Chapter 4

A MODEL CASH FLOW TAX

1. Introduction

This chapter presents a proposal for a consumption based tax as an alternative to a comprehensive income tax. It is called a "cash flow" tax because of the simple accounting system used. The cash flow tax is designed to replace the current taxes on the income of households, individuals, trusts, and corporations. The major difference between the cash flow tax and the comprehensive income tax outlined in Chapter 3 is that the change in an individual's net worth is effectively excluded from the base of the cash flow tax. In many other respects, the two taxes are the same. Consumption is effectively included in both tax bases; the definition of consumption in the cash flow proposal is broadly similar to that in the comprehensive income tax proposal (it differs mainly in including the flow of consumption from consumer durables and owner-occupied housing) though both differs to some degree from the definition of the consumption component of taxable income in the current tax code. The definition of the family unit for tax purposes is also the same in both the accretion and cash flow proposals.

The proposal here focuses on the appropriate base of the cash flow tax system. The issue of the vertical progressivity of the tax system is a separable problem which has to be faced with both a cash flow and an accretion type income tax.

The central feature of the tax is the use of cash flow accounting of financial transactions to obtain a measure of annual consumption for any individual. The principle involved is very simple. For any individual, monetary receipts in a year can be used for three purposes: personal consumption, saving, and gifts. By including <u>all</u> monetary receipts in the tax base, and allowing deductions of purchases of assets and itemized gifts, it is possible to measure the annual consumption of any individual without directly monitoring his purchases of goods and services in the market place.

The way cash flow accounting of financial asset transactions can be used to compute the tax base of an average wage earner is illustrated by the following example. Suppose an individual worker earns $10,000 per year in wages, of which he uses $9,000 for personal consumption and $1,000 for saving. Under the cash flow tax outlined in this proposal, the worker may deduct $1,000 from his tax base if he deposits the $1,000 in a qualified account. Qualified accounts will be handled by banks and other financial institutions which will keep records of deposits and withdrawals by individuals. The worker's $1,000 deposit in the account may be used to purchase any type of financial asset, including savings bank deposits, stocks, bonds, mutual funds, or any other claim to future income or share in ownership of a capital good. The future amount available to the worker in the qualified account will depend, of course, on the profitability of his investments. No tax will be paid on interest, dividends or capital gains as they are earned, <u>but the taxpayer will be required to include in his tax base any future withdrawals from his qualified account that are not reinvested in similar accounts</u>.

The qualified accounts described here are very similar to the Keogh plans now available to the self employed, in which tax deductible contributions to retirement funds can be made and tax must be paid on retirement income. However, there are two major difference between the qualified accounts proposed here and Keogh plans. First, withdrawal of funds from the account can be made at any time during an individual's lifetime though, as with the Keogh plans, he will be subject to a tax upon withdrawal. Second, there is no planned statutory limit to the amount an individual may contribute to a qualified account.

Thus, in the above example if the worker deposits $1,000 in a savings account, his tax is computed on an annual cash flow base of $9,000. If, in the following year, he consumes his entire salary of $10,000 and in addition withdraws $500 from his savings account to purchase a color TV set, his cash flow tax base will be $10,500.

The use of qualified accounts to handle financial transactions enables us to trace the annual flow of funds available for consumption uses. An alternative way of handling investment accounts, which enables an individual to alter the timing but not the present value of his recorded cash flow base, is to include purchases of assets in the tax base but exempt all income from assets from tax. In the example above, the worker may deposit $1,000 of his $10,000 annual wage income in a savings bank without using a qualified account. In this case, the entire $10,000 wage income is included in his tax base in the initial year, but future income earned on the savings deposit and withdrawal of the principal is not included in the tax base. As we discuss more fully below, the present value of the worker's lifetime tax base is the same for both methods of accounting as long as he consumes the proceeds of his account during his lifetime.

Thus, under the cash flow tax, the computation of the base for investments made outside qualified accounts is very simple. The investment is treated as if it were consumption in the year it is made, but all returns on the investment are untaxed. In other words, income from investments made outside of qualified accounts is not subject to tax. In effect, tax has been prepaid on the consumption from the proceeds of the investment at the time the investment was made.

The remainder of this chapter presents the details of a model cash flow tax base and a discussion of its most important characteristics. Section 2 points out those tax issues which have common solutions in the model comprehensive income tax and the model cash flow tax. Section 3 sets out the major differences between the two tax bases. Section 4 discusses the economic consequences of adopting a cash flow tax, and Section 5 presents a sample tax calculation form.

2. Elements in Common with the Comprehensive Income Tax

A number of issues that were discussed in the preceding chapter in connection with the model comprehensive income tax would also be resolved in the same way under a cash flow tax. These are questions of the definition of consumption, to be taxed alike in both models, and the related issue of the appropriate treatment of families of varying size and circumstances.

Family Size and Family Status

The family is to be taxed as a unit for reasons analogous to those argued earlier. In order to assess tax to each family member as an individual, it would be necessary to allocate consumption among family members. This would destroy much of the administrative simplicity of the cash flow tax, which rests upon deducting certain cash outlays made, in most cases, on behalf of the family from receipts that are usually combined at the family level. Similarly, the argument that standards of living vary by family size holds as well for a consumption measure of living standard as for an accretion standard. The adjustment device, an exemption per family member, is the same under the cash flow tax although differences in the size of the tax base under the two taxes may require that the exemption levels be different for model taxes that would raise the same revenue.

Those adjustments that account for differences among families in the number of wage earners and the availability of a full-time adult in the household are in terms of labor-related earnings and expenses only. They are, therefore, just as appropriate under a consumption tax as under an income tax. The applicable structure of rates to achieve the desired pattern of progressivity may, however, be different.

Deductions for Charitable Contributions, Medical Expenses and Taxes

A standard-of-living concept of consumption leads to the same conclusion about charitable contributions as is recommended under the accretion type income tax. From the point of view of the donor, such contributions are gifts which are deducted as a part of determining consumption. By this same argument, they should be added to receipts of the recipient. Following the earlier discussion, including receipts from charities in the tax base is rejected on grounds of impracticality -- charity is usually not given in cash, nor in goods that are easy to value. Allowing tax free consumption of goods and services provided by charities also has an element of tax incentive for what may be regarded as public-service functions.

One aspect of the accretion tax discussion of charities is different here. There is no question about taxing the endowment earnings of charitable organizations until they are distributed to beneficiaries. This would not be called for under the cash flow tax.

The issues involving medical expenses and medical insurance are exactly the same for the cash flow tax as for the accretion tax. Consequently the same policy options are prescribed in both model taxes.

The model cash flow tax treatment of State and local taxes is, likewise, the same as that in the model accretion tax--sales and income taxes are fully and explicitly deductible, because they are not regarded as part of consumption. Other taxes are not deductible.

The rationale for denying deduction of the property tax for owner-occupied homes is, however, somewhat different in the case of the cash flow tax. The cash flow tax measures the owner's consumption of housing services as the purchase price (or capital value) of the dwelling. In an equilibrium market, this price is the present value of the prospective stream of imputed rents, less current costs including property taxes. Therefore, an increase in the local property tax (uncompensated by services to the property) will reduce the market price of the dwelling. In this sense, an implicit property tax deduction is allowed under the cash flow tax and no explicit deduction is warranted.

Health, Disability and Unemployment Insurance

Certain types of insurance that are purchased for a one year term and pay benefits directly to the insured --health, disability, and unemployment insurance -- are no different in concept or proposed treatment under the cash flow tax than under the accretion tax. They are all included in the consumption definition. The differences in treatment among them -- taxation of benefits in the case of disability and unemployment, and of premiums for health insurance -- is explained in the preceding chapter. The recommended tax treatment is the same for each of these items whether the insurance is public or private, employer-paid or employee-paid. Life, casualty, and old age insurance do present differences in concept under the consumption tax and will be discussed below.

3. Differences Between the Cash Flow Tax and the Comprehensive Income Tax

The major difference between the cash flow tax outlined here and the comprehensive income tax presented in Chapter 3 is that the cash flow tax does not include changes in net worth in the tax base, while the income tax attempts to include all changes in net worth to the extent administratively feasible. Thus, the cash flow tax and the income tax differ in their treatment of purchases and returns from financial assets. Specifically, the major areas of difference between the two taxes are in the handling of corporate profits, income from unincorporated business, capital gains, interest received on savings and interest paid on loans, rental income, income accrued in retirement plans and life insurance, and casualty losses.

The first part of this section discusses in some detail the treatment of investment assets and consumer durables under the cash flow tax proposal. Then, in the second part of this section, a comparison is made between specific provisions of the comprehensive income tax proposal and the handling of the corresponding items under the cash flow tax proposal.

The Treatment of Assets Under a Cash Flow Tax

The cash flow tax simplifies drastically the administration of real and financial assets. Accounts to determine capital gains, depreciation and inventories, among the most complex in the current tax code, are no longer required. Balance sheets for changes in net worth, required for the accretion type income tax, need not be kept. For many individuals, a direct accounting is unnecessary for all asset purchases and receipts. For others, simple annual flow data which record annual deposits and withdrawals from investment accounts provide all the necessary information for computing tax liability. Because it rests solely on current year marketplace transactions, the cash flow tax minimizes the need for long term recordkeeping.

The simplicity of the cash flow tax is best illustrated by the tax treatment of a family-owned business. For such a business, all cash in-flows are normally counted as receipts. Cash outlays which represent business expenses, including all purchases of equipment, structures, and inventories, are deducted. In other words, instantaneous depreciation for tax purposes is allowed on all capital investments. The difference between receipts and cash outlays is included in the individual's tax base. If cash outlays exceed receipts in any year, a deduction may be taken against other income.

For example, suppose a family derives all its income from a family-owned grocery store. In computing its tax base, the family adds up all receipts from its cash sales and subtracts from this amount all its business costs including payments to employees, electricity and rent payments for the store, cash outlays on any machinery and purchases of inventories. This is the only calculation the family would need to make to determine its tax base under the cash flow tax. As the only information needed for the calculation is current receipts and current outlays, tax accounting would be greatly simplified. No data on capital gains and depreciation would be needed to determine taxable income.

Tax liabilities on financial assets, including stocks, bonds, and savings deposits, owned by individuals and families via a qualified account would be computed the same way as tax liabilities from an individual or family-owned business under the cash flow tax. All deposits for purchases of assets would be deductible from other income in computing the tax base, while all withdrawals, whether of dividends or interest or return of capital would be included in the tax base.

For example, suppose an individual deposits $100 in a qualified savings bank account, where it earns 10 percent annual interest. In the year he makes the $100 deposit, he is allowed to deduct $100 from current income in computing his tax base. If, in the following year, he withdraws the principal plus earned interest, now equal to $110, the amount withdrawn is added to income from other sources in computing the tax base. If the savings deposit is instead left in the bank to accumulate interest, there are no current tax consequences, but a tax will be paid at a later date on any future withdrawals.

Inclusion of current cash flow from financial asset purchases and sales in the tax base requires the keeping of records of annual flows into and out of financial asset accounts every year. The device of qualified accounts offers a simple way to assure compliance with the law, since tax deductions would be allowed only for assets purchased through such accounts. Individuals would be permitted to keep qualified accounts with savings banks, corporations, stockbrokers, and many other types of financial institutions. The net amount of deposits in, and withdrawals from qualified accounts during the year would be reported by the institution to both the taxpayer and the tax authorities. Financial institutions would probably be willing to perform the required recordkeeping in return for the privilege of handling investment accounts. The way corporations currently report dividend payments to stockholders can be viewed as a model for the way institutions can report net withdrawals and deposits of individuals.

The tax base of any individual will include the sum of net withdrawals from all qualified accounts. If deposits exceed withdrawals, this sum will be negative and will be subtracted from other receipts in computing the tax base. The sale of one asset to purchase an equal dollar value of another asset within a qualified account will have no net tax consequences.

It is technically feasible, but not practically attractive, to apply the same cash flow rules to the purchase of consumer durables as have been outlined for the purchase of financial assets. Unlike financial assets, consumer durables such as an automobile, a house, and major home appliances all yield a flow of services to the owners which are not measured by annual monetary flows in the marketplace. Thus, allowing a deduction for consumer durable purchases while including only future monetary receipts in the tax base would understate the value of consumption services yielded by the durable good.

For example, suppose an individual purchases a new automobile for $4,000 and sells it for $2,000 3 years later. Allowing a deduction for the purchase, and including the sale in receipts would mean that the individuals' total tax liability has been lowered by owning the automobile. However, the individual has expended $2,000 plus some lost interest for the purpose of owning the automobile and enjoying consumption services over the 3-year period. The depreciation and foregone interest from ownership of the car during that 3-year period, which measures the cost of the consumption services, would not be included in the tax base if the automobile were taxed the same way as an asset in a qualified account.

The appropriate way to treat consumer durables is to allow no deduction on purchase and exclude receipts from sales from the tax base. In other words, purchase of a consumer durable would be treated the same way as current consumption of goods and services. The justification for this approach is that the price paid for a consumer durable reflects the present value of future services the buyer expects to receive.

In the example above the $4,000 for the purchase of the automobile is not deducted from the tax base. The $2,000 from sales of the automobile 3 years later is not included in the tax base. Thus, if an individual sells a used car and buys another used car for the same price, or uses the proceeds for current consumption, there are no tax consequences. If he sells a used car for $2,000 and invests the proceeds in a qualified asset, he deducts $2,000 from his tax base in the year of the transaction.

In summary, purchase of a durable good is treated as present consumption even though the good yields a flow of consumption services over time. The reason for this approach is that the price of the good reflects the expected present value of its future stream of services. Measuring service flows directly requires measuring both annual depreciation and the annual imputed interest on the capital value of the asset at every point in time, and would introduce unwanted and unnecessary complexity into the cash flow tax.

The equivalence between the purchase price of a consumer durable good and the present value of expected future services from the good suggests an analogous equivalence between the price of an asset and the present value of the expected future stream of returns from the asset. This point can best be illustrated by a simple example. Suppose the interest rate is 10 percent and an individual deposits \$100 in a savings account in year 1. In year 2, he withdraws the \$100 deposit plus \$10 earned interest, and uses it to buy consumption goods. If the savings deposit is purchased through a qualified account the individual lowers his tax base by \$100 in year 1 and raises it by \$110 when he withdraws his funds from the account in year 2. As the interest is 10 percent, the discounted present value in year 1 of his tax liability in year 2 is \$110/1.10, or \$100. Now, suppose that the individual does not receive a deduction for depositing money in a savings bank and is <u>not</u> taxed on interest earned or on withdrawal of either the principal or interest. The discounted present value of his tax base is the same as under the cash flow rules initially outlined. The tax base in year 1 is $100 higher and the discounted present value of the tax base in year 2 is $100 lower. In other words, allowing a deduction for purchases of assets and taxing withdrawals is equivalent to allowing no deduction and exempting all interest earnings from tax.

Note that the consequences to the government of the two ways of taxing the asset are also the same in present value terms. If the individual buys the asset through a qualified account, the government collects revenue on a tax base of $110 in year 2. If the interest is exempt from tax, and no deduction for the asset purchase is allowed, the government collects revenue on a tax base of $100 in year 1, which can then be invested at 10 percent interest. If the tax rate is proportional, the government is left with the same revenue at the end of year 2 in both cases.

The example above suggests an alternative way of treating assets under a cash flow tax. Under the alternative asset treatment, asset purchases are <u>not</u> deducted from the tax base and all earnings from assets and sales of assets are <u>not</u> included in the tax base. For assets not purchased through qualified accounts, and therefore not eligible for deduction at time of purchase, all return flows, including earnings, would be tax-exempt. Thus, it is not necessary to keep any records for tax purposes on assets outside of qualified accounts. The expected present value of the tax base is the same for both methods of tax treatment of assets, although the timing of payments is different. Thus, both methods of tax treatment of assets are consistent with a cash flow approach to taxation.

This fact provides a convenient way to deal with problems which would arise in the event large outlays were to be included in 1 year (e.g., to buy a house, pay for college, etc.). Normally, under cash flow accounting, receipts from a loan would be handled through qualified accounts. If an individual sets up a qualified account for a loan, he would be required to report the loan proceeds in his tax base in the initial year. Interest and principal payments on the loan through the qualified account would be deductible from the tax base in the years the payments are made. Normally, the proceeds from such a loan would be offset by outlays on earning assets, so the tax base in the accounting period would not be large. However, since cash outlays for consumer durables are not deductible, there would be no such offset in the case of, e.g., a mortgage loan for a house. In this case, the individual would normally take out the loan through an ordinary account. Because the loan is not through a qualified account, the proceeds of the loan would not be included in the tax base, and the principal and interest payments would not be deductible. Note that the present value of the tax liability is the same in either case because the present discounted value of future interest and principal payments on a loan is equal to the current proceeds of the loan. The only difference between the two ways of treating loans for tax purposes is the timing of tax liabilities. If the loan is taken through a qualified account, a tax liability in the initial year is offset by tax deductions in the future. If the loan is not recorded in a qualified account, there is no initial liability and there are no future deductions.

The existence of alternative ways of treating financial assets and loans for tax purposes gives individuals great flexibility in altering the timing of tax liabilities. This feature of the cash flow tax is desirable because it minimizes the need for special averaging provisions. Averaging is desirable because of the progressivity of the rate structure. With progressive rates, an individual with a tax base of $10,000 in year 1 and $30,000 in year 2 will pay higher taxes than an individual with a tax base of $20,000 in both years. It is hard to see how the former individual can be viewed as being in a better position to pay taxes than the latter individual. In general, it would be desirable to tax individuals according to their relative present values of lifetime standards of living and not on the basis of the extent to which measured cash flow fluctuates from year-to-year.

Let us review these features of the cash flow tax base in the example of an individual who purchases a large durable good, such as a house, or is faced with a lumpy consumption expenditure, such as payment of tuition for his child's education. The option of placing investments and loans in or out of qualified accounts enables a consumer to smooth out over a period of years the recorded cash flow from these types of expenditures.

For example, suppose an individual wishes to purchase a $40,000 house, on which the bank makes available to him a $30,000 mortgage. If the individual chooses not to include the loan proceeds from the $30,000 mortgage in his tax base, he cannot deduct mortgage payments in future years. In effect, the individual can pay the principal and interest on the mortgage every year out of current income. The income used for the annual mortgage payments is included in the tax base. Thus, the tax base on the mortgage can be made to approximate the schedule of mortgage payments on the house.

This leaves the problem of what to do about the down payment. The $10,000 used for the down payment, if withdrawn from a qualified account, is included in its entirety in the tax base the year the house is purchased. The individual, if he had foreseen buying a house, could have avoided this problem by saving outside of the qualified account. The money deposited in financial assets would have been included in the tax base every year while the saving was occurring, but the lump sum withdrawal would not be subject to tax. Thus, by accumulating assets <u>outside</u> of qualified accounts, individuals can transfer the cash flow from future lumpy consumption expenditures into previous years.

In most cases, individuals will probably want to save in qualified accounts for averaging purposes. Most saving occurs during an individual's most productive years, when income is highest, and is used to finance consumption after retirement. By saving in qualified accounts, an individual can reduce his tax liability in the years when income is high relative to consumption, and raise it in the future when income is low. However, saving outside of qualified accounts may be an individual's best strategy when anticipating such large consumption expenditures as a down payment for a house or college expenses.

Some questions may arise as to the appropriateness of allowing some kinds of assets to be purchased outside of qualified accounts. When an asset is purchased through a qualified account, the government shares in both the investment, by allowing a tax deduction, and in the return on the investment. For assets purchased outside of qualified accounts, the investment is not deducted and the entire proceeds of the investment can be liquidated for consumption purposes tax free. In effect, with qualified accounts the government is a partner in the investment, sharing in the cost and appropriating a fraction of the return. The expected return net of tax is the same for assets purchased with or outside of qualified accounts, but for assets bought outside of qualified accounts large winners do not pay a higher tax and losers do not receive a loss offset. While both types of tax treatment allow investors equal opportunity to earn after-tax dollars, the tax treatment of assets purchased outside of qualified accounts does not distinguish between winners and losers of investment gambles. If this is regarded as undesirable, a possible solution to the problem would be to restrict purchases of highly risky types of assets to qualified accounts.

The same problem exists for consumer durables. As consumer durables may not be purchased using qualified accounts, all windfall capital gains from holding consumer durables are untaxed and there is no tax offset for losses. For example, if the value of an individual's house doubles in a year, his tax liability is unchanged. For the most part, however, returns of consumer durable investments are not very variable compared to returns on financial assets. For practical reasons, it is best to leave consumer durables outside of qualified accounts.

However, investments in individual businesses would be eligible only for tax treatment on a current cash flow basis. All outlays for the business will be eligible for deduction while all net receipts will be subject to tax. The reason for not allowing the alternative treatment of exempting capital returns from tax is that it is sometimes difficult to distinguish between profits and wages to the individual businessman. If profit income alone is exempted from tax, the businessman will have an incentive to avoid tax on the value of his labor services by paying himself a low wage and calling the difference income from investment. This problem exists for individual proprietorships and possibly for small partnerships and closely held corporations.

For such enterprises, all net receipts should be taxable and outlays for capital goods should be eligible for immediate deduction.

Table 5-1 summarizes the proposed regulations for tax treatment of financial assets, durable goods, loans, and family business enterprises.

Table 5-1

Summary: Tax Treatment of Assets Under Cash Flow Tax

	Qualified Accounts	Accounts Outside of System
1. Financial Assets	purchases deductible; all withdrawals of earnings and principal	purchases not deductible; interest and return of capital not taxed
2. Durable Goods	not available	purchases not deductible; sales not included in tax base
3. Loans	receipts in tax base; repayments deductible	receipts not in tax base; repayments not deductible
4. Family Business*	all outlays deductible, including capital outlays; all receipts taxed	not available

* Includes limited class of small businesses owned and operated by same person(s).

All investments in family business are treated as if purchased in qualified accounts, while consumer durable goods may not be purchased through qualified accounts. Financial assets may be purchased, and loans obtained either through qualified accounts or outside of the system.

Differences Between Cash Flow and Comprehensive Income Taxes: Specific Provisions

Casualty Losses. Under the model comprehensive income tax, casualty losses are deductible because they are clearly reductions in net worth. Under cash flow tax, changes in net worth, whether positive or negative, are not included in the tax base. Thus, there is no justification for allowing deductibility of casualty losses under a cash flow tax.

Following this principle, uninsured losses would not be deductible from taxes, as they are under the comprehensive income tax proposal. In addition, casualty insurance premiums, which are deductible under the comprehensive income tax proposal, are not deductible under the cash flow tax proposal, but the proceeds which are includable under the income tax proposal, are excluded from the cash flow tax base.

Pension Plans and Social Security. Under the cash flow tax, all contributions to pension plans may be viewed as contributions to qualified accounts, whether by the employee or by the employer. By this logic, contributions are not included in the tax base, while retirement income is included in full. Similarly, for social security all contributions will be tax exempt, while all social security retirement benefits will be taxable. There is no need under the cash flow tax to compute the income on pension funds attributable to individual employees because accumulation is not subject to tax. Thus, the proposals under the comprehensive income tax to keep records which distinguish between principal repayments and earnings in retirement funds are irrelevant to computing the base under the cash flow tax.

Life Insurance. Term life insurance and whole life insurance are both treated differently under the cash flow tax than under the comprehensive income tax, but for different reasons.

With term life insurance, there is no investment income, and thus no change in net worth. Under the comprehensive income tax proposal, premiums for term life, whether paid by the employer or the employee, are included in the insured's tax base, while proceeds from term life insurance policies are tax exempt. The general principle of treatment of gifts under a cash flow consumption base tax argues for a different treatment. Term life insurance may be viewed as a wealth transfer from the policyholder to the beneficiary.

Purchase of a term life insurance policy lowers the lifetime consumption of the policyholder and raises the expected lifetime consumption of the beneficiary. Thus, a cash flow tax which taxes consumption of individuals should not tax premiums paid by the policyholder but should include proceeds from a term life insurance policy in the tax base of the beneficiary. In practice this means that employer contributions to term life insurance will not be imputed to the income of the policyholder while term life insurance premiums paid directly by the policyholder will be deductible.

Whole life insurance poses a different issue, though it receives the same treatment as term insurance under a cash flow tax. A whole life insurance policy does provide investment income to the policyholder in the form of an option to continue to buy insurance at the premium level appropriate for the initial eyar. Under a cash flow tax, unlike under the comprehensive income tax, the increase in the value of the option does not need to be computed for tax purposes, as it represents a change in net worth and not consumption. However, if the individual cashes in the option value, the receipts from this transaction are included in the cash flow tax base.

Under the cash flow proposal, all premiums paid by policyholders for whole life insurance will be tax deductible, while premiums paid by employers for policyholders will not be imputed to policyholders' incomes. All receipts from life insurance policies, whether in the form of cash surrender value to policyholder or proceeds to beneficiaries, will be included in the tax base of the recipient.

State and Local Bond Interest. Under the cash flow tax, State and local bond interest for securities not purchased through a qualified account will remain tax exempt, as under the present law. However, as with the comprehensive income tax proposal State and local bonds will lose their special status relative to other assets. Under the comprehensive income proposal, State and local bonds lose their special status because interest from them becomes taxable. Under the cash flow tax, State and local bonds lose their special status because returns from other assets become tax exempt.

If State and local bonds are purchased under a qualified account, under the cash flow tax, all contributions to the account will be deductible and all withdrawals from the account will be subject to tax. Thus, the purchase price of a State (or local) bond will be deductible while withdrawals of interest payments and principal from the bond for consumption will be subject to tax.

Interest Paid. Under the comprehensive income tax, all interest paid is tax deductible because such outlays represent neither consumption nor additions to net worth. This includes interest payments for mortgages on owner-occupied homes. Under the cash flow tax, interest payments for consumer loans, including home ownership loans, are in general not tax deductible because changes in net worth are not included in the base of the cash flow tax. However, if a loan is taken through a qualified account, the initial proceeds of the loan are taxable, while subsequent principal and interest repayments are tax deductible. The net effect of a loan on the tax base is zero.

Corporate Income. Corporations will not be taxed as entities under either the cash flow tax or the comprehensive income tax. As noted in Chapter 3, under the comprehensive income tax all corporate income, including undistributed income, will be attributed to individual shareholders. Under the cash flow tax, there is no need to impute undistributed income to anyone, as taxes are only assessed on funds available for personal consumption.

The treatment of corporate income under the cash flow tax is exactly the same as the treatment of other kinds of investments. There will be no separate tax at the corporation level. Individuals will be permitted to purchase corporate stock through qualified accounts held with brokers. For stock owned in a qualified account, the initial purchase price will be deductible from the tax base at the time of purchase, while subsequent withdrawals from the account from dividends received or from either return of capital or capital gain from the sale of stock will be taxable in full. For stock purchased outside of a qualified account, no deduction will be allowed for purchases and no tax will be assessed on dividends or on capital gains in any form, and no deductions will be allowed for capital losses.

Capital Gains. Under the cash flow tax, there is no need to keep records of the basis of asset purchases to compute capital gains. For assets purchased outside of qualified accounts, capital gains are simply exempt from tax. For purchase of assets within qualified accounts, which allow deduction of the initial purchase price, no distinction is made between the part of the sale of the asset that represents capital gain and the part of the sale that represents return of basis.

Because the cash flow tax does not tax accumulation, issues of deferral, inflation adjustment, and the appropriate rate of tax on capital gains which are discussed in the comprehensive income tax proposal do not need to be considered.

<u>Business Income Accounting</u>. Income accounting for any individual's business under the cash flow tax will be strictly on a cash flow basis. The individual must compute in any year net receipts from operating the business. To perform this computation, he must add to the sale of goods and services during the accounting year any receipts from borrowing and subtract the purchases of goods and services from other firms, wages paid to employees, interest paid to suppliers of debt finance, and all purchases of plant and equipment. Net receipts calculated by this method are included in the individual's tax base, if positive, and deducted, if negative. Note that the major difference between the treatment of business accounting and cash flow tax and under comprehensive income accretion tax is the treatment of capital assets. Under the cash flow tax, purchases of capital assets entitle the businessman to an immediate deduction. Under the comprehensive income tax, deductions are allowed for a capital consumption allowance, which estimates the loss in value during the year of capital assets used in production. Also, business loans are treated differently. Under the cash flow tax, all receipts of loans to a business are included in the base, while interest and amortization payments are deductible. Under the comprehensive income tax, loan receipts and amortization payments have no tax consequences and interest payments are deductible because they represent a reduction in net worth.

For partnerships, the rules are simpler. The partnership must simply report the annual cash contribution of each owner to the business and the annual distribution to each owner. The difference between distributions from partnerships and net contributions to partnerships enters the individual owner's tax base. If the owner sells his shares, it enters the tax base as a negative contribution.

4. Special Problems: Progressivity, Wealth Distribution and Wealth Taxes

The cash flow tax outlined in this proposal taxes consumption but not accumulation. The base of the tax is equivalent to a tax on labor income alone, with income from capital exempt from tax. People are likely to conclude that such a tax must be regressive and that it must encourage excessive concentration of wealth and economic power by allowing all accumulation to go untaxed. In this section, we briefly discuss both these concerns, showing that the concern about regressivity is largely misplaced and that the tax can be complemented in any desirable degree by a transfer tax to influence the wealth distribution without eliminating the important administrative, equity and efficiency advantages of the tax.

The regressivity argument stems from the fact that capital wealth is much more highly concentrated than labor earnings. As the cash flow tax exempts earnings from capital, it must necessarily tax labor more heavily to raise the same revenue. Thus, it might appear that the cash flow tax is a way of shifting the tax burden to the middle class and relieving the wealthy taxpayer.

Such a criticism of the cash flow tax, while superficially persuasive, is misleading on several grounds. First of all, the progressivity of any individual tax is in large degree determined by the rate structure. The choice between an accretion type income base and a consumption base is independent of the degree of vertical progressivity of the rate strucutre. Second, while accumulation from capital is untaxed, the initial capital endowment of all individuals is subject to tax. This is accomplished by including in the individual's tax base all receipts of gifts and inheritances.

The mechanism through which gifts and inheritances will be included in the tax base is simple. All gifts, in order to be eligible for deduction by the donor, must be included in the tax base of the recipient. Gifts will be recorded only if they are transfers between taxable entities. Thus, a gift of a ffather to his nine year old son will be included in the family's taxable income unless it is added to a qualified account, being neither deductible to the giver nor taxable to the recipient because the recipient is not an independent taxable unit. When the son leaves the family unit, or turns 26, he will become a separate taxpayer. At that point all accumulated wealth from past gifts, as well as from inheritances will be included in his initial tax base and deducted from the family's. If the initial base is large, the individual will have an incentive to purchase a qualified account to avoid a steep progressive tax, but will have to pay tax on subsequent withdrawals for consumption out of that account. Thus, an individual does not have the opportunity to realize tax free consumption out of a past inheritance.

Note that the taxation of gifts and accessions to the donee, and the deduction of itemized gifts by the donor, is a logical, integral part of the cash flow tax necessary to assure that the tax base is related to the lifetime consumption of every individual.

With initial financial endowments included in the tax base, the elimination of capital income from tax simply means that individuals who save from labor income earned in the early part of their working life will not be subject to a tax on the return from that saving. In effect, capital income may be thought as a form of income resulting from deferred consumption of income from labor. If the rate structure is appropriately progressive, so that the high wage earners are paying a significantly higher tax than low wage earners, there seems to be no particular reason to discriminate in tax liability between people with different patterns of lifetime consumption. Viewed in that manner, the tax does not favor the wealthy but does favor, relative to an accretion income tax, those individuals who, at any given income level, choose to postpone consumption.

One further potential objection on progressivity grounds is to the opportunity afforded by this particular cash flow tax proposal for individuals to acquire wealth by a lucky investment gamble, while paying only the small tax on the amount wagered. People seem to differ in their view of the equity of this result. This possibility could be greatly reduced, at a price in complexity and compliance costs, by, for example, taxing the returns on investments not made through qualified accounts, except for special "tax anticipation" accounts.

A second common objection to a cash flow tax is that it places no restraint on accumulation. While all consumption out of accumulated wealth is taxed, the cash flow tax, compared to an income tax, makes it easier for individuals to accumulate financial wealth. The effect of this on the distribution of capital wealth in the United States is ambiguous. Presumably individuals at all levels would tend to hold more wealth, so that the dispersion of wealth might either increase or decrease. At the same time, there would presumably be an increase in the size of the largest wealth holdings.

The cash flow tax, with wealth transfers deductible to the donor and included in the tax base of the recipient, is a tax on the standard of living of individuals. Like the model comprehensive income tax, it could be converted into a tax on lifetime ability to pay if wealth transfers are regarded as consumption by the donor, as well as income to recipient. In that case, gifts and inheritances would be included in the base of the recipient, while gifts would not be deductible to the donor and bequests would be taxed as use of lifetime income. Including gifts given and bequests in the tax base transforms a standard of living tax to an ability to pay tax.

However, a simpler approach, and one more consistent with present policies, is to retain the estate and gift tax as the principle instrument for affecting the distribution of wealth. Such a tax, which is levied by reference to the situation of the donor, forms a logical complement to the model cash flow tax, and does not damage either the basic simplicity inherent in the treatment of assets under the cash flow tax or the neutrality in tax treatment of individuals with the same endowment who have different time patterns of either labor earnings or consumption. All features of the cash flow tax remain exactly as before except for the wealth transfer tax. Tax rates of gifts and bequests under the cash flow tax can be designed to achieve any desired degree of equalization in initial wealth of individuals.

5. Information on Sample Tax Form for Cash Flow Tax

Filing Status

1. Check Applicable One

   a. Single

   b. Married

   c. Unmarried Head of Household

   d. Married Filing Separately

Exemptions

2. If applicable enter 1 on line

   a. Regular

   b. Spouse

3. Number of Dependent Children

4. Total Exemptions (Add lines 2a, 2b, 3)

Receipts

5a. Wage, Salaries, and Tips of Primary Wage Earner (attach forms W-2)

b. Wages, Salaries, and Tips of all other Wage Earners (attach forms W-2)

c. Multiply line 8b by .75

d. Wages Subject to Tax. Add lines 5a and 5c

6a. Employer Contributions to Health Insurance (includes Medicare)

b. Other Employee Compensation

7. Gross Business Receipts (from Schedule C)

8. Gross Distributions from Partnerships (from Schedule E)

9. Distributions form Pension Funds and Trusts (includes Social Security benefits)

10. Gifts and Inheritances Received

11. Withdrawals from Qualified Accounts (if positive)

12. Disability pay, Unemployment Compensation, Workmen's Compensation, Sick Pay, Public Assistance, Fellowships, and other cash stipends

13. Total Receipts, Add lines 6 through 12

Deductions

14. Gross Business Expenses (Schedule C)

15. Contributions to Partnerships (Schedule E)

16. Contributions to Trusts

17. Deposits in Qualified Accounts (From S-2)

18. Other Deductions (Schedule A)

19. Total Deductions, add lines 14 through 18

Computation of Tax

20. Income Subject to Tax, Subtract line 19 from line 13

21. Gross Tax (from either married or single schedule or Tables)

22. Tax Credits (from credits)

23. Net Tax Payment = line 22 minus line 21

Credits or deductions may include exemptions for family size.

Schedule A -- Deductions

Taxes

1. State and local income

2. General sales (see sales tax tables)

3. Total (add lines 1 and 2)

Gifts and Charitable Contributions

4. Gifts or Donations to an Identified Taxpayer or Entity (itemize)

Cost of Earning Income

5. Union Dues

6. Child Care Expenses (only for secondary workers or single adult households)

7. Multiply 6 by one-half

8a. Enter line 7 or $5,000, whichever is smaller

b. Enter line 8a or line 5b (line 5a for unmarried head of household), whichever is smaller

9. Others (itemize)

10. Add lines 5, 8b, and 9

11. Subtract $300 from line 10

12. If line 11 positive, enter line 11, if line 11 negative enter 0

13. Add lines 3, 4 and 12. Enter on Form 1040, line 21

Schedule C (Business Receipts and Expenses)

Like current Schedule C except

Line 5 - total outlays for purchase of assets

Enter line 5 (total income) on Form 1040, line 7

Enter line 20 (total deductions) on Form 1040, line 14

Schedule E -- Note partnership will have to send information on Form 1065 of gross distributions and gross contributions

Form S-2's -- Supplied by brokers of qualified accounts

1. Total Deposits

2. Total Withdrawal

3. Net Withdrawal (line 2 minus line 1) if positive

4. Net Deposits (line 1 minus line 2) if positive