could contribute property to a loss corporation to soak up the losses. While current law partnership rules do not require control on formation, the partnership rules do have some rules to prevent transfers of losses or gains to new partners. Nevertheless, given that the problem with losses under the Flat Tax will be less than under current law and that the control requirement is not a serious attempts to limit the problem, a control requirement would probably not be optimal. See the discussion in the text on loss trafficking.
never produce overall gain or loss because any gain to the subsidiary would be offset by deductions to the parent. But if losses are not refundable, we must count on the parent being able to use the deduction (for the acquisition of sub’s property) or the distribution will have a net tax effect. It would, therefore, be desirable to have a nonrecognition rule somewhat like rule under current law for distributions to and liquidations into parent businesses.

The rules governing corporate acquisitions raise similar issues. Because the Flat Tax is R-based, the purchase of the stock of one business by another is tax-free. But, without a special rule, the purchase of assets of a business would be taxable. The question is whether we should ever treat a stock purchase as a taxable asset purchase or a taxable asset purchase as a tax-free stock purchase. Once again, if losses were refundable, the two treatments would be the same, except for administrative costs. European countries, for this reason, generally “zero rate” (tax but at a tax rate of zero) the purchase of an ongoing line of business, effectively allowing an asset purchase of a line of business to get nonrecognition treatment. If losses are not refundable, the treatment of a transaction as a tax-free stock purchase or a taxable asset purchase can make a difference. Buyers with losses would be unusable deductions in an asset sale. Sellers with losses would have exempt gain on a stock sale.

Current law attempts to minimize the differences between stock and asset purchases, for example, through an election to treat a stock purchase as an asset purchase. Eliminating the distinction between two virtually identical transactions seems desirable. Moreover, if the Flat Tax has a nonrecognition rule for formations, similar rules for mergers or other acquisitions are necessary as many mergers can be structured as formations. That is, it would be anomalous to have a nonrecognition rule for formations but not mergers.

Subject to a loss trafficking rule (discussed below), the Flat Tax can have relatively loose merger rules as compared to current law because, unlike current law, nonrecognition treatment will is often

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39 Note that there would be no need for a corollary to section 1060 in the Flat Tax as allocation of purchase price to assets would make no difference. If Congress were to enact special rules for particular assets, say to encourage or discourage some type of activity, a corollary to section 1060 might then be needed.
be the same as taxable treatment. For example, the Flat Tax could mimic the European rules and simply have a line of business type rule, so that any acquisition of a line of business is non-taxable. Similarly, the Flat Tax could have a rule similar to current law section 338 that would allow the acquisition of the stock of a business to be treated as the acquisition of the assets of the business. In both the asset and stock acquisition cases, we may be more concerned about consistent reporting between the parties than the substantive rules, so a completely elective regime (that requires joint elections by the parties) might also be attractive.40

The general pattern from these examples is that transactions between businesses can and often should be treated as nonrecognition transactions, primarily to prevent the nonrefundability of losses from distorting the results. At the same time, transactions between businesses and individuals (and other nontaxpayers) should be taxable.

The limitation on this logic is the concern about loss trafficking. Nonrecognition rules in the Flat Tax would allow businesses to transfer assets to loss companies to use up losses. For example, a profit making company could purchase a readily marketable good, claim a deduction for the purchase, and transfer it to a loss company in exchange for (preferred) stock in a nonrecognition transaction. The loss company would sell the good and use the losses to offset the tax on the receipts. The net result is to transfer the loss to the profit making company.

Transferability of losses may be a good thing, but it is not the regime that Hall and Rabushka proposed. There is a significant

40 Spin-offs would be very simple. The distribution of stock would be automatically tax-free as the Flat Tax is R-based, making all spin-offs tax free.

One interesting question is how much the design should be based on expensing, that is, on the exact offset of the taxable receipts to the seller and deductible payments by the buyer. As future Congress's could easily amend the expensing rules in the Flat Tax, the design of the system should be sufficiently robust to work in a depreciation regime. If the Flat Tax had depreciation rules, nonrecognition would matter even in the absence of losses. (Once the tax law uses depreciation, timing matters and nonrecognition offers deferral.) Arguably, little would change because, given the tax-free sale of stock for cash, it would be difficult to require the sale of assets to be treated differently. Indeed, elective nonrecognition regimes have long been proposed for the current corporate tax.
Ironing Out the Flat Tax

The tension between the need for nonrecognition rules and the rule that losses are not freely transferable. The question is, assuming transferability will not be literally allowed, whether or to what extent rules should be adopted to limit loss transferring transactions (including rules governing the purchase of loss company such as current law section 382).

One possibility is limitations on nonrecognition similar to those found under current law. For example, current law does not allow transfers to corporations to be tax free unless the transferors have at least 80 percent control of the corporation. Similarly, liquidations are tax-free only into 80 percent corporate parents. Similar limitations on loss transferability might need to be written into the nonrecognition rules.

Current law also has explicit rules that limit the ability of businesses to acquire other businesses to take advantage of unused losses. The goal of these rules is to prevent the treatment of losses from causing distortions in the market for corporate control caused by the loss regime. These rules are very complex under current law and similar rules would be equally complex under the Flat Tax. There is no clear way to differentiate the bad transactions from the good so that the rules are inaccurate, over-taxing some transactions yet missing others that should be covered. Given that increasing losses each year by the interest rate will mean the need to transfer losses will be less than under current law, the scope of explicit anti-loss trafficking regimes should be limited.

The one area where the business tax would be simpler than current law is in the treatment of distributions. The current rules for both partnership and corporate distributions are complex—the

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41 These rules can be found in current law section 382 and a variety of other provisions. See, e.g., the consolidated return separate return limitation year rules.

42 If the financial products rules do not adequately deal with the straddle transactions discussed above, taxpayers will be easily able to transfer losses to eliminate business taxes. Suppose an individual owns a thriving business. The individual would like to avoid having the business pay tax. To eliminate tax, the individual enters into a straddle and transfers the losing position to the business in a nonrecognition transaction. When the business takes delivery on the loss property and promptly sells it, using the net loss to offset its operating income. The individual pays no tax on the gain. If the straddle rules do not prevent this transaction, loss importation rules might be needed.
partners rules are designed to prevent disguised sales; the corporate rules enforce the double level tax. In the Flat Tax, distributions would simply be tax free and few rules would be needed.

The overall assessment of the business tax rules is that they would be somewhat simpler than current law although many of the basic elements of current law, such as nonrecognition rules and distribution rules, would remain in the Flat Tax.43

C. Accounting Methods and Periods

This section considers two separate but related questions: (i) what is the appropriate method of determining when transactions are to be accounted for in the Flat Tax (the accounting method); and (ii) what is the appropriate period for cumulating transactions (the accounting period).

An initial intuition might be that the accounting method and period do not matter in the Flat Tax because, as demonstrated in Section I above, timing does not matter in the Flat Tax. The savings from the initial deduction for an investment exactly pays for the tax on the sale of the investment. If the sale is accelerated or deferred,

43 Current law also allows certain groups of controlled corporations to consolidate their taxes, which effectively allows a single filing and allows losses of one member of a consolidated group to be used against gains from another member. Consolidation, effectively, allows businesses to put subsidiary operations in separate entities for non-tax reasons but to be treated as a single entity for tax purposes. Prohibition of consolidation would force businesses to operate in less efficient form as branches rather than separate corporate entities.

Consolidation has the same benefits in the Flat Tax: use of losses is important, so consolidation may be necessary to prevent inefficient internal structures. Given that losses increase each year with interest, the need for consolidation might be less than under current law, but nevertheless, it would still be worthwhile. In addition, if most of the contribution and distribution problems discussed above arise in closely held groups of businesses, consolidation may eliminate many of the problems without the need for special nonrecognition rules. The particular scope of the consolidation rules could be based on current law or loosened somewhat. The various complicated rules for consolidated entities under current law would largely not be needed under the Flat Tax. For example, the stock basis adjustment rules would not be needed as all stock transactions would be tax free.

Hall and Rabushka would allow completely elective consolidation but imply that it is only available for “subsidiaries.” Rules similar to those of current law defining controlled groups would probably be necessary.
the value of the tax savings from the initial deduction decreases or
increases accordingly because both the investment and the tax
savings grow at the same rate. Accelerating or deferring a
transaction, therefore, would have not benefit. Accounting methods
and periods (by definition) are solely to determine the timing of
transactions, and if timing does not matter, accounting methods and
periods should not matter. In fact, one scholar has argued that the
fact that timing does not matter in a consumption tax (so that the
timing of realization is not an issue) is one of the principal
administrative arguments in favor of such a tax over an income tax.44

The examples demonstrating that timing does not matter were
correct within their assumptions. The examples, however, assumed
that the accounting period is the same as or shorter than the
duration of a transaction. If a business purchased an asset in one year
and sold it ten years later, the equivalence between yield exemption
and cash-flow taxation is demonstrated with ten year or shorter
accounting periods. Suppose, instead, that the accounting period is
longer than the length of the transaction.

Example

An individual or foreigner sells an asset to a business for
$100 on December 31, 1999 and repurchases the asset for
$100.01 on January 1, 2000.

The individual or foreigner has no tax because under the Flat
Tax they are exempt. The business deducts $100 in 1999 and
includes $100.01 in 2000. If returns are filed on an annual basis, the
deduction would come a full year before the inclusion. For the cost
of the tax on one penny the business gets the use of the value of the
$100 deduction for one year.45 If, however, the property were
repurchased at the end of the year 2000, so that the accounting
period matched the length of the transaction, there would be no net
benefit or tax on the transaction. A nother version of this transaction

Tax,” in New Directions in Federal Tax Policy for the 1980’s (Charles Walker and
Mark Bloomfield, eds. 1983).
45 This has been pointed out previously by Michael Calegari, Flat Taxes and
is simply to accelerate the purchase of property from nontaxpayers or
deferring the sale to nontaxpayers. Moving a purchase up by a few
days to an earlier year accelerates the deduction at a very low cost.
Deferring a sale by a few days can delay tax on the receipts for a year.
Timing can matter in the Flat Tax and, therefore, we must
determine the appropriate accounting period and method.

The obvious solution to this problem is to have short accounting
periods. If the accounting period were a single day (or a single
minute), there were be no distortions. One day's (or one minute's)
delay or acceleration of a transaction will produce one day's (or one
minute's) change in the timing of the tax deduction or inclusion.
Timing would no longer matter.

The obvious problem with daily accounting periods is
complexity. While a very short accounting period would not
necessarily require a filing for each period, it would require taxpayers
to track exactly when each transaction took place and make
adjustments, such as an interest charge, to reflect the timing of the
transaction. This would be impractical.

Most VATs require quarterly filings, and some allow monthly
filings (mostly to allow businesses to get refunds more quickly). 46
Quarterly filing reduces the effect of timing disparities without
imposing enormous administrative costs. Some similar approach
might be necessary under the Flat Tax. Quarterly filing need only be
required of businesses as the accounting period problem is a problem
with the cash-flow mechanism, not the yield exempt mechanism.
Current law already requires businesses to make quarterly payments,
so quarterly filing would not be a big increase in filing costs. 47

The shorter the accounting period, the lower the benefits to
manipulating the timing of transactions (and the lower the
inadvertent penalties for those on the wrong side). The question is

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46 See Sweet & Maxwell, Ernst & Young VAT in Europe (1989) for a summary
of the European VAT rules.

47 Note that similar problems might occur if businesses are free to choose their tax
years. Then a sale from one business to another will not produce offsetting income
and deduction as the timing of their tax payments will vary. The question is
whether this effect, which can go either way, either a present value tax receipt or
present value tax loss, is large enough to distort transactions and to require that all
businesses have identical tax years, particularly given that requiring shorter
accounting periods reduces the problem.
whether quarterly accounting periods are sufficiently short that we need not worry about the accounting method. The answer depends on the cost of imposing accounting method rules that reduce problems with the timing of transactions. (Note that eliminating the problems through an accounting method is not possible because taxpayers will have incentives to actually change the timing of transactions, not just to manipulate the accounting rules.)

Hall and Rabushka propose to put all businesses on the cash method of accounting. The idea seems to be that the cash method measures actual inflows and outflows, so it is uniquely appropriate for a cash-flow tax such as the Flat Tax. The cash method, however, would be extremely easy to manipulate. For example, if a receipt is delayed from the end of one quarter until the beginning of the next, the loss of the use of money for a short time may be less than the benefit of paying taxes a quarter later. Similarly, accelerating a payment from one quarter to an earlier quarter may cause the taxpayer to lose the use of money for a short time but may be offset by the acceleration of the deduction.

Current law requires the accrual method of accounting in part because it is thought to be less manipulable than the cash method. Many elements of the accrual method, however, would have to be rethought for the Flat Tax. The reason is that the accrual method is designed to tax the return to investments. For example, the accrual method requires current inclusion of unpaid interest on a debt instrument. This would be inappropriate in the Flat Tax (leaving aside that interest is not taxed) because the owner of the debt still holds the investment. Any current inclusion would have to be offset by an immediate deduction representing the continuing investment. Only when the investment is sold should the owner be taxed.

All other rules in the accrual method would similarly have to be evaluated. To illustrate the complexity of the task, consider the rules for future payments that are fixed currently. These payments are subject to the “economic performance rules” of current law. The economic performance rules are designed to tax the return to

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49 See section 461(h).
investments, so one might think initially that they are inappropriate for the Flat Tax. It turns out, however, because of the way they are structured, they work in the Flat Tax.

Suppose a defendant promises to pay a plaintiff in the future. Under the economic performance rules, the deduction to the defendant is deferred until payment. A cash method plaintiff is not taxed until payment is received. Because the plaintiff is not taxed until cash is received, the plaintiff is effectively exempt (under the usual cash flow mechanism logic) The defendant, who holds and invests the damages, however, is effectively taxed on the return to the invested damages. The return to the investment is taxed under the economic performance rules, but it is taxed to the defendant rather than the plaintiff even though the plaintiff has the legal right to the money.

Under the Flat Tax, this system will continue to work notwithstanding the intent of the rules to tax the return to investments. The reason is that the defendant who holds and invests the money will not be taxed on the return. The economic performance rules would yield the correct result, zero tax on marginal investments, under the Flat Tax. Other rules for deferred payments, such as the nuclear decommissioning rules, qualified settlement funds, or mine reclamation, however, use a different mechanism to solve the same problem and may not work in the Flat Tax.

Another common problem is distinguishing between loans, prepayments, deposits, and receipts. The Flat Tax has a sharp distinction between financial and other types of payments, so these rules would be critical. For example, the Flat Tax will have to determine when a power company that holds deposits from users must include the deposits. In many cases, determining when such a deposit has changed ownership from the utility user to the utility, is difficult. The accrual method, therefore, might be appropriate but each accrual rule would have to be reconsidered to reflect the goal of no tax on the return to investments rather than a tax on the return.

An alternative would be rules similar to those used by European VATs. VATs have detailed timing rules, often with different rules

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for the supply of goods and for services. Generally, however, they treat the supply of the good or service as the taxable event. One reason for looking to the supply of goods or services might be that supply is less manipulable than the payment of cash. The problem with adopting these rules is that they would be largely unfamiliar to domestic businesses.

Given that accounting rules will matter and that there is likely to be more than one acceptable method of accounting, the Flat Tax will probably need a counterpart to the rules in the current law that prevent double counting when taxpayers change methods. These are among the more complex set of accounting rules under current law—they must define a method of accounting, permissible methods, and rules for changing methods.

While the Flat Tax will need some accounting rules, the problems with accounting methods should not be overstated. The single biggest area of simplification in the Flat Tax is probably accounting issues. The Flat Tax will eliminate many of the most troublesome aspects of accounting under current law. The capitalization requirement as embodied in common law principles and in complex statutory rules would be eliminated, substantially simplifying accounting problems. Inventory rules would no longer be necessary as inventory would be deducted when purchased. In

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51 See Sweet and Maxwell, VAT in Europe (1989), for a description of the timing rules in the various European VATs.
52 Moreover, the European rules would create some problems under the Flat Tax and might require some modifications. For example, if the supply of goods or services is the taxable event, prepayments cause problems. Unless interest is imputed on the prepayment, so that the taxable amount is the fair market value of the goods at the time they are taxed, too little income will be included. Including prepayments on the cash method would work better. Consider a business that receives an up-front payment to provide services in the future. If the payment is taxable and the cost of providing the services is deductible, the usual pattern of an initial deduction for costs followed by a receipt for sales is reversed. Nevertheless, an up-front tax followed by future deductions should still lead to a present value zero tax.
53 See sections 446(e) and 481.
55 See the uniform capitalization rules of section 263A.
56 See section 471.
addition, timing problems are limited by the length of the accounting period while there is no similar limit under the income tax. For example, special rules for long term contracts, which are extremely complex and important under the income tax, would have far less importance under the Flat Tax because taxpayers could only achieve deferral of the length of one accounting period.

The net result for accounting methods and periods is that the rules would be substantially simpler than current law. But accounting methods and periods would still matter. Moreover, the many of the accounting method rules would probably have to be different than those of current law.

D. International Transactions

This section considers design issues relating to international transactions. While adequate taxation of international transactions is critical to any tax reform plan, the conclusion of this section is that the Flat Tax, from a design perspective, offers few new, difficult problems and substantially simplifies current law. Note, however, that the problems created by having an open system, which significantly includes being open internationally, are not generally treated here as separate international tax problems although they could be because the relevant transactions are across international borders. Thus, a problem with a cross-border financial transaction is treated here as a problem with the taxation of financial products.

Recall that the Flat Tax will be origin-based, so that businesses deduct the cost of imports and are taxed on exports. The basic rules for an origin-based system are straightforward. They are the same as for domestic transactions: taxpayers get a deduction for purchases and inclusion for sales. If goods or services are transported across borders without a sale, (e.g., a transfer to a foreign branch of a domestic business), the good is treated as sold at the border for its fair market value, and, similarly a good imported into the U.S. without a sale is treated as purchased at the border for its fair market value. A number of other issues arise in the international setting which are discussed below.

57 See section 460.
1. Transfer Pricing

Because goods must be valued when they cross the border, valuation and, in particular, transfer pricing (i.e., pricing of goods transferred between controlled entities), is a problem. For example, consider a taxpayer who begins the manufacture of a car in the United States, ships it to Mexico for some stage of production and then ships it back to the United States to be finished and sold. If the transfer price when the car is shipped to Mexico is low and the price when the car returns is high, the taxpayer can shift income to Mexico from the United States. Similarly, a service provider might sell services from an offshore tax haven while providing all the work domestically. Only to the extent value is added in the tax haven, are the receipts properly allocable to the tax haven, but enforcing appropriate transfer pricing will be difficult.

It is likely that the regime would have similar scope and complexity to that of current law. Because the Flat Tax is territorial while current law has world-wide jurisdiction, locating earnings offshore may create more of an advantage under the Flat Tax than under current law, but the extent of the difference is not clear, given the ability to defer the taxation of foreign earnings under current law. At most, more enforcement or a slightly stronger set of regulations might be needed. The details of transfer pricing enforcement, however, are not as important as noting that the need for transfer pricing enforcement is a very significant fact in evaluating the simplicity of the Flat Tax.

2. Creditability of the Flat Tax

If a foreign country has an income tax that taxes worldwide income, generally only other income taxes are creditable against the foreign income tax. This is the case, for example, for the U.S. worldwide income tax with respect to foreign taxes. The issue is whether the Flat Tax would be creditable for foreign tax purposes. Reuven Avi-Yonah suggests that this might be a problem.58

I do not believe this issue is very serious. On the margin, the Flat Tax imposes no tax on capital income, so, on a present value basis, credits do not matter. Effectively, if the Flat Tax is not

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58 Reuven Avi-Yonah, The International Implications of Tax Reform, Tax Notes 913 (November 13, 1995)
creditable against foreign income taxes, the initial reduction in credits when the investment is expensed exactly offsets the value of the credits from the U.S. tax on the future returns form the investment.

As noted above, an origin-based tax taxes inframarginal returns on inbound investments, so whether the tax is creditable matters only here. But if the inframarginal investment is specific to the United States, whether the foreign country grants a credit will not affect the decision where to invest. Whether to grant the credit will be up to the foreign country and while it may matter to individual businesses, it need not concern us as a serious issue in implementing the Flat Tax. The only case remaining, where the inframarginal return is not specific to the United States, is unlikely to be large category.

3. Treaties

Avi-Yonah, in the same article, as well as elsewhere, has suggested that the Flat Tax would not qualify under existing treaties, requiring renegotiation of our entire treaty network. Moreover, as the Flat Tax eliminates the withholding tax on dividends and the withholding tax is one of the main negotiating tools in the treaty process, renegotiation may not be possible. The Flat Tax would, then, effectively, toss out the entire network of tax treaties of the United States. And treaties are important to U.S. businesses as they provide reductions or exemptions from foreign withholding taxes, they scale back the tax reach of host countries, and they prevent discriminatory treatment of foreign investment by host countries. Renegotiation of treaties would be a major implementation cost of the Flat Tax.

Tax treaties apply to income taxes. Avi-Yonah notes that the Flat Tax is not an income tax and, concludes that, therefore, it does not qualify as under existing treaties. Nevertheless, as a matter of treaty interpretation, existing treaties should apply to the Flat Tax. Treaties typically apply to “federal income taxes” and any identical or substantially similar taxes. Generally, income taxes are not defined in treaties. While the Flat Tax would tax consumption, not income, it is not labeled a consumption tax, which seems to be the key factor.

59 See, e.g., Model Treaty Article 2.2
For example, the United States has previously had periods under its so-called income tax where, because of accelerated depreciation and investment tax credits, the tax on capital was zero or negative, effectively creating a consumption tax. A brogation of treaties because we adopted accelerated depreciation and an investment tax credit was not an issue. There is no reason to believe that treaties would be less applicable to the Flat Tax than to the income tax in periods when the tax on capital was zero.60

If the Flat Tax qualifies as an income tax under the treaties, the only issue is whether other countries would abrogate their treaties in response to some perceived or real threat from the Flat Tax. It is difficult to determine the response of other nations. There are arguments on both sides and commentators have differed in their speculations. All I can offer here is that if other nations abrogate their treaties, renegotiation would be difficult as there would have to have been some reason for abrogation. The Flat Tax eliminates withholding taxes on foreign investments in the United States. Witholding is the most important leverage we have to induce other nations to sign treaties. To help with renegotiation, consideration should be given to retaining the withholding tax.

4. U.S. as Tax Haven

The decision by other nations to abrogate treaties may depend on whether U.S. would become a tax haven under the Flat Tax because of its low tax on capital. If the U.S. were a significant tax haven, given the size of the economy and richness of investment

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60 The Flat Tax would most likely qualify as an income tax under Treas. Reg. §1.902-2. It is hard to imagine that depreciation rather than expensing is the necessary qualification of an income tax. And clearly, economic depreciation is not required as our current tax system allows depreciation faster than economic depreciation, which would mean some level of depreciation faster than economic but slower than expensing is required.

Avi-Yonah also argues that the denial of the interest deduction would mean that the Flat Tax is not an income tax. (See p. 922). This makes no sense. Substitute taxation is not inconsistent with income taxation. A purely business level income tax, such as CBIT would not be an income tax under this theory.

Finally, it is hard to imagine that the Flat Tax would both be treated as a direct tax under the GATT, forcing us into an origin-basis system and fail to be treated as an income tax under the treaties. While the terms direct tax and income tax are not correlated in theory, in their application one can imagine some linking.
opportunities, capital would flow to the U.S. and away from more productive uses, particularly in developing countries, which could create serious consequences. Other countries would be forced to abandon their taxes on capital, forcing the world into less progressive taxation and limiting other country's choices for financing their governments. Avi-Yonah, consistent with his prediction on treaties predicts that the U.S. would become a tax haven.

I think this prediction is simply incorrect. The United States previously has had a very low, even negative, tax on capital income and problems with foreign investors sheltering income in the United States were not sufficient to cause serious international concerns. And under the prior low capital tax regimes, interest was deductible to the payer while under the Flat Tax, interest would not be deductible, making it much more difficult for a foreigner to repatriate gains without tax. Moreover, to the extent capital is located in the U.S., there will be an additional demand for dollars, so currency adjustments should quickly eliminate any benefits from investing in the U.S.

5. Simplification

The simplification potential of the Flat Tax with respect to international tax rules is significant. For example, the foreign tax credit rules and the anti-deferral rules, both of which are a significant element of foreign tax planning and complexity, could be eliminated. Moreover, the source rules could be substantially simplified as we would not need separate baskets or expense allocation rules. The rules for cross-border nonrecognition exchanges could be eliminated as any movement of an asset across

61 This point can be stated more carefully. Suppose taxing capital were efficient, fair, or otherwise desirable and suppose that capital is highly mobile. If each country acts on its own, each country has an incentive to have a lower tax rate on capital than other countries to attract capital, leading to an undesirably low tax on capital. Only through cooperation can the appropriate tax on capital be achieved. The U.S., by adopting a zero tax on capital, would be failing to cooperate.

62 See sections 901-908.

63 See, e.g., sections 951-964 (Subpart F), and 1291-1298 (the passive foreign investment company rules).

64 See sections 861-865.

65 See section 367.
the border would be taxable and movements of stock across the border would be irrelevant to the tax base.

6. Summary of International Issues

Despite the complexity of the economic issues, the design considerations for international taxation under the Flat Tax are mostly good news. The Flat Tax would allow substantial simplification of the international tax rules. The most important downside (at least with respect to design) of adopting an origin-based tax, like the Flat Tax, is that it requires transfer pricing.

E. Small Businesses

This section considers the treatment of small businesses. Hall and Rabushka have no definition of a business (other than the useless statement that each sole proprietorship, partnership, and corporation constitutes a business), and no explicit exception for small businesses. Discussion in their book indicates that the definition of a business is intended to be broad. There is no small business exception under current law—small businesses, while subject to many simplifying rules, must file returns and pay taxes like any other business. Nevertheless, despite the lack of small business exceptions in the Hall and Rabushka outline and in current law, there are good reasons for having a small business exemption in the Flat Tax.

To motivate the problem, consider an example given by Alan Feld. A taxpayer owns a home and uses it as a personal residence. This is a durable, nonproductive asset currently used jointly for consumption and investment. It would under the Flat Tax be taxed under the yield-exemption method and avoid the transition tax.

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66 For example, their 1985 book, The Flat Tax, has a sample business return in which the business has gross receipts of about $47,000. In their 1983 book, they refer to a landlord (of an apartment building) as a taxable business.

Note that there is a relatively easy definitional issue lurking underneath the discussion of small businesses. The Flat Tax needs to ensure that irregular profit making activity, such as the sale of a home or of used property is not treated as a business. VATs generally solve this problem by requiring regular and consistent activity and explicitly exclude occasional sales. The Flat Tax will need a similar definition regardless of any small business exception.

67 Alan Feld, Living with the Flat Tax, __ National Tax J. 603 (199_).
the tax on any inframarginal return. Suppose the taxpayer decides to rent out a room for a six month period while continuing to live in the rest of the house.

If the rental were treated as a business, we would, as noted above in Section __ above, treat the formation of the rental business as the purchase of an asset by a new business, the rental business, which would get a deduction for the fair market value of the room. The business would include the rents, and, at the end of the six month period, be treated as selling the room back to the original owner. This system is complex and, most importantly, requires valuation. The homeowner would have to value the room on the date of the formation of the business and on the date of the liquidation of the business.

The valuation requirements probably make this treatment infeasible for many and subject to significant abuse by the aggressive. An initial reaction, therefore, is that the example illustrates an intolerable situation. The task is to consider the costs and benefits more explicitly.68 There are (at least) four reasons for having a small business exception and several countervailing factors.

68 VATs around the world almost uniformly have some small business exception, but they vary greatly in size. In Europe, thresholds range from the equivalent of $61,000 gross receipts in the United Kingdom to a little over $1,000 in Norway and Denmark. The EC recommends an exemption level of about $6,700. The Japanese VAT, which is open, has a large exemption, covering businesses with gross receipts of less than about $300,000. Our federal income tax, however, has no small business exception – businesses of any size must file returns.

There is a limit, however, to how much we can learn from these other systems. As noted in the text in Section __, if the tax is closed, the effect of exemption is different than if the tax is open. A small business exception in an open tax exempts the product of small businesses no matter where they are in the chain of production. A small business exception in a closed tax only exempts their product if they are at the retail level and has the potential to double tax small businesses operating at prior stages of production. For these reasons, small businesses frequently elect to be taxable in closed VATs. In addition, because the tax is closed valuation is not an issue on business formations as no credit would be allowed for the acquisition of assets from a non-taxpayer.

The Japanese consumption tax is closer to the Flat Tax because it is open, and it exempts a large number of businesses. My current understanding is that the Japanese system does not allow businesses credits for the acquisition of assets when they cross the threshold. I do not understand why this does not create substantial distortions for business formations. One possibility is that Japan retained its
First, as indicated in the rental example, taxing all small businesses would impose significant valuation problems. Assets would be over-valued on contribution, creating large deductions, and under-valued on distribution, creating small inclusions. The government would find it difficult to challenge these valuations given both the large number of transactions at issue and the difficulty of challenging any individual transaction.

Second, allocation of costs between personal consumption and the business would be difficult if small businesses are taxed. In the Feld example, cutting the lawn will be partially a business activity and partially consumption, and the costs would have to be allocated between the two, as would furnace repairs, shoveling snow, and paying property taxes. There are strong incentives to allocate consumption costs to businesses as doing so generates a tax deduction.

This problem exists under the current income tax but it would probably be worse under the Flat Tax. The reason is that there is a sharper distinction under the Flat Tax between businesses and individuals than under current law. The Flat Tax eliminates all business related deductions by individuals, such as deductions for unreimbursed employee expenses. But the same expenses incurred by an independent contractor taxed as a business would be deductible. There will, therefore, be a stronger incentive under the Flat Tax to be classified as an independent contractor. A small business exception would reduce the problem as there would be no advantage to allocating costs to an exempt business.

Third, the administrative costs of taxing small businesses are substantially higher than for other businesses. For example, a New Zealand study reported that on average, a firm with under income tax when the consumption tax was put in place, so structuring a formation as a sale may reduce the VAT but would result in an income tax liability. This might particularly be true because the Japanese consumption tax rate is only three percent. If this is the explanation then the Japanese experience is also not that helpful as the Flat Tax would repeal the income tax and be imposed at a sufficiently high rate to give businesses incentives to avoid it.

Another problem with looking to VATs for small business models is that VATs tax wages at the business level while the Flat Tax does not. The effect of a small business exception, even aside from whether the tax is open or closed, will be different in the Flat Tax and a VAT.
approximately $16,000 (U.S.) gross receipts spent 500 times as much (as a percentage of sales) to comply with their VAT as businesses with over $26 million in receipts. The United States General Accounting Office reports that the government’s administrative costs can be substantially reduced by exempting small businesses.

Fourth, the reduction in tax revenues from a small business exception may be low because the vast majority of business assets are held by larger businesses. For example, the GAO reports in the same study that in the United States, when sole proprietors and farmers are included as businesses, 0.4 percent of the business income tax returns account for 70 percent of the income tax revenue. Danforth-Boren justified their $100,000 exemption for their proposed subtraction method VAT by noting that only _% of assets were held by businesses with gross receipts less than that amount. Similarly, the Japanese small business exception, while even larger than the Danforth-Boren proposal, exempts only a small portion of business receipts from tax. Moreover, the business tax in the Flat Tax generally only taxes transition assets and inframarginal returns, which should lower the costs even further. Finally, a small business exception will reduce taxpayers’ ability to treat consumption expenditures as business expenses, further lowering the revenue costs of an exception.

These four considerations create a strong argument for a small business exception. Note, however, that only the valuation problem is unique to the Flat Tax as creation of a business under the current income tax or under a credit-invoice VAT is usually a non-taxable event. The administrative benefits and the benefit of simplifying the allocation of personal and business items are both present in current

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71 The Japanese consumption tax exempts businesses with taxable sales of less that $300,000 (during the prior two years). In 1992 the Japanese government estimated that 60 percent of all businesses were exempt from tax yet sales by these businesses accounted for only 2-3 percent of total domestic taxable sales. See Alan Schenk, Japanese Consumption Tax After Six Years: A Unique VAT Maturess, Tax Notes 899, 904 (November 13, 1995).
law (although there are some additional advantages to being classified as independent contractors under the Flat Tax). Nevertheless, these problems are sufficiently difficult that combined with the valuation problem, some type of small business exception is warranted.

There are some countervailing factors, however. If small businesses were exempt, business owners would have incentives not to pay wages above the personal allowance as any wages above the personal allowance would be taxable. If, instead, the business paid wages to the owner up to the personal allowance and paid all other earnings as dividends, the business and owner together would pay no taxes. While the Flat Tax could impose reasonable compensation rules, a sizable small business exemption would realistically exempt a good portion of wages of small business owners. Exempt small businesses could also provide employees with tax-free fringe benefits which would not be subject to a reasonable compensation claim.

To the extent a reasonable compensation rule cannot be adequately enforced, a generous small business exception may make the independent contractor, employee distinction worse rather than better, as suggested above. Many employees would seek to become independent contractors, exempt from tax as small businesses and pay themselves below market wages. This could be policed through the definition of independent contractor, but like policing a reasonable compensation rule, doing so would be difficult.72

In addition, a small business exception might make valuation problems worse. Without any small business exception (or a very small one), taxpayers will be able to misvalue assets like the rented room in the above example to reduce taxes. But an expansive

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72 Credit-invoice VATs should have this same problem, however, and they almost universally have small business exemptions, although they vary greatly in size. Because the Flat Tax is open, however, a small business exception in the Flat Tax would exempt more businesses than in credit invoice VATs. That is, in a credit invoice VAT, exemption is a mixed blessing and many businesses elect to be taxable. For retail businesses, exemption eliminates tax on the valued added at that level. But for businesses selling prior to the retail level, exemption double taxes as the business would not receive a credit for the purchase of its inputs and the purchaser of its outputs would not receive a credit for the cost. In an open tax, exemption would eliminate tax at both the retail and wholesale level, which may greater expand the size of any exemption.
exception for small businesses may exacerbate the valuation problem rather than reduce it. For very small businesses, the range of possible valuations will be relatively small. As the business gets larger, it may more legitimately claim very large valuations of its assets, particularly as the business develops intangible assets—think of a start-up biotech company that can claim to have the cure for the common cold, or even a one in a thousand chance of a cure. It will claim a huge deduction up front and corresponding receipts will never be taxed. Moreover, the business could eventually be sold to a profit-making business that can use the losses generated by the huge up front deduction.73

There does not seem to be any easy solution. Taxing all small businesses would be unnecessarily complicated but an expansive exception would create its own problems. The best answer I have seen so far is to have a threshold somewhere near the personal allowance amount, say receipts of $40,000, but allow businesses that cross the threshold to deduct only their historic costs. Consider a business that starts off very small with a few assets and in time grows sufficiently large to cross the threshold. Had it been taxed under the cash-flow mechanism all along, its deductions would have been limited to its costs. In many small businesses, increase in value is due to labor. If the business pays the employees a salary, the salary would be an historic cost, so this increase in value would be deductible. If the business does not pay appropriate salaries, no deduction would be allowed for these costs, effectively recapturing the tax that should have been paid on the salaries.

This solution is very rough. It reduces the administrative benefits of a small business exception because it requires businesses to keep records, regardless of their size, if they eventually want to claim a deduction for the costs. Moreover, because historic costs would only include salaries if they are actually paid, businesses would have to pay salaries even if the payment is nondeductible to the

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73 Another problem with a large small business exception is the need for aggregation. If the small business exception is sufficiently large, it will become worthwhile to structure businesses in separate entities to avoid crossing the size threshold. Presumably, some sort of aggregation rule would be needed and any such rule would be complex. The larger the exception, the greater the need for aggregation as it will become useful to larger and larger businesses.
business and not includible to the owner/employee because of the personal allowance, further complicating the lives of small business owners. And given the zero tax rate created by the personal allowance, there is an incentive to increase costs artificially by paying related parties salaries up to the personal allowance. Combine these complexities with aggregation rules and one can imagine that there would still be a market for tax advice for small businesses, even after enactment of the Flat Tax.

More important, the historic cost limitation is only a rough proxy for true costs. The deduction is deferred until the business crosses the threshold even though the costs were incurred earlier, reducing the value of the deduction by the time value of money. But if the operation had been a taxable business all along, receipts would have been taxed. Unless we require the business to record its receipts and increase costs by the interest rate there is no easy way to adjust for these problems. But imposing such a regime would impose a level of complexity that would fully moot any small business exception. Perhaps the best solution is to assume the two factors roughly offset and allow a deduction only for actual historic costs.

Finally, an historic cost rule would create an anomaly whereby a business that purchases an asset would get a deduction equal to the fair market value of the asset (the purchase price) but a business that merely grows sufficiently to cross the threshold would only get a deduction for historic costs. We would effectively be treating the owner of the business worse than an acquirer. One might reduce this anomaly by allowing businesses a deduction for current value if it can prove to some degree of confidence its actual value (for example, a third party loan would be evidence of true value) but any such rule would be complex.

The only obvious conclusion from the discussion is that there is no simple way out. Having no small business exception would impose large administrative costs, particularly when one considers examples like Feld's rental of a room. A large small business exception creates other problems, particularly, the need to value assets when the threshold is crossed or to keep records of historic costs. A moderate sized exception with an historic cost limitation may be the best we can do, but further searching for a solution is needed.
One final note on the definition of a business. Leasing presents an important problem. If holding leased property is not a business, there will be incentives for individuals to lease property to businesses to avoid the transition tax and the tax on inframarginal returns. For example, before the Flat Tax took effect, businesses with high basis assets would sell the assets to individuals and lease them back. Similarly, investments likely to produce inframarginal returns could be formally owned by individuals and leased to businesses. One solution is to treat leasing as a business regardless of size, although this would make the Feld example into a business. Compromises might include a lower limitation for leasing than for other small businesses, different rules for real estate leasing, or more narrowly, different rules for leases of residences.

F. The Distinction between Investment and Consumption.

The difference between investment and consumption is basic to both the income tax and the consumption tax. In a cash-flow consumption tax, investments are deducted while consumption is not. In an income tax, investments receive basis or an immediate deduction while consumption does not. But both taxes must distinguish between investment and consumption, and there are few reasons to believe it would be easier under the Flat Tax than under current law.

One advantage of the Flat Tax is that it taxes individuals on a yield-exempt basis, which means there is no difference between investment and consumption for individuals, at least with respect to yield-exempt assets. For example, whether a work of art is investment or consumption would not matter. Whether the purchase of a house is investment or consumption (or some of both) would not matter. While this seems to offer some simplification, most of the issues under an income tax would be the same under the Flat Tax because most issues involve a business. Consider three typical problems involving mixed consumption and business expenditures: (i) fringe benefits, (ii) hobby losses, home offices and other problems determining whether an expense is allocable to a business; and (iii) personal expenses of producing income, such as the costs of commuting or child care.
1. Fringe Benefits

Fringe benefits raise difficult issues under current law because they combine elements of business expense and personal consumption. These problems will be the same under the Flat Tax.

Consider an employer that purchases a car and allows an employee to use it without restriction. Under an income tax, if the car is not taxed as a fringe benefit but is deducted by the employer, the income (and the consumption created by the income) escapes taxation. For example, if the company earns $100 profit selling widgets and uses the profit to compensate the employee with a car, some of the profits go untaxed. The business would have to pay an immediate tax on the $100 but would get to depreciate the car, so the difference between $100 and the present value of the depreciation deductions gets taxed, but the remainder of the $100 of earnings goes untaxed. Under a cash-flow tax the business would get an immediate deduction for the car, meaning the entire $100 would go untaxed. This distinction does not seem to make the Flat Tax significantly worse than the current tax.

Hall and Rabushka would deny businesses deductions for fringe benefits. This approach to fringe benefits is not limited to the Flat Tax and similar approaches have been proposed for the income tax.74 That is, there is no reason to believe that the solution to fringe benefit problems is any easier under the Flat Tax than under current law.

Moreover, Hall and Rabushka’s simple statement of their proposal for fringe benefits conceals the complex nature of the problem. It would be very complicated to define fringe benefits. We would have to determine which meals eaten on the job are fringe benefits and which are not. When travel is a fringe benefit? Would a fancy room at the Royal Hawaiian Hotel provided free to the manager or meal vouchers for policemen be fringe benefits?75 What


about parking spaces, company provided gyms, and discounts at the company store? What about a corner office with expensive art, fancy furniture and a secretary to do your bidding? Current law has struggled with all of these problems. Many non-cash benefits involve mixed consumption and business motivations, and a rule denying a deduction for fringe benefits does not reduce or change in any significant way the problems with distinguishing the two elements. While some fringe benefits, such as health care, are easy to identify, the complexity of current law stems from difficult classification problems, all of which would be present in the Flat Tax. Record keeping and classification rules such as those found in section 274 of current law would be necessary.

Denying the deduction would also, in many cases, over-tax the benefits as many fringe benefits have some business element. The appropriate treatment of a fringe benefit that has both compensatory and productive elements is to tax the compensatory element but not the productive element.76 For example, under current law, we only deny 50% of the expense for meals and entertainment on the theory that some element of these expenses is for business purposes. To the extent that the Flat Tax would over-tax fringe benefits, it would introduce inefficiencies in the opposite direction from those of current law.

In any event, there is no reason to believe that fringe benefit taxation would be any easier under the Flat Tax than under current law. The incentives remain about the same and the complexity of the issues and transactions would remain.

2. Claiming Business Deductions for Personal Expense

Claiming business deductions for personal expenses is a common method of deducting consumption expenses under current law. Absent a small business exception, the incentives would be the same under the Flat Tax (and maybe even stronger as businesses can fully expense all purchases.)

One of the most common examples is home offices. Under current law, draconian rules are needed to prevent abuse of home office deductions. Under the Flat Tax, no deduction is allowed for

76 See Avery Katz and Gregory Mankiw, How Should Fringe Benefits Be Taxed?, 38 National Tax J. 37 (198_).
any business costs of employees so only those claiming to run their own business from their home would be able to claim the home office deduction. Removing employees from the home office deduction would not help much. Independent contractors are the guts of the problem and the problems would be identical under the Flat Tax and the current income tax.

The only reason the Flat Tax might be simpler is if, as suggested above, a small business exception is adopted. Then individuals would be unable to claim a home office deduction until the business exceeded the threshold. If the threshold is reasonably large, many cases would disappear. This would still leave a category of sole proprietors with reasonably sized businesses who could illegitimately claim a home office deduction, but the category would likely be smaller than current law. (Note also that adopting a closed version of the Flat Tax would solve this problem as well.) Of course, the income tax could very well solve the problem the same way by exempting small businesses.

Along similar lines, individuals frequently attempt to deduct the costs of a hobby as business expenses. For example, an individual might invest money in a horse farm and deduct the expenses on theory that the farm is a business. Once again, the problem is the same under the income tax as under the Flat Tax and a small business exception would reduce many of the problems.

3. Mixed Expenses

Individuals incur a variety of expenses that have both business and consumption elements, such as the costs of commuting, work clothing, and child care. These costs are associated with labor income which makes accurately measuring labor income is difficult.

The Flat Tax proposal would deny all of these deductions presumably because these costs reflect consumption choices. This approach is similar to that of current law, although current law does offer some exceptions, such as the non-taxation of employer provided subsidies for public transportation or parking and the child-care credit. The problems with properly measuring labor income under the Flat Tax should be the same as under the current income tax and there is no reason to expect that the implementation would be or should be any different.
4. Summary

The Flat Tax will need rules similar to current law to distinguish consumption from business costs. A small business exception would eliminate some problems, and some of the Hall and Rabushka proposals would be an improvement to current law. To the extent Flat Tax proposals simplify these rules, however, the simplifications would work for current law. Design choices here are readily accessible by looking to current law or the large number of articles discussing changes. There is nothing special about the Flat Tax that makes these problems easier or more difficult.

III. Additional Design Issues

This section will briefly consider ten additional design issues to get a sense of the overall complexity and administrative costs. These ten issues (and the six considered above) are only a sampling of the issues that would have to be covered in a complete version of the Flat Tax.

A. Independent Contractors

As mentioned several times above, the Flat Tax will have to distinguish between independent contractors and employees. The distinction is extremely problematic under current law. The IRS uses a 20 factor test that is frequently at odds with taxpayers' asserted classifications and there are frequent significant disputes.

The distinction will have greater effects under the Flat Tax than under current law. In some ways it will be more burdensome to be an independent contractor and in some ways less so. In particular, independent contractors, under the Flat Tax have to file business tax returns calculated on the cash flow basis. Employees are taxed only on wages. Under current law, many independent contractors need not file separate business returns. The separate filing requirement will be a surprise to many who believed they could use the postcard return.

On the other hand, many will attempt to structure relationships as independent contractor relationships, happy to file the extra return for the tax benefits. For example, costs that are deductible to independent contractors would not be deductible to an employee.
And independent contractors can pay themselves below-market wages, taking the remainder of their true wages as return on equity. We can fully expect, therefore, significant controversy, complexity, and litigation over this distinction. The level of controversy and complexity should as great or greater than that of current law.

B. Pensions and Deferred Compensation

The treatment of pensions under the Flat Tax has already been subject to preliminary analysis. This section will briefly discuss some of the conclusions.

Under the Flat Tax, investment income is generally exempt from tax, either under the cash flow mechanism or the yield exempt mechanism. Pension income in a qualified plan under current law is subject to the cash flow mechanism. Employers deduct the contribution to the pension like the payment of any other wages. Employees have no immediate inclusion, which can be understood as an immediate inclusion followed by a deduction for the pension investment. When the employee withdraws the money, the employee is taxed. Effectively, pensions are taxed under the cash flow method. Therefore, the general treatment of investments under the Flat Tax is the same as the treatment of pensions under current law.

Current law, however, imposes a number of restrictions on cash flow treatment. For example, current law imposes nondiscrimination requirements, which prevent employers from offering pensions only to highly compensated employees. In addition, current law has withdrawal restrictions and funding requirements. All investments under the Flat Tax receive this treatment, so as Michael Graetz and Dan Halperin point out, there will be an incentive to avoid pensions under the Flat Tax if they are subject to these requirements. Effectively, under the Flat Tax, the law could not impose any

significant requirements on pensions except perhaps to the extent the pensions provide some market benefit above and beyond private savings. Requirements more costly than such benefits would simply drive savings outs of pension plans.

The Flat Tax removes many but not all requirements for pensions. Qualified plans would no longer need to satisfy the nondiscrimination requirements, benefit limits, and the restrictions on the timing of distribution. The employee protection requirements of ERISA are retained, however, including standards as to eligibility, vesting, funding and fiduciary rules. The empirical question is the effect of retaining these rules in a world where most of the benefits of a qualified plan can be achieved outside the plan and the general conclusion is that the reduction in pension coverage would be nontrivial.79

While the economic and policy issues associated with the change in pension rules are significant, there are few surprising implementation issues. To the extent the Flat Tax imposes requirements in qualified plans, the rules will have to be implemented and one imagines that they would look like those of current law. Given the reduction in requirements from current law, it is clear that the Flat Tax will be simpler than current law.

C. Death and the Estate Tax

Current law allows taxpayers to step up basis at death.80 The Flat Tax has no particular rules about death but it does not need to. The yield on investments is exempt, so a rule exempting gain on death would have no effect.

Hall and Rabushka would eliminate the estate tax. This raises many economic and fairness issues. From an implementation point of view, however, elimination of the estate tax would be an enormous benefit. The estate tax, of course, could be eliminated under the current income tax structure.

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80 See section 1014.
D. Tax-Exempt Entities

Hall and Rabushka retain tax exemption for a category of entities that roughly corresponds to charities under current law. Other tax-exempt entities under current law, such as labor unions and trade associations, would be subject to the business tax. Employees of tax-exempt entities under the Flat Tax would be subject to the wage tax like any other employee. The entity would pay a special tax on fringe benefits to mimic the nondeductibility of fringe benefits for taxable entities. Contributions to tax-exempt entities would not be deductible, unlike current law.

The benefit of tax exemption under the Flat Tax will often be lower than under current law. The marginal return to capital is not taxed under the Flat Tax so the business tax only taxes inframarginal returns and transition capital. Exemption under the Flat Tax, therefore, means exemption from these taxes. Some tax-exempt entities, such as hospitals and educational institutions, may have substantial operating assets and exemption from the transition tax would be valuable for these entities. Other entities (as well as educational institutions and hospitals) may have large endowments. These endowments, however, are generally invested in taxable businesses and the transition tax will be paid on these investments at the business level.

Because the benefit of exemption is less under the Flat Tax, many of the details of the existing tax-exempt regime will be less important. Nevertheless, entities will care about exemption and many of the current rules will be needed.

For example, the need to classify entities as exempt or not means detailed rules for classification will be needed. Hall and Rabushka define exempt entities as “educational, religious, charitable, philanthropic, cultural, and community service organizations that do not return income to individual and corporate owners.” Each of these terms will need a definition and the notion of returning income to owners will need substantial clarification. Although the concept of an owner of a nonprofit is not clear, I assume Hall and Rabushka mean to impose some sort of private inurement rules like those of current law.

The taxation of non-exempt but nonprofit entities is not clear. The most likely treatment would be for a labor union or a trade
association be treated as selling services to its members in return for
dues. Dues would then be taxable receipts offset by the cost of
services provided. Any net receipts retained by the union or
association would be taxable. If in any year dues exceed expenses, the
union or association could face tax liability.

Suppose an entity that was tax-exempt ceases to be either
because it in part does not meet one of the required purposes or
there is private inurement. Its purchases would have occurred in
earlier years so no deduction would, without a special rule, be
available for the purchases, but any receipts would be fully taxable.
Effectively, there would be a one-time tax on all its capital. This is a
severe penalty to pay. Some sort of lesser sanction would be
necessary. One possibility is to treat the cessation of tax exemption
as the formation of a business, which would mean the business could
deduct the fair market value of its assets. This, however, would
require valuation. Another alternative is some sort of intermediate
sanctions regime under which entities could be penalized without
losing their exemption.

Suppose the entity basically retains its tax-exempt purpose but
runs a candy store on the side. Under current law, the profits of the
candy store are subject to the unrelated business income tax
(UBIT).\footnote{See sections 511 through 515.} Would UBIT be necessary under the Flat Tax? There
would seem to be no reason to exempt assets of unrelated businesses
held by tax exempt entities from the transition tax or the tax on
infra-marginal return. Therefore, as Hall and Rabushka acknowledge,
the UBIT rules would be needed, including the rules classifying
activities as related or not.

The private foundation rules would probably not be necessary
under the Flat Tax. There would be no tax advantage to forming a
tax-exempt entity to control funds because direct control by an
individual would be tax-exempt and there would be no deduction on
contribution. Even on transition there would be little or no benefit
because a private foundation is likely to have its assets invested in
taxable businesses which would be subject to the transition tax. If,
however, a deduction is allowed for charitable contributions, the
private foundation rules might be needed.
The treatment of financial intermediaries in consumption taxes, including the Flat Tax, has been subject to analysis. The general problem is that services such as free checking or intermediation are not priced separately from the lending of money—the price of these services are built into the interest rate. Interest, however, is exempt under the Flat Tax, making it difficult to capture the consumption element of these services. Observers have noted that the rules for financial intermediaries are among the most complex rules in a typical VAT.

The Flat Tax does not create problems for financial services different than those created generally by a VAT. In fact, the Flat Tax may have some advantages over a VAT in this regard. The reason is that VATs commonly exempt the services provided by financial intermediaries. In the Flat Tax, such exemption does not cover the value added by employees of the intermediary as they are explicitly taxed on wages. Thus, failure to capture the value of financial services provided by intermediaries is of less consequence in the Flat Tax.

Hall and Rabushka provide a regime that attempts to capture the value of financial services. They would require banks and insurance companies to report the price of the services they provide to depositors, measured as the difference between the market interest rate and the lower rate that the bank pays on accounts that have bundled services. Similarly, the service element in mortgage interest charges, in the form of higher interest charged than the market rate would be added to the tax based on a bank. This regime will be very complex to implement.

David Bradford points out that bundled financial services are not taxed under current law. It is not clear, therefore, that it is

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worth the complexity to impose the valuation regime proposed by Hall and Rabushka. In addition, there is at least some argument that financial services are not generally consumption goods and, therefore, should not be subject to tax.85

In any event, the most that can be said here is that the VAT rules applicable to financial services are among the most complex in the entire VAT system. There is no reason to believe that the Flat Tax rules would be substantially simpler.

F. Odd Income and Deduction Items (such as tort benefits, prizes, etc.)

The basic income tax class at most law schools is filled with a host of odd fact patterns designed to elicit answers to the question of what is income. While many cases involve timing issues and, therefore, will have reduced significant in the Flat Tax, many will be present in the Flat Tax.

For example, the treatment of prizes or awards in the Flat Tax must be determined. Hall and Rabushka propose to tax prizes given by an employer to an employee but not other prizes. Prizes and awards are generally considered income under current law and certainly represent opportunities for consumption that can be taxed under a consumption tax. Whether they should be taxable under the Flat Tax, however, will depend on the treatment of the donor of the prize. It is not clear under the Hall and Rabushka plan whether prizes are deductible by the donor if the donor is a business.

Similarly, Hall and Rabushka propose to tax individuals on workman’s compensation or other compensation for damages. This language is ambiguous because it is not clear if it includes damages unrelated to work. For example, amounts received for pain and suffering in a slip and fall tort suit might not be covered under this language. Under current law, some such damages are excludable and commentators have differed on the desirability of such an exclusion. The Flat Tax will have to determine the treatment of such items.

The tax benefit rule is likely to be needed under the Flat Tax. That is, if a business claims a deduction, subsequently liquidates, and the facts turn out to be inconsistent with the claimed deduction, the

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85 See Harry Grubert and James Mackie, Must Financial Services be Taxed Under a Consumption Tax? (on file with the author).
deduction will have to be recaptured.\textsuperscript{86} And if the accrual method of accounting is used, the claim of right doctrine will be needed.\textsuperscript{87}

Unfortunately, much of the lore from current law, whether right or wrong, cannot be adopted in the Flat Tax. The reason is that the Flat Tax shifts the collection point of most taxes to the business level from the individual level. Thus, whether an item should be in the tax base may have similar answers under the Flat Tax and under the income tax, but the proper treatment of the item to individuals and to businesses may be very different.

G. Low-income Taxpayers and the Earned Income Credit

Hall and Rabushka do not include the earned income credit (EIC) in their outline of the Flat Tax. Elimination of the EIC means elimination of a significant poverty assistance problem. One in five American families now collects the EIC.\textsuperscript{88} In addition, without the EIC, the Flat Tax is likely to be significantly less progressive than current law but the Flat Tax with the EIC may be a reasonable facsimile to current progressivity.\textsuperscript{89} Pressure to maintain some version of the EIC may be strong.

The current EIC is generally based on wages but is phased out in part based on overall income. The Flat Tax, however, does not require taxpayers to retain records or determine income other than wage income. Implementation of the EIC, therefore, faces two choices.

First, the EIC could be based solely on wage income. This would significantly simplify the EIC. Adding only one or two lines to the postcard return would allow such an EIC to be included in the Flat Tax. The problem with this approach is that Congress has never thought it appropriate to base the EIC solely on wages because those living off of investments with low wages could claim the credit.

\textsuperscript{86} See Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983) for a Supreme Court holding on these facts.

\textsuperscript{87} The claim of right doctrine governs both when a disputed item of income must be included and the treatment if a previously included, disputed item, is never received.


\textsuperscript{89} See William Gale, Scott Houser, and John Scholz, Distributional Effects of Fundamental Tax Reform, in Economic Effects of Fundamental Tax Reform 290 (Henry Aaron and William Gale eds., 1996).
notwithstanding ample resources. Since its inception the EIC has included provision to prevent those with ample resources from claim the credit and the rules have recently been strengthened. It is not clear that Congress would be any more willing to base the EIC solely on wages under the Flat Tax that it is under current law.

The second option for the EIC under the Flat Tax is to require some level of income computations for all those claiming the EIC. This computation could be relatively simple, such as a net worth test or a realized income test. The problem is that doing so would effectively put those who claim the EIC at least in part back in an income tax system. Their net payments to the government would depend in part on income. To the extent there are benefits to a consumption tax for low wage individuals, this second option would reduce these benefits. In addition, this option would increase record keeping requirements considerably for many individuals.

Moving the EIC out of the tax system to the welfare system does not change the analysis at all. A different agency and different bureaucrats would administer the system but the implementation and economic issues would remain the same. Combining the EIC with existing welfare programs might reduce costs, but this decision can be made notwithstanding the adoption of the Flat Tax.

H. State and Local Governments

The most significant issue facing state and local governments would be the elimination of their ability to base their tax systems on the federal income tax. Currently many states “piggyback” their systems off the federal system, greatly simplifying administrative and compliance costs.

Unless states switched to a base similar to the Flat Tax, few of the implementation benefits of the Flat Tax would be achieved. Taxpayers would have to compute their income for state tax purposes and their Flat Tax liability for federal purposes. In fact, subjecting taxpayers to both systems would likely increase implementation costs from current law. Therefore reduction in implementation costs requires a change in state tax laws.

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90 The original EIC had a phase out based on modified adjusted gross income. See H.R. conf. Re. No. 94-120 (1975). In 1995, Congress added the disqualified income test. See section 32(i).
All interest is exempt under the Flat Tax. Therefore, the rules for tax-exempt bonds under current law could be eliminated. This would be a great simplification but it would have the effect of eliminating the preference for state and local bonds. Retention of the preference would likely require rules similar to those of current law.

I. Filing Unit

Problems with the filing unit under the Flat Tax should be similar to those under current law. Current law compromises between three goals: progressivity, taxing married couples with the same total income the same, and having individual's tax situation unchanged by marriage. These three principles are mathematically incompatible. Under the joint filing system of current law, the third principle is compromised so that tax liability may go up (in the case of equal earners) or go down (in the case of unequal earners) upon marriage.

The Flat Tax should have the identical problem with the only difference being that it is generally less progressive than current law. Thus, the Flat Tax will have marriage penalties or bonuses or tax equal earning couples unequally.

The treatment of children is less problematic under the Flat Tax than under current law. Current law includes the so-called “kiddie tax” which taxes children at their parents’ rates. The most important reason for the kiddie tax is to prevent parents from nominally giving capital income to their children to take advantage of lower tax rates. In the Flat Tax, capital income is not generally taxed, so the kiddie tax will not be needed.

J. Transition

Hall and Rabushka propose no transition relief on the change to the Flat Tax. Businesses would be subject to the cash flow tax without regard to existing tax basis. Having no transition relief, while raising political and economic issues, greatly simplifies implementation.

Even with no transition relief, however, there will be opportunities for taxpayers to avoid the transition tax. In particular, sales immediately prior to the transition tax to non-taxpayers would allow recovery of existing basis. The sold property could then be leased back or repurchased. Thus, one would expect substantial...
activity prior to an announced transition date to avoid the tax. Virtually all of this activity would be inefficient and would lower revenues.

From an implementation perspective, the question is whether any rules should be put in place to prevent or reduce this activity. It is not clear that any such rules would be successful. One option is an explicitly retroactive transition date, that reached back to eliminate basis for some unanticipated prior period. This would be reasonably simple but unpopular. The alternative is to try to police sale-leasebacks and sales followed by repurchases. Any such rules would be extremely complex although if sufficient revenue is at stake, may be worthwhile.

Transition without relief would also have the potential to cause significant dislocation for long term contracts. The most important set of such contracts are debt instruments with fixed interest rates. Debt instruments can have extremely long terms and if interest rates are set under a system of deductible/includible interest, they may be uneconomic under the Flat Tax rules. The exact effect will depend on how prices and interest rates adjust on transition.91

If there is a significant chance of dislocations, some rules might be needed to alleviate any that occur. For example, if interest rates do not adjust downward but home mortgage interest becomes nondeductible, many individuals may have trouble making payments. Housing prices presumably would drop and these individuals would be better off defaulting than continuing to try to make mortgage payments. Even if this scenario has a small probability of happening, if it cannot be ruled out on enactment of the Flat Tax, some rules to accommodate homeowners might be needed. It is not clear exactly what rules would be appropriate—a better understanding of the likely transition effects is needed, but the need for some such rules should be added to the implementation costs.

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Finally, there is a strong likelihood of transition relief (aside from rules reducing dislocations from the lack of relief). A Fortune article aptly stated, “Were Washington to disallow deductions [for preenactment basis], every CEO-laden corporate jet in America would commence strafing Capitol Hill.” Transition relief would be complex. Ron Pearlman explores the various issues in creating such relief. It is not worth repeating Pearlman’s analysis here. It is sufficient to note that the implementation costs will be high.

IV. Conclusion: Evaluation and Comparison to Current Law

Most students of the tax law generally had the intuition that once the details of the Flat Tax were spelled out, the claims of extreme simplicity would be discredited. The analysis here confirms this intuition. The Flat Tax cannot be as simple as claimed and still both raise revenue and not create adverse incentives. Many of the implementation issues in the Flat Tax will be extremely complex, and one can expect rules close to the level of detail and complexity of those in current law. The Flat Tax will not come close to living up to Hall and Rabushka’s prediction of postcard returns.

There are at least three reasons for the complexity of the Flat Tax. First, the economy is complex. A simple concept such as taxing fringe benefits at the business level, which Hall and Rabushka propose for the Flat Tax, is extremely difficult to implement because, in a complex economy, there are a wide variety of ways that businesses can mix compensation and business expenditures. Similarly, disallowing interest deductions but not deductions for other expenditures, as proposed in the Flat Tax, sounds simple but turns out to be complex because interest can be hidden. Implementation of the current income tax in a complex economy is complex, and implementation of virtually any other tax will be as well.

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93 Louis Richman, The Flat Tax; It’s Hot; It’s Now; It Could Change the Way You Live, Fortune (June 12, 1995), pp. 36, 44.
Second, the Flat Tax has several unique features that introduce both complexity and novelty. The most important of these features are that the Flat Tax is open domestically and origin-based, unlike any other significant consumption tax in the world. A tax that is open and origin based will have inconsistencies and line drawing problems that are difficult to eliminate. For example, transfer pricing rules and complex rules for the taxation of financial instruments will be needed because the Flat Tax is open and origin-based. Similarly, the openness and origin-basis of the Flat Tax force the treatment of losses to be modified from the usual treatment in consumption taxes, which in turn means a host of business tax rules will be necessary. The unique features of the Flat Tax mean that many compliance and complexity problems will be completely new.

Finally, the taxation of small businesses is particularly vexing in the Flat Tax. Under the Flat Tax, the treatment of a small business is quite distinct from the treatment of the owner of the business or from nonbusiness investments made by the owner. This distinction is much sharper than under current law and creates problems. If small businesses are taxed, they will be subject to onerous valuation requirements. Moreover, they will be subject to all of the complexity of the system for larger businesses (such as the transfer pricing, financial products, and business tax rules discussed above). Difficult issues under current law, such as the definition of independent contractors and the use of small businesses to claim deductions for personal expenses, will remain. If small businesses are exempt, however, they will need to be subject to restrictive rules governing the switching from exempt small business to taxable business. In particular, valuation problems will particularly vexing on this transition.

These three sets of problems involved only those issues given close examination here. The brief examination of other issues, such as the treatment of financial institutions, the earned income credit, and tax-exempt entities, indicates that further complexities will arise when the Flat Tax is actually implemented. One should also remember that the Flat Tax considered here was pure—political compromises were not generally considered. Thus, tax benefits for powerful constituencies were not included. Political compromises such as tax benefits for powerful groups impose large compliance
costs under the current income tax. There is no reason to believe that these compromises would not be repeated in the Flat Tax and impose similar costs.

The claim of complexity, however, should not be overstated. There are some significant simplifications in the Flat Tax. In particular, the international tax rules can be significantly simplified, primarily because of the territorial base. Elimination of capital gains taxation and the classification issues associated with the capital gains tax is a great improvement. Capitalization issues and inventory accounting disappear. These are significant simplifications. Even so, the claims of simplicity by proponents of the Flat Tax are wildly overstated. Overall, one should expect a system that is simpler than current law but not extremely so.94

To the extent that these simplifications are valuable, it may be possible to achieve them through tax reforms other than the Flat Tax. For example, the Flat Tax will be substantially more complex than a European-style VAT. A reformed income tax, even one that retains the realization requirement, may also be as simple as the Flat Tax. For example, much of the international simplification in the Flat Tax comes from its territorial system, which could easily be adopted in an income tax. Similarly, a single level business tax might reduce many of the complexities and adverse incentives of the

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94 Quantification of the compliance and administrative costs would be extremely helpful to the analysis. It is difficult, however, even to determine the total compliance costs of current law, although estimates put it at about $75 billion per year and it is even more difficult to estimate compliance costs under the Flat Tax. See Joel Slemrod, The Simplest Tax System, in Economic Effects of Fundamental Tax Reform, (Aaron and Gale, eds., 1996). It seems clear that they would be lower, but the magnitude is uncertain.

Slemrod estimated that the total compliance costs of the Flat Tax to be about $35 billion per year. Slemrod very likely underestimated the costs because many if not most of the complexities discussed above were not known at the time Slemrod did his estimates. For example, the mischaracterization of interest, the problems with the loss carryforward rules, and the various business tax rules for formations and liquidations of business, create the need for a host of rules and expensive tax advice. One would expect that most of these rules would be on the same order of magnitude as current law. Moreover, the complexities and inaccuracies identified above create adverse incentives. Businesses will structure transactions to take advantage of slightly incorrect tax rules rather than as they would absent taxes. This type of restructuring is inefficient and loses revenue.
current corporate tax. The financial products rules under an income
tax probably have greater potential to be coherent than under the
Flat Tax because an income tax will not have to have the same
distinction between interest and other flows. Accounting methods,
however, will be more vexing under a realization-based income tax
than the Flat Tax, although they are closer under an income tax to
book accounting, which is an advantage. Thus, many but not all of
the simplifications of the Flat Tax can be achieved in a reformed
income tax.

Without the claim of simplicity, the case for the Flat Tax
becomes extremely weak. A reformed income tax, or a combination
of an income tax and a VAT, can probably achieve virtually all of the
efficiency benefits of the Flat Tax while retaining the progressivity of
current law. At a minimum, given this complexity, advocates for the
Flat Tax should be required to demonstrate that its claimed
advantages in terms of economic efficiency and equity are real and
cannot be achieved through another method.
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