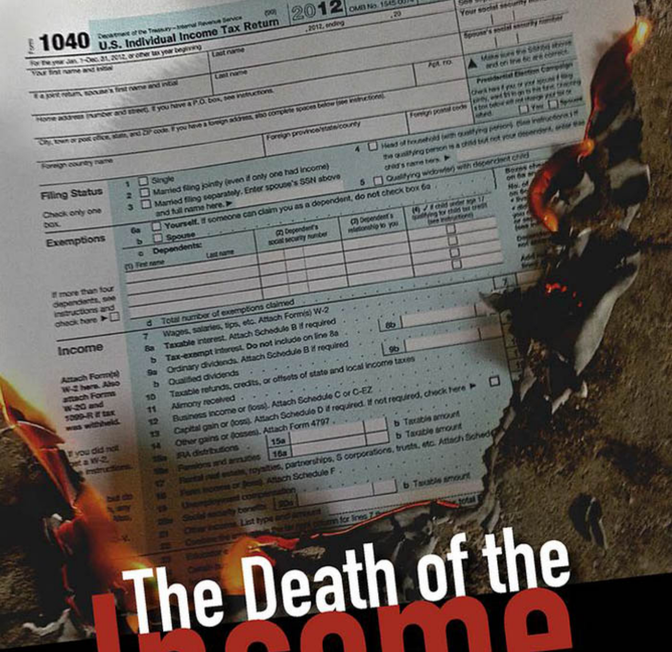

The Death of the Income Tax

A Progressive Consumption Tax and the Path to Fiscal Reform

Daniel S. Goldberg

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DANIEL S. GOLDBERG

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To my loving wife Marion, whose persistent encouragement kept this project going, and to our children Richard, Andrea, and Michelle, and Michelle's husband Justin and our granddaughter Lauren, for whose generations the tax reform proposed in this book is intended and who I hope will see its fruition in the near future.

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Contents

List of Figures

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List of Tables

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Preface

THE INCOME TAX is structurally flawed, as this book explains in detail, and has been made intolerable since the years of its original enactment as a result of micromanagement and mismanagement by Congress. These problems in the income tax have led to substantial income tax cheating, costing hundreds of billions of dollars of uncollected tax revenue each year, and to staggering costs of administering the tax system each year, both to taxpayers and the government. The problems are beyond repair and a better tax system needs to be found.

This book explains the flaws in the income tax, some of which are inherent and some of which are self-inflicted. It proposes that the solution to the current income tax problem is to kill off the income tax completely, giving it a decent burial of course, and replace it with a progressive consumption tax collected electronically and automatically at the point of sale, free of burdensome tax returns as we now know them.

This book comes at an appropriate time for several reasons. First, the year 2013 is a fiscal crisis year, and the crisis will get appreciably worse in the next few years. The Bush tax cuts of 2001 and 2003 were extended two years and then made permanent, just as they were expiring (except for high-income taxpayers, whose tax rates were increased). In addition, in 2013 the baby boomers will begin to retire and put additional pressure on Medicare. A perceived need for more revenue from the income tax will ensure that tax reform will be on the table, while retirement of the baby boomers will mean that there will be insufficient unallocated revenue coming from social security collections to buy off everyone with tax cuts. Also, the fiscal crisis will be heightened by the need to pay for the stimulus program enacted to combat the recession and for the new health care entitlements.

In the meantime, commissions will be formed, write reports about reforming the income tax, be criticized, and then re-formed, and will eventually realize that any income tax reform process is hopeless and cannot achieve the necessary objectives of real reform even if agreement could be reached. At that point, one hopes that Congress will turn to modern alternatives to the antiquated income tax and be receptive to a new platform on which a new tax structure can be built. This book can be the catalyst for transformation.

Daniel S. Goldberg
January 12, 2013

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PART ONE

The Problem: The Income Tax Is Broken

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1

What Is the Income Tax and Why Is It Broken?

An old tax is not necessarily a good tax; it is simply an old tax.

THINK APRIL 15. What does that date conjure up in your mind? Any fond memories? Doubtful! One wonders what life in America would be like without our annual correspondence with the IRS. Indeed, what would a spring be without the searching for 1099s, finding a year's worth of old brokerage company stock records, receipts for charitable contributions, and the somehow misplaced but required valuations of personal property given to charity? Why do we depend upon March madness, culminating on April 15, the tax filing deadline for individuals?

As is often said, death and taxes are the only certainties, and scientists are busily working on death. Perhaps surprisingly, neither an April 15 deadline nor the IRS as we currently know it is necessary for raising revenue for the federal government. The income tax as it currently exists should be abandoned. It is broken beyond repair. The nation is entitled to a new and better system of taxation for three reasons.

First, even in its most pristine form, the income tax is complex. It calls for distinctions that are often difficult to make by the taxpayers who are called upon to make them.

Our current income tax is far from a pristine form of income tax. It is hugely expensive, costing the economy as much as $320 billion per year just to administer, comply with, and plan around (see chapter 8), and serves as a feeding trough for talented professionals, who could be doing something more productive with their time and efforts. It is also hugely inefficient, collecting, under the Treasury's own estimate, about $385 billion per year less than it should collect under the law as written, and that is after the IRS has chased down about $65 billion of tax per year that is either not reported or paid at time of filing (see chapter 7). These amounts represent over $700 billion per year of potential saving for the economy if we can find a replacement for the hugely expensive and inefficient income tax system. Over a ten-year span, the potential saving amounts to $7 trillion, which no one can say is not real money.

Further, the current income tax is perceived as unfair by almost everyone, both on the right and on the left ends of the political spectrum. Yet we cling to it at least in principle as if the Internal Revenue Code were written on stone tablets.

Some would-be reformers have acknowledged that the income tax does not work terribly well, but believe that it accomplishes what it must: it raises large amounts of revenue in ways that fairly allocate the burdens. Indeed, the United States' major revenue source is the federal income tax. (Payroll taxes—Social Security and Medicare—are second.) The income tax raised approximately $1.272558 trillion in 2011 (down from its recent high of $1.533715 trillion in 2007).[1] Most importantly, defenders of the income tax insist that it is better than any of the alternatives proposed to date. These sentiments, however, arise primarily from a lack of imagination about alternative systems.

Second, the income tax is antiquated by current technology standards. Its defenders fail to appreciate that alternative systems have become feasible because of technological advances in computing and electronic commerce, which have already brought about tremendous changes in the way business is done both in the United States and worldwide. In contrast, the income tax is mired in the past, requiring essentially by-hand compilations of information for the tax return.

Let me illustrate this phenomenon. A few years ago, I addressed my faculty and asked my colleagues to reach into their wallets and count the amount of paper money that they were carrying. Amidst the chuckles, the responses generally went into the double digits and not more, although some did not even reach that level. I carried $100 (I am a tax guy), which was likely to last me for the month. Now, academics are known to be penurious and in fact pride themselves on being nonmaterial beings in thought and in action, but they are human and they have to eat and to get themselves to work. So, what is the answer? They use credit cards for groceries and gasoline. Cash was restricted generally for the pick-up lunch. (One faculty colleague insisted, however, that the only proper etiquette for buying beer was cash, which was the way he learned it forty years ago.)

Today cash use is even less important than when I asked the question a few years ago. Its importance has given way to credit cards. You can even use a credit card for a New York City cab ride. Furthermore, other money transfers have given way to electronic funds transfers as well. Monthly bills can be paid on-line without resort to paper checks.

The ubiquitous use of electronic payments means that record keeping is automatic and easily traceable. As a result, taxation at the point of the sale or other transaction could be fully inclusive and automatic, and a point of sale tax would not have to rely on later scrambling to compile records of the year's previous transactions. The income tax, however, was developed one hundred years ago, long before electronic tracing became possible. As a result, our current system fails to tap the technological possibilities that other forms of American industry and culture have embraced for several years. If a national tax were created today rather than at the beginning of the twentieth century, it is inconceivable that the current pencil and paper income tax system would be chosen.

The third reason why we need to replace the current tax system is that the income tax does not measure and tax what should be taxed. It taxes what one earns, by measuring what one adds to society's resources, rather than what one consumes, by measuring what one takes out of society and thereby precludes others from enjoying. It taxes amounts that are saved in the same manner as it taxes amounts that are lavishly consumed. This is particularly egregious in a society such as ours, which under-saves and goes into debt doing it.

In contrast, a consumption tax, that is, a tax based on what individuals consume rather than on what they earn as under an income tax, is viewed by most economists as superior to an income tax. Whether accomplished through a sales tax or a value added tax (VAT), as described in this book, or by computing income, as is currently done under the income tax, and then allowing a deduction for savings, thereby leaving only consumption in the tax base, a consumption tax taxes only consumption. As such, it relieves individuals from tax on amounts saved and invested. Accordingly, it encourages saving.

Most economists believe that a change to a consumption tax from our current system would stimulate capital formation, thereby creating greater production and efficiency, and generally enlarging the economic pie. This view is gaining support among policy makers willing to think expansively. Some policy makers are concerned, however, about the allocation of the tax burden under a consumption tax. The tax system proposed in this book addresses that concern.

This chapter begins a discussion of the three previously mentioned points by providing background on how the income tax works and how it is viewed by those who are subject to it, administer it, create it, and critique it. It then explains why the structure of the income tax, including both the measurement of income and the means of tax collection, is poorly conceived for today's world. As a result, the current system is doomed to fail: to fail to collect all of the tax that is properly due from taxpayers. In short, the income tax is broken.

What is the Income Tax?

Like the proverbial elephant described by four blind men, each touching a different part of the animal, our income tax system has four varying descriptions. The first perspective is that of taxpayers, who have to comply with the tax laws. For taxpayers, the main problems are uncertainty about what is ultimately included in the tax base and thus subject to tax, line drawing between deductible and nondeductible items, and difficulty and expense of tax planning and complying with complicated laws.

The second perspective is that of IRS administrators, for whom it is important to have a tax system that lends itself to IRS oversight. Effective oversight and ease of taxpayer compliance generally go hand in hand. Both depend upon workable rules, which taxpayers and administrators can understand and upon interpretation with which taxpayers can comply, and the IRS can use to ensure this compliance. The IRS is charged with administering the rules created by Congress and with filling in the interstices.

Effective oversight and ease of taxpayer compliance, however, sometimes work at cross-purposes. Highly complex and technical rules designed to create certainty in the law foster noncompliance, often by nonexperts just seeking to get through the onerous process of tax reporting by ignoring rules too complex and voluminous to find, understand, and digest. Moreover, the oversight process has a significant problem under the income tax because it relies largely upon taxpayer self-reporting, which is not always as forthright as it could be. From that vantage point, the current system falls far short of an ideal.

The third perspective is that of Congress, which attempts to use the tax system to accomplish much more than collect taxes. Congress uses the tax system to redistribute wealth, to control taxpayer behavior through economic incentives, which it builds into the tax code and tinkers with periodically, and to reward loyal constituents with special tax benefits.

Finally, the fourth perspective is that of tax philosophers, which include academics and policy wonks. They understand the viewpoints of the first three observers, but are the only ones to focus on the importance of income tax purity and thus the only ones to study deviations from the professed goal of taxing income. These deviations are sometimes inherent in the current income tax system and sometimes are the result of explicit policy choices. These deviations create economic distortions and inequities in the system.

Tax philosophers even question the wisdom of taxing income because it results in taxing amounts that are saved and not consumed. Many such philosophers look at a consumption tax as a superior alternative to the income tax.

Combining observations from all four perspectives reveals that the tax code is an enormous elephant, which is outmoded and poorly suited for the tasks asked of it; it is costly to feed, care for, and clean up after like any other elephant. This chapter focuses on the defective process by which income tax is assessed and collected. It discusses the defects that are inherent in an income tax system, which seeks to impose tax directly on the recipients of income and requires them to report income and to pay tax to the IRS. Successive chapters explain why taxing income itself is a flawed concept, how Congress's expansion of the aims of the tax system has added to the mess behind the elephant, and why the income tax works even worse in practice than it would be expected to work in theory.

The Uncertain Concept of Income Faced by Taxpayers and the IRS

What is Income and How is it Taxed?

The emphasis of the income tax is on measuring what the taxpayer has acquired as a result of his labor or the investment of his capital and even sometimes good fortune (such as in the case of found property). In the thousands of pages that comprise the tax code, the statutory source of the income tax, income is never actually defined. Rather, the concept of income in the tax code begins with the somewhat circular definition of gross income as "all income from whatever source derived,"[2] but contains examples of the types of receipts that are included in income such as wages, interest, dividends, and so on.[3] The Supreme Court, however, has supplied a more inclusive and useful test for determining when a taxpayer's receipt is income. In a 1955 case,[4] the Court identified the touchstone of income as enrichment. In the words of the Supreme Court, taxpayers have income when they have "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[5] Thus, an item of receipt can be characterized as income if it provides a consumption benefit to the taxpayer or increases the taxpayer's wealth, provided there is no statutory exception (the tax code provides exemptions from income for certain receipts, such as gifts received,[6] and some others, which are excluded from income for various policy reasons[7]) or nonstatutory exception (imputed income or unrealized gain are not included in gross income) to that treatment.

Similarly, the concept of deductions, which are subtracted from gross income to compute taxable income, focuses on what is spent by a taxpayer. Thus, if amounts are spent to earn income, they are generally deductible, because taxable income is a net income concept.[8] In addition, amounts spent on legislatively sanctioned personal items, discussed in chapter 5, are deductible as well, even though not connected with earning income. These deductions, which are unrelated to the taxpayer's earning of income, are referred to as personal or itemized deductions. In general, they reduce the taxpayer's taxable income below economic income, and each deduction has its own particular policy justification.[9] For example, charitable contributions[10] are deductible in order to encourage gifts to charity, although some see the justification as somewhat more complicated than merely providing an incentive.

In contrast, amounts spent on personal consumption, like food, clothing, shelter, movies, and other similar kinds of consumption expenditures are not deductible. Amounts saved or invested by the taxpayer also are not deductible.

The Tax Computation Process

The tax computation process begins with the taxpayer's annual correspondence with the Internal Revenue Service on Form 1040, or one of the shortened forms, 1040A or 1040EZ. These forms are surpassed in producing anxiety only by letters from the draft board beginning "Greetings" (for those whose memories of the military draft go back that far). Form 1040, the so-called long form, begins with a list of categories of income, including wages, interest, dividends, income from business, and a few other categories designed to elicit the usual kinds of income that taxpayers have. The form then contains various deductions, but most of the deductions relevant to taxpayers are on the schedules to be attached to the form 1040.[11] In general, income after deductions is taxed at tax rates that increase as income increases (which is discussed in chapter 4), although certain kinds of income are taxed at a preferential rate. The principal type of income that falls into this preferred category, called long-term capital gains, are gains from the taxpayers' sale or exchange of investment property (more precisely, capital assets) and certain business property that have been held for more than one year.[12]

Importantly, however, amounts saved or invested by the taxpayer are not deductible. Saving is treated no differently than lavish consuming, which many economists believe to be a fundamental defect of the income tax. Moreover, if the taxpayer does choose to save or to invest, the subsequent income earned on those savings, whether in the form of interest, dividends, or gain, is again subjected to tax.[13] As a result of both the treatment of savings and the treatment of earnings on those savings, the income tax discourages saving. Treating savings in the same manner as consumption misdirects societal resources away from future productivity. This theme will be developed further in chapter 9.

Despite an articulated standard for determining taxable income and an apparently organized way of collecting tax on it, our system is burdened by several conceptual problems, some of which are insurmountable. Moreover, taxing income in the hands of the recipient entails practical problems in self-assessment by taxpayers and oversight by the IRS.

Tax Complexity and the Flawed and Outmoded Design of the Income Tax

The structure that I have outlined in this chapter has been with us for many years, indeed since 1913, the year in which Congress enacted the modern income tax, which commenced in 1916.[14] There have been changes, amendments and even renumbering of sections of the tax code,[15] but the basic structure of the income tax has been in effect for almost one hundred years. Moreover, the means of notifying the government of the amount of one's income and tax liability, through a self-completed tax form submitted to the government, the so-called self-assessment system, has also remained a fixture of the tax system.

The Complexity in Simply Filing a Tax Return

The process of completing and filing of an income tax return is far from automatic. For the nonbusiness, ordinary taxpayer, the gross income items on the tax return generally can be copied from the Form W-2 furnished to an employee by the employer, or the Form 1099 furnished by payers of interest, dividends, and so on.

More troublesome, however, are the itemized deductions, including charitable contributions, deductible taxes paid, and miscellaneous itemized deductions for investment expenses and unreimbursed employee business expenses. These deductions require retrieval of records by taxpayers of expenditures or property transfers made throughout the year. Most taxpayers find the process of compiling information and completing the return onerous. Some find it downright painful. Almost all wish that it would just go away.

On the investment side, there is a panoply of investment choices that contain special beneficial tax treatment features and therefore are generally made with tax considerations in mind. Contributions to Section 529 plans to fund educational benefits for children, for example, permit income to be earned in the plan tax-free, if it is used to pay for the beneficiary's education. Section 401(k) and other retirement plan contributions give rise to excluded amounts of income or deductions until funds are withdrawn from the plan. Capital gains are taxed at a preferential rate, but need to be computed using basis information for property purchased sometimes many years before its ultimate sale. Chapters 3 and 12, which deal with planning opportunities and consumption tax features of the present income tax, catalogue more of these special tax benefit opportunities. All of these separate reporting items can ruin what would otherwise be the joys of spring after a harsh winter, even as tempered by global warming. They cannot be ignored, however, because to do so would cost the taxpayer the benefits of the special tax treatments and the psychological pain of overpaying taxes.

The problem is substantially more serious for the business taxpayer, even an individual who has a small side business to supplement his employment earnings. Tax return reporting requires record keeping, just as it does for the nonbusiness taxpayer, but the record keeping is much more extensive for a business than it is for a nonbusiness individual. It includes keeping account of office expenses, even for a home office, business supplies, telephone use, automobile use for business purposes, business meals and entertainment, and other normal business expenses. It also requires distinguishing between business expenses that are deductible and expenditures that are not, either because they must be capitalized or are personal and thus nondeductible. Both of these issues are discussed in detail in the next chapter.

The Taxpayer's Self-Assessment of His Tax

Finally, the process of assessing and collecting the income tax is flawed because it relies on a hopelessly outmoded design for reporting tax liability. Even if the measurement of income as it is measured under the current tax system were not inherently difficult and uncertain, as discussed in the next chapter, tax compliance would still be a problem. The reason is that the current tax system has a perverse and outmoded method of reporting and verifying income and of collecting tax, all of which foster taxpayer noncompliance and general aversion to a cumbersome and time-consuming system.

As explained earlier, a taxpayer self-reports income and tax by filing a tax return. Some people quip that the tax return represents a taxpayer's first offer to the IRS. The IRS can either accept the offer by doing nothing or make a counteroffer by auditing. There is more than a little bit of truth in this quip. The kernel of truth lies in the way the process starts. It starts with the exercise of the taxpayer's judgment as to the treatment of an item on the tax return. For example, the taxpayer makes an initial determination whether an expenditure to rehabilitate rental property is a currently deductible repair or an improvement that must be capitalized, or whether a meal with a customer and friend is a deductible business expense. These decisions are not made in consultation with the repair contractor or restaurant. The IRS is not consulted either.

Rather, the decisions are made by the taxpayer or advisors paid by the taxpayer. Is there any question in whose favor the taxpayer or the advisors are likely to exercise judgment? The IRS gets an opportunity to review and question the taxpayer's reporting of the items, but only if it audits the taxpayer. As chapter 7 will discuss, only a very small fraction of all returns are audited by the IRS. And, even on audit, the IRS has to discover that behind a bare number on the tax return lurks a disputable issue. Therefore, as a result of the mechanics of the tax reporting procedure, a substantial amount of the government's tax money is left on the table, or more precisely, in the offending taxpayer's pocket.

The income tax involves drawing lines and making difficult judgments by a taxpayer, as discussed in the next chapter. The self-assessment system provides little oversight or even awareness by anyone other than the taxpayer as to how the taxpayer's judgment is being exercised. Superimposing a self-assessment system on conceptually uncertain terrain is bound to create an unsatisfactory fiscal result.

Improvements in taxpayer compliance through mandatory year-end reporting of income to taxpayers and to the government and through withholding of tax by some payers such as employers has made the tax system more fiscally manageable and less porous. In addition, many taxpayers and virtually all professional tax preparers employ computers in making the entries of items, computing the tax liability and printing the forms or electronically filing the tax return. Although an increasing number of taxpayers now file their tax returns electronically, this system is far from an electronically collected tax. Despite developing technology, the system is antiquated, as the taxpayer must engage in a mechanical and labor-intensive endeavor to compile the information necessary to complete the form. It is subject to abuse, as the system invites the taxpayer's aggressive judgments, which tend to creep into the returns. The system more closely resembles a 1913 system than a 2013 one.

The most that computer technology can reasonably be expected to add to the process under the current income tax is to reduce the current tax's mechanical compliance burden. Financial institutions keep track of a taxpayer's investment earnings (interest and dividends), which are reported on Form 1099s and which can be downloaded onto a taxpayer's tax return under standard tax preparation software programs like TurboTax. Capital gains are not so simply done because in many cases the institution does not have reliable basis information. Moreover, it is unlikely that electronic data would be available for every entry item. For example, charitable donees could be required to send 1099s with regard to cash donations they receive, although they are not now required to do that. It would be unreasonable, however, to require them to send 1099s with regard to contributions of property that they receive for which the valuation is exclusively in the hands of the donors (with the exception of automobiles sold by the charity). The computer's assistance simply better facilitates the entry of the financial data on a self-prepared and tax-preparer-prepared tax return, replacing keystrokes, and of course significantly reduces computation time and errors. In those ways, computers have made a great contribution to the tax return process. However, the process is far from automatic.

The availability of computer technology has been a mixed blessing for the tax system. It has prompted Congress to enact all sorts of computationally complicated provisions such as the exceptionally complicated passive activity loss rules,[16] enacted as part of the Tax Reform Act of 1986, which require a taxpayer to keep track of previous losses from each separate passive activity investment, and various phase-out provisions for itemized deductions, personal exemptions, education credits, and so on. These have added substantially to the complexity of the process and the onerousness of compliance and tax planning.

The basic nature of the income tax, as it is currently structured, is rooted and stuck in the past. The income tax is a personalized tax assessment system. As such, the burden of compiling the necessary data and making the necessary judgments for business income and deductions falls on the taxpaying individual, although it can be reduced somewhat through computer technology. A truly automatic and electronic tax assessment and collection system requires that the tax system be transaction based. It requires that a tax be assessed and collected at the time that the transaction generating the tax takes place. A twenty-first century tax system should do exactly that.

The Next Step: Where to Go from Here

Thus, the income tax is structurally flawed. It is needlessly complex, contains perverse incentives against saving and investment, fails to use modern technology to ease compliance and collection burdens, and is subject to micromanaging and mismanaging by Congress. These problems, in turn, lead to noncompliance with the income tax resulting in hundreds of billions of dollars of tax revenue not collected each year, and to large costs required to run the tax system.

Some of these problems are inherent in an income tax and some are the product of years of ill-conceived legislation. Even if the former problems could be fixed in the income tax, which they cannot, the latter problems have proven to be beyond the politicians' ability to correct at this point in our history. A better tax system needs to be found.

This book proposes that the solution to the problems of the current income tax is completely replacing it with a progressive consumption tax collected electronically at the point of sale. The acceptance of this solution requires understanding first, that a tax on consumption will serve the country better than a tax on income (see chapter 9); second, that a consumption tax can be implemented in several different ways (see chapters 10 and 11); third, that the current tax system is an eclectic income tax/consumption tax system already (chapter 12); fourth, that an efficient and leakproof tax system is best designed as a point of sale tax on transactions as they occur (see chapters 13 and 14); and, finally, fifth, that such a system can be made progressive by using a two-tier variant of a credit VAT, carving out wages and taxing them at graduated tax rates (see chapters 13 through 15). The difficult problems of transition to the replacement system are dealt with as well (see chapter 16).

The book proposes e-Tax, a convenient contraction for an electronically collected tax (see chapter 14).

e-Tax is based on a European-style, credit value added tax (VAT) because with modern technology a VAT can be collected electronically and automatically (see chapters 13 through 15). e-Tax builds in progressivity at the wage-earner level. It combines straightforward concepts with appropriate use of technology to achieve ease, efficiency, and assurance of compliance and collection.

Adoption of e-Tax can reduce substantially both the loss of tax revenue from tax cheating and the deadweight loss from the costs to both taxpayers and the government of administering the tax system. As the country heads into the fiscal crunch of increasing demand for government-funded benefits and reduced tolerance for higher taxes, e-Tax will be an attractive alternative to reducing government spending or increasing taxes.

2

Taxing Income Is a Flawed Concept

Insanity: Doing the same thing over and over and expecting different results.

TAXING INCOME IS a flawed concept because income itself is an ambiguous concept. It is difficult to define, and its measurement is complicated and subject to substantial disagreement. As a result, an income tax would be deficient, even if it were pristine, free of tax incentive provisions and personal itemized deductions. The income tax thus cannot be fixed with just some tinkering. In short, you can't make a silk purse out of a sow's ear, no matter how acute her hearing is.

Unrealized Appreciation and the Realization Requirement

The Achilles heel of the income tax lies in its concept of realization.[1] The tax code does not include in the gross income of a taxpayer the increase in wealth as a result of mere appreciation in the value of property owned by the taxpayer, but rather the income tax seeks to tax only income that is realized. Income (i.e., gain) is realized with regard to property transactions when the taxpayer sells property and the sales proceeds are received by the taxpayer.[2] As such, a taxpayer who year after year is enjoying appreciation in the value of property and therefore an increase in wealth, nevertheless, does not have taxable gain from the tax code's point of view. The gain is not taxed until it is realized through a sale or exchange of the property. Thus, neither Bill Gates nor Warren Buffett was subject to tax as they amassed their vast amounts of wealth through appreciation of their Microsoft and Berkshire Hathaway stock. The principle of realization dates back to the inception of the income tax and its tentacles in the income tax are quite long.

The realization requirement, which keeps increased value in property from being taxable until there has been an event of realization of the gain in the property (e.g., a sale of the property or an exchange of the property for other property), has been explained on the basis of two policy justifications. The first justification is that it would not be practical or even feasible to require a taxpayer to value her property every year for purposes of taxable gain computation. It would be expensive and a verification nightmare.

While this rationale made sense in the early twentieth century, it is somewhat problematic in the twenty-first century. Many items of property are indeed difficult or expensive to value. Real estate, for example, requires expensive appraisal and even then, getting a precise figure for actual "fair market value" is virtually impossible. Valuing a closely held business is even more problematic. These kinds of properties tend to be entrepreneurial and represent a means of earning money through a combination of capital and services. Value is highly dependent on their prospects of future earnings. Thus, businesses are very difficult to value with the kind of precision one would want when imposing a tax.

In contrast, publicly held stock is generally very easy to value because there is an active market in the stock that one can consult. Indeed, several sites on the Internet offer minute-by-minute valuations of publicly traded stock. Moreover, mutual fund companies like Fidelity Investments and many others compute the closing value of their myriad of highly diversified mutual funds for the day by around 5:30 p.m. of the same day. The folks in 1913 could never have imagined that this kind of information would be available to the ordinary investor. Consequently, claiming difficulty in valuation by the ordinary investor in publicly traded stocks or mutual funds is ludicrous.

In response, one could ask about limited partnerships interests, which are illiquid and not readily traded. How about an investor whose holdings in a publicly traded company are large relative to the average public market trading volume, rendering it more illiquid than it would at first appear? These are good questions, showing that there is merit to the difficult-to-value point. The most usual case for investors, however, is publicly traded stock and mutual funds and valuation for this kind of property is no longer a problem.

The second justification is that the realization requirement is necessary because the owner of an appreciating property lacks sufficient liquidity to pay tax as long as the appreciated property is retained and not sold. If mere appreciation were taxable, a taxpayer whose property has appreciated could be forced to sell that property to pay the resulting tax on the appreciation. Avoiding such a forced sale is a facially appealing reason to allow the owner to await sale before having to pay tax.

Liquidity is particularly a problem with real estate and closely held company stock, both of which are illiquid. However, it is not a problem with publicly traded stock and mutual funds, which are readily saleable. Perhaps the taxpayer does not want to sell just to pay taxes. Well, hey, many others who do sell for cash just want to reinvest their proceeds and do not want to reduce their reinvestment just to pay taxes. And, there are many others who do not want to alter their lifestyles just to pay taxes.

In any event, abandoning the realization requirement under the income tax is highly unlikely. Any attempt to do so would undoubtedly confront a substantial amount of public resentment, many individuals believing that so-called paper gains do not amount to real gains until cashed in when the property is sold.[3]

Taxing realized and reinvested gains differently and more harshly than unrealized gains makes very little sense and is unprincipled. Either all increases in wealth should be taxed or no increases in wealth should be taxed. Under a true income tax, both would be subject to tax. Under a consumption tax, neither would be subject to tax. The realization rule of the current income tax law makes the tax inequitable and haphazard in its application.

The reluctance or perceived inability to tax unrealized appreciation has given rise to some of the most egregious tax policy distortions of modern times. Both Bill Gates and Warren Buffett, two of the wealthiest people who ever lived, have railed against the income tax's unfair burden sharing. After discovering that his tax rate was lower than his receptionist's, Warren Buffet declared in an interview with NBC that "[t]he taxation system has tilted toward the rich and away from the middle class in the last 10 years[,] . . . and I think it should be addressed."[4] They, of course, were referring to the preferential rate, 15% (20% for high-income taxpayers after 2012), accorded capital gains, which may very well be the source of the majority of their taxable income. However, wealthy critics of this perceived unfairness in tax rates resulting from the capital gains preference are rarely if ever heard to clamor for a fix of the vastly more important inequity between those who sell and reinvest, who tend to be less wealthy, and those who simply hold onto their existing investments, like Gates and Buffett.

Economists would include unrealized appreciation as income in an income tax because unrealized appreciation represents increased wealth and purchasing power, just as the regular and taxable salary of a firefighter does.[5] Would Gates and Buffett really want their unrealized appreciation in Microsoft and Berkshire Hathaway, respectively, to be taxed currently every year? Maybe yes, maybe no. One would have to ask them, but I have my doubts. In any event, they have not clamored for it.