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# Chapter 5. Transition Rules Under Basic Tax Reform

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Chapter 5

# TRANSITION RULES UNDER BASIC TAX REFORM

## 1. Introduction

Major changes in the tax code such as would accompany a switch to either an accretion or cash flow base may lead to substantial and sudden changes in current wealth and future after-tax income flows for some individuals. Transition rules need to be designed to minimize unfair losses, or undeserved windfalls, to individuals whose investment decisions were influenced by the provisions of the existing code.

This chapter discusses the major issues in transition and proposes transition rules for both the comprehensive income tax and the cash flow tax. Section 2 outlines the major wealth changes that can be expected under a switch to either a comprehensive accretion income tax or a compre-ehensive cash flow tax, and discusses the relevant equity criteria to be applied in the design of transition rules. In Section 3, instruments for amelioration of transition problems, including phasing-in provisions of the new law and grandfathering, or exempting, existing assets from the new rules are discussed. The effects of applying these transition instruments to different types of changes in the tax law are outlined. Section 4 presents a series of specific proposals for transition rules to be applied to changes in the tax law that would result from adoption of the accretion tax proposal in Chapter 3. Finally, in Section 5, special problems of transition to a cash flow tax are discussed and a plan is presented for transition to the cash flow proposal in Chapter 4.

## 2. Wealth Changes and Their Equity Aspects

Two separate problems requiring special transition rules can be identified: carryover and price changes. Carryover problems would occur to the extent that changes in the tax code affect the taxation of income earned in the past but not yet subject to tax or, conversely, income taxed in the past that may be subject to a second tax. Price changes would occur in those instances where changes in the tax code alter the expected flow of after tax income from existing investments <u>in the future</u>.

### Carryover Problems

Under the present tax system, income is not always taxed at the time it is earned. For example, accretion that occurs in the form of capital gains is not taxed prior to realization. A change in the tax rate on realized capital gains, therefore, would alter the tax liability on gains accrued but not realized before the effective date of the tax reform. Application of the new rules to past capital gains would either raise or lower the applicable tax on that portion of past income, depending on whether the increase in tax from including all capital gains in the income base exceeded the reduction in tax caused by any allowance of a basis adjustment for inflation.

The problem of changes in the timing of tax liability is especially severe if the current tax system is changed to a consumption base. Under a consumption base, purchases of capital assets are tax deductible and sales of capital assets that are not reinvested are fully taxable. Under the current tax system, both the income used to purchase capital assets and the capital gain are subject to tax, the latter, however, at a reduced rate. Recovery of the original investment is not taxed. An immediate change to a consumption base would penalize individuals who have saved in the past and who are currently selling assets for consumption purposes. Having already paid a tax on the income used to purchase the asset under the old rules, they would also be required to pay an additional tax on the <u>entire</u> proceeds from the sale of the asset. On the other hand, if owners of capital assets are allowed to treat those assets as tax-prepaid, they would receive a gain to the extent they plan to use them for future consumption or bequest. Income on past accumulated wealth would then be free from future taxes, and the government would have to make up the difference by raising the tax rate on the remaining consumption regarded as non-pre-taxed.

Other carryover problems include excess deductions or credits unused in previous years and similar special technical features of the tax law. In general, carryover can be viewed as being conceptually separate from changes in the price of assets. In the case of capital gains tax, for example, the change in tax liability to an individual for past accrued earnings does not affect the tax liability of another individual purchasing an asset from him; in general, the asset price depends only on <u>future</u> net-of-tax earnings. However, the new tax law <u>and</u> the transition rules, by altering future net-of-tax earnings, would change the price of capital assets.

In most cases, carryover problems could be handled by special rules that define the amount of income earned but not realized before the effective date of implementation of the new law. Changes in the definition of an individual's past income will alter asset prices only if they provide an incentive for pre-effective date sales of existing assets. For example, if, under the new system, past capital gains are taxed at a higher rate than under the old system, an incentive may be created for sales of assets prior to the effective date.

Price Changes

Adoption of a broadly based tax system would change prices of some assets by changing the taxation of future earnings. Under an accretion base system, for example, the following changes in the tax code would alter tax rates on income from existing assets: integration of the corporate and personal income taxes; taxation of all realized capital gains at the full rate; adjustment of capital taxation for inflation losses; inclusion of interest on State and local government bonds in the tax base; elimination of accelerated depreciation provisions that lower the effective rate of tax on income arising in special sectors, including minerals extraction, real estate, and some agricultural activities; and elimination of the deductibility of property taxes by homeowners. Adoption of these and other changes in the tax code would change both the average rate of tax on income from all assets and the relative rates imposed among types of financial claims, legal entities, and investments in different industries.

The effects of changes in taxation on asset values differ for changes in the average level of taxation of the associated returns and changes in the relative rates of tax on different assets. A change in the average rate of taxation on all income from investment, while it will affect the future net return from wealth or accumulated past earnings, is not likely in itself to change individual asset prices significantly. For any single asset, a change in the average rate of taxation of returns would reduce net after-tax earnings roughly in proportion to the reduction in net after-tax earnings on alternative assets. Thus, the market value of the asset, which is equal to the ratio of returns net of depreciation to the interest rate (after tax), will not tend to change. On the other hand, an increase in the relative rate of taxation on any single asset generally will lead to a fall in the price of that asset, because net after-tax earnings will fall relative to the interest rate. The opposite holds for a decrease in the relative rate of taxation.

The behavior of the price of any single asset in response to a change in the relative rate of taxation of its returns depends on the characteristics of the asset and the nature of the financial claim to it. For example, suppose the asset is a share in an apartment project. In the long run, the price of the asset will depend on the costs of building apartments; if unit construction costs are independent of volume, they will not be altered by changes in the tax rate on real estate profits. Now, suppose the effective rate of tax on profits from real estate is increased.

The increase in tax will drive down the after-tax rents received by owners; as the value of the asset to buyers depends on the stream of annual after-tax profits, the price a purchaser is willing to pay also will fall. With the price of the structure now lower than the cost of production, apartment construction will decline, making rental housing more scarce and driving up the before-tax rentals charged to tenants. In final equilibrium, the before-tax rentals will have risen sufficiently to restore after-tax profits to a level at which the price buyers are willing to offer for the asset is again equal to its cost of production.

Thus, the immediate effect of the tax is to lower the price of equity claims to real estate. The wealth loss to owners of those shares at the time of the tax change depends both on the time period required for adjustment to final equilibrium and the extent to which future increases in the gross rentals (from the decline in housing supply) are anticipated in the market place. The faster the adjustment to equilibrium and the larger the percent of gross rentals change that is anticipated, the smaller the fall in asset price will be for any given increase in the tax on the returns.

If the asset is a claim to a fixed stream of future payments (e.g., a bond), a change in the rate of taxation will alter its price by lowering the present value of the future return flow. For example, if interest from municipal bonds becomes subject to tax, the net after-tax earnings of holders of municipal bonds will fall, lowering the value of those claims. New purchasers of municipal bonds will demand an after-tax rate of return on their investment comparable to the after-tax return on other assets of similar risk and liquidity. The proportional decline in value for a given tax change will be greater for bonds with a longer time to maturity.

The effect of corporate integration on the price of assets is less certain. Viewing the corporate income tax as a tax on the earnings of corporate equity shareholders, integration will increase the rate of tax on income from investment of high bracket shareholders and lower the rate of tax on such income of low bracket shareholders. 1/ In addition, many assets owned by corporations also can be used in the noncorporate sector. To the extent that relative tax rates on income arising in the two sectors are altered by integration, those assets can easily move from one sector to the other, changing relative before-tax earnings and output prices in the two sectors, but keeping relative after-tax earnings and asset prices the same.

In conclusion, raising the relative tax on capital income in industries and for types of claims currently receiving relatively favorable tax treatment is likely to cause some changes in asset prices. Immediate asset price changes generally will be greater for long-term fixed claims, such as State and local bonds, than for equity investments; greater for assets specific to a given industry (e.g., apartment buildings) than for assets that can be shifted among industries; and greater for assets whose supply can only be altered slowly (e.g., buildings and some mineral investments) than for those the supply of which can be changed quickly.

The effect of integration on capital values is not likely to be large. On the other hand, changes in the special tax treatment currently afforded in certain industries, for example in real estate and in mineral resources, and changes in the treatment of State and local bond interest are likely to cause significant changes in asset values.

Equity

Considerations of equity associated with changes in tax laws are different from equity considerations associated with the overall design of a tax system. Changes in the tax code create potential inequities to the extent that individuals who made commitments in response to provisions of the existing law suffer windfall losses (or receive windfall gains) as a result of the change. These gains (and losses) can be of two types: (1) wealth changes to individuals resulting from changes in tax liabilities on income accrued in the past but not yet recognized for tax purposes, and (2) changes in the price of assets or the value of employment contracts brought about by changes in future after-tax earnings. These two types of problems, carryover and price change, pose somewhat different equity issues.

Carryover poses the problem of how to tax equitably income earned while a different set of tax laws was in effect. For example, consider one aspect of the proposed change in the tax treatment of corporations under the accretion income tax. Presently, capital gains are subject to lower tax rates than dividends, especially when realization is deferred for long periods of time. Individuals owning shares of corporations paying high dividend rates relative to total earnings pay more tax than individuals owning shares of corporations with low dividends relative to total earnings. As both tpyes of investments are available to everyone, individuals purchasing shares in high-dividend corporations presumably are receiving something (possibly less risk or more liquidity) in exchange for the higher tax liability they had to assume. To subject the shareholders of low-dividend corporations to the same rate of tax on income accumulated in the form of capital gains prior to the effective date as they would have paid had the earnings been distributed would be unfair.

Carryover poses another equity problem: some taxpayers may be assessed at unusually high or low rates on past income because of changes in the timing of accrual of tax liability. The above example can be used to illustrate this point too. Under current law, the special tax treatment of capital gains in part compensates shareholders for the extra tax on their income at the corporate level. Under integration, the separate corporate income tax would be eliminated but shareholders would be required to pay a full tax on their attributed share of the corporation's income, whether or not distributed. Now, suppose integration is introduced and a shareholder has to pay the full tax on appreciation of his shares which occurred before the effective date. 2/ The taxpayer is, in effect, being too heavily taxed on that income as it was subject to taxation at the corporate level before being taxed at the full individual income tax rate. Before integration, he would in effect have paid the corporate tax plus the reduced capital gains rate; after integration, he would be liable for the full tax rate on ordinary income. However, in the absence of transition rules, he is in fact subject to a higher tax on income which accrued before but not recognized until after the effective date of the new law.

The most desirable solution to the problem of equity raised by carryover is to design a set of transition rules that insure that, to the maximum extent consistent with other objectives, tax liabilities on income earned before the effective date are computed according to the old law and tax liabilities on income earned after the effective date are computed according to the new law.

Changes in future after-tax income brought about by tax reform raise a different set of equity issues. A radical tax reform that is to a large extent unexpected will cause capital losses to owners of assets in previously tax-favored sectors. Imposition of such capital losses may be viewed as unfair, especially since past government policy explicitly encouraged investment in those assets. For example, if two individuals in a given tax bracket are indifferent between holding subsidized State and local bonds and unsubsidized Treasury bonds before the tax change, it seems reasonable to compensate the holder of State and local bonds for the loss suffered upon removal of the subsidy so that he ends up in the same position as the holder of Treasury bonds. Note that this concept of distributive justice does not imply that a third taxpayer, who earns higher after-tax income from tax-free bonds than from Treasury bonds because he is in a higher tax bracket than the other two, should retain the privilege of earning tax-free interest. Equity does not require that the tax system maintain loopholes; it does require some limitation on wealth losses imposed on individuals because they took advantage of legal tax incentives.

The counterargument to the view that compensation for such wealth changes is required by principles of justice is that all changes in public policy alter the relative incomes of individuals and frequently asset values. For example, a government decision to reduce the defense budget will lower relative asset prices in defense companies and their principal supplying firms and also lower relative wages of individuals with skills specialized to defense activities (e.g., many engineers and physicists). Although some special adjustment assistance programs exist, [3] it is not common practice to compensate individuals for changes in the value of physical and human assets caused by changes in government policies. In addition, it can be argued that, because investors in tax-favored industries know that the tax subsidy may end, the risk of a public policy change is reflected in asset prices and rates of return. If, for example, it is believed that the continuing debate over ending remaining special tax treatment of the oil industry assets poses a real threat, it can be argued that investors in oil are already receiving a risk premium in the form of higher than normal net after-tax returns, and further compensation for capital losses upon end of the subsidy is unwarranted.

The discussion above suggests that cases can be made both for and against compensation of individuals for capital losses caused by radical changes in tax policy. As the capital value changes resulting from the tax change alone are virtually impossible to measure precisely, designing a method to determine the appropriate amount of compensation would be difficult on both theoretical and practical grounds. However, it would be desirable to design transition rules so that capital losses and windfall gains resulting from adoption of a comprehensive tax base would be moderated to some degree. Two possible design features, grandfathering existing assets and phasing in the new rules slowly, are discussed in section 3.

3. Instruments for Ameliorating Transition Problems

The main criteria that transition rules should satisfy are: (1) simplicity, (2) minimizing incentive problems, and (3) minimizing undesirable wealth effects.

Simplicity. The transition rules in themselves should not introduce any major new complexity in the tax law. To the extent possible, transition rules should not require that corporations or individuals supply additional data on financial transactions or asset values.

Minimizing Incentive Problems. The transition rules should be designed to minimize the probability of action in response to special features of the change from one set of tax rules to another. In particular, there should not be special inducements to either buy or sell particular kinds of assets just before or after the effective date of the new law.

Minimizing Undesirable Wealth Effects. Transition rules should moderate wealth losses to individuals holding assets that lose their tax advantages under basic tax reform as well as gains to those whose assets are relatively favored. At the same time, special transition rules to protect asset from loss holders should not give them the opportunity to earn windfall gains.

Alternatives

Two alternative methods of reducing capital value changes are discussed here: grandfathering existing assets and phasing in the new law.

Grandfathering. The grandfather clause was originally used by some southern States as a method for disfranchising black voters following the Civil War. It exempted from the high literacy and property qualifications only those voters or their lineal descendants who had voted before 1867. More recently, grandfather clauses have been used to exempt present holders of positions from new laws applicable to those positions, e.g., setting a mandatory age of retirement. In the context of tax reform, a grandfather clause could be used either to exempt existing assets from the new law as long as they are held by the current owner or to exempt existing assets from the new law regardless of who holds them. A grandfather clause also could be applied to capital gains accrued but not yet realized at the time the new law went into effect.

Consider, for example, the effect of eliminating the special depreciation rules that result in a low rate of tax on income arising from real estate investments. A grandfather clause that exempted existing buildings only as long as they are held by the current owner(s) would mean that current owners could depreciate their buildings to zero according to the old rules, but that new owners could not do the same. Grandfathering the buildings independently of their owners would allow subsequent purchasers to depreciate according to the old rules. 4/ This would have the effect of raising the value of the buildings. Elimination of tax-incentives in real estate would discourage new construction, reducing the supply of housing and raising gross rentals before tax. Thus, grandfathering, by making existing property more valuable, would give a windfall gain to investors in real estate tax shelters. On the other hand, grandfathering the buildings only for current owners would not prevent a wealth loss to real estate investors because the value to new buyers would decline. The loss would be mititgated by the anticipated increase in after-tax profits to current investors (because of the decline in housing supply).

Grandfathering existing buildings unconditionally would be simpler than grandfathering them only as long as they are owned by their existing owners. The new law could be made to apply only to ownership of buildings constructed after a certain effective date; proof of the date of purchase would not be required.

The effect of grandfathering on asset prices for fixed-interest securities, is less certain. For example, if existing municipal bonds are grandfathered, annual interest received net of tax will be unchanged. However, the value of the tax saving from owning municipal bonds will change for two reasons. First, there will be no new tax-exempt municipal bond issues under the new rules; with fewer available tax-exempt bonds, the marginal bracket of the buyer who is indifferent between tax exempt and other securities will rise, driving up the price of the tax exempt securities. Second, the other changes in the tax system would probably lower all marginal tax rates by widening the base, thereby reducing the tax advantage and the price of tax-exempt securities. It is not clear in what direction the price of the grandfathered securities would change, though the price change is likely to be much smaller than the price change if the new rules were immediately adopted for all tax-exempt securities.

The main danger of grandfathering is that it can provide a windfall gain to current owners of assets subject to favorable tax treatment. These owners would receive a gain because the new tax law would reduce the supply of previously favored assets, thus raising before-tax profits.

Grandfathering probably should be limited to cases where gross returns are not likely to be altered significantly by the tax. For example, changes in the tax treatment of pensions are not likely to affect before-tax labor compensation significantly, assuming the supply of labor to the economy is relatively fixed. While grandfathering tax treatment of pensions in current employment contracts is not likely to raise significantly the value of those contracts relative to their value under the old law, an immediate shift to the new law would reduce the value of previously negotiated pension rights.

Phasing In. An alternative method of avoiding drastic changes in capital values is to introduce the new rules gradually. For example, taxation of interest on currently tax-exempt State and local bonds can be introduced slowly by including an additional 10 percent of interest in the tax base every year for 10 years. Phasing in the new rules would not alter the direction of capital value changes, but it would reduce their magnitude by delaying tax liability changes and making them occur more slowly.

Assuming that the market incentives under the new law are preferable to the incentives under the current law, phasing in poses a distinct disadvantage. Phasing in delays application of the new rules, thus reducing the present value of the economic changes that would be encouraged. The length of the phase-in period would depend on the desired balance of the gains from changing the tax system against the costs of imposing capital value changes on some investors.

Combination of Phase in and Grandfathering. A possible variant of the two approaches outlined above is to adopt the new rules immediately for new assets, while phasing in the new rules for existing assets. In many cases, grandfathering existing asests when new assets are taxed more heavily under the new tax law will raise the market price of the old assets. By phasing in the new rule for the old assets, it is possible to moderate the increase in present value of future tax liabilities, while at the same time the immediate effects on supply of new assets are raising before tax returns. The two effects may roughly cancel out, leaving asset prices almost the same throughout the early transition period. For example, a gradual introduction of new, and more appropriate, depreciation schedules for existing residential real estate 5/ with a concurrent adoption of the new rules for new buildings, would have the same incentive effects on new buildings as immediate adoption of the new law. Before-tax rentals on existing real estate would rise gradually, as supply growth is reduced, while tax liabilities on existing real estate also would rise. It is likely that, for an appropriate phase-in period, the asset value change to existing owners will be small. However, tax shelters on new construction will be totally eliminated immediately.

## 4. Proposed Solutions to Selected Problems in the Transition to an Accretion Tax

As described in Chapter 3, a change over to an accretion income tax system would have significant impact on the taxation of capital gains, corporate income, business and investment income, and personal income. The following discussion examines the problems that these changes present for transition. In most cases possible solutions to these problems are suggested.

### Capital Gains

Under an accretion income tax system, the deduction and alternative tax with respect to capital gains will be discontinued. The transition mechanism proposed is to allow capital gains (or losses) that have accrued as of the general effective date of the proposal to continue to qualify for capital gains treatment upon a sale or other taxable disposition for 10 years following such date. This "capital gain account" inherent in each capital asset could be determined in either of two ways:

(1) By actual valuation on the general effective date of enactment of the proposal (or on an elective alternative valuation date to avoid temporary distortions in market value), or

(2) By regarding the gain (or loss) recognized on a sale or exchange of the asset as having accrued ratably over the period the seller held the asset. The portion of the gain (or loss) thus regarded as having accrued prior to the effective date would be taxed at capital gain rates (or be subject to the limitation on capital losses) provided that the asset continues to meet the current requirements for such treatment. Recognition of capital gain (or loss) on the asset after the effective date will extinguish the capital gain (or loss) potential of the asset. Thus, gains on sale or exchange of an asset purchased after the effective date would not receive any special tax treatment.

A number of technical rules relating to transfers and subsequent adjustments to basis will have to be provided. In general, the account should carry over to the transferee in certain tax-free transfers that refelct a change in the transferor's form of ownership of, or interest in, the asset, such as contributions to a controlled corporation (under section 351) or partnership (section 721) or a complete liquidation of certain controlled subsidiaries (section 332). In the case of a transfer of an asset to a controlled corporation or partnership, it may be appropriate to allow the shareholder or partner to elect to transfer the capital gain account of the asset to his stock or partnership interest, and have the asset lose its capital gain character in the hands of the corporation or partnership. Also, in the case of a sale or exchange where the seller is allowed nonrecognition of gain on the transaction because he acquires an asset similar to the asset disposed of, the capital gain account should attach to the newly acquired asset. For example, if a taxpayer is to be allowed nonrecognition treatment on the sale of a personal residence, where another residence is acquired within a specified time, the capital gain account would attach to the new residence.

Rules also will be needed to take into account an increase or decrease in the basis of the property after the effective date. An increase in the basis of the property generally should not decrease the capital gain account, since the increase in basis generally will be accompanied by an increase in the fair market value of the asset (for example, where a shareholder contributes cash to a corporation); the increased fair market value due to the increase in basis will, when recognized, represent a return of the investment increasing the basis. On the other hand, a decrease in basis resulting from a deduction against ordinary income should reduce the capital gain account (i.e., code sections 1245, 1250, and other recapture provisions currently in the code that prevent the conversion of ordinary income into capital gain because of excess depreciation deductions or other means should continue to apply). The capital gain account should follow an allocation of the basis of the asset, such as is required with respect to a nontaxable stock dividend.

Special rules also would be needed for section 1231 property, since net gains from the sale of such assets qualify for capital gains treatment. 6/ A workable rule would be to apply section 1231 to assets that are section 1231 assets in the hands of the taxpayer on the general effective date, and continue to so qualify as of the date of sale or other taxable disposition. Such property would have a "section 1231 account" similar to the capital gain account attaching to each asset. Similar rules relating to transfers, basis adjustments, etc., also would apply.

Since a capital asset may be held for an indefinite period, a cutoff date for capital gains treatment is needed; otherwise, the complexity of the capital gains provisions in the code will continue for at least a generation. (Under the proposal, donors and decedents will be required to recognize gain or loss on the assets transferred, subject to certain exceptions, and thus the capital gain account will not carry over to a doneee or heir.) Accordingly, at the end of a specified period (say, 10 years), the capital gains deduction and the alternative tax treatment would expire. Admittedly, some of the problems described in section 2 of this chapter will exist if the complete repeal is delayed 10 years as would be present if the capital gain provisions were completely repealed when the proposal is enacted. The 10-year phase-out period, however, will allow gradual market adjustments and help protect the interests of investors who purchased assets in reliance on the current capital gains provisions.

An alternative to the capital gain account (and section 1231 account) procedure would be to phase out the deduction for capital gains (and the alternative tax) ratably over a specified number of years. For example, the 50 percent deduction for capital gains could be reduced five percentage points a year, so that at the end of 10 years the deduction would be eliminated. The simplicity of this alternative is the best argument for its adoption, since no valuation as of a particular date would be required.

Corporate Integration. Transition problems related to the foreign area are discussed in Section 11 of Chapter 3

Under an accretion income tax system, corporations will not be subject to tax. Instead shareholders will be taxable on their pro-rata share of corporate income or will be allowed to deduct their pro-rata share of corporate loss. (See the discussion in section 8 of Chapter 3.)

The most significant transitional problems involve the question of timing and the treatment of income, deductions, credits, and accumulated earnings and profits that are earned or accrued before the effective date of the change-over to integration, but that would be taken into account for tax purposes after such date.

Pre-effective Date Retained Earnings

Perhaps the most difficult transitional problem posed by corporate integration is the treatment of corporate earnings and profits that are undistributed as of the effective date of integration. Such earnings would have been taxed to the shareholders as dividends if distributed before the effective date, or taxed at capital gains rates if recognized by means of sale or exchange of the stock (provided the stock was a capital asset in the hands of the seller). Under corporate integration, distributions made by a corporation to its shareholders will be tax-free to the extent of the shareholder's basis; distributions in excess of the shareholder's basis in his stock will be taxable. However, corporate earnings and profits accumulated before the effective date but distributed afterward should not be accorded tax-free treatment: to do so would discriminate against corporations that distributed (rather than accumulated) their earnings and profits in pre-integration taxable years. (In the case of the shareholders who are content to leave the accumulated earnings and profits in corporate solution, however, the effect of corporate integration on the income generated by such earnings may give the same result as if such earnings had been distributed tax free, since such income will be taxed directly to the shareholders, without the interposition of corporate tax, and will then be available to the shareholders as a tax-free dividend.)

The problem of accumulated earnings can be addressed by continuing to apply current law to corporate distributions that are made within 10 years after the effective date of integration and that (1) are made to persons who held the shares on such effective date with respect to which the distribution is made, and (2) are made out of earnings and profits accumulated before such date. Thus, a distribution to such shareholders out of earnings and profits accumulated by the corporation before the first taxable year to which corporate integration applies would be a dividend, taxable as ordinary income, unless the distribution would qualify for different treatment under current law. For example, a distribution received pursuant to a redemption of stock that is not essentially equivalent to a dividend under current law would be treated as a distribution in part or full payment in exchange for the stock. On the other hand, an attempt to bail out the pre-effective date earnings and profits by means of a partial redemption of stock that would be treated as a dividend distribuiton under current law would continue to be so treated. The provisions of current law relating to electing small business (subchapter S) corporations would be helpful as a model in drafting this particular transition proposal. For purposes of determining how much of a distribution that is treated as a sale or exchange under current law would qualify for special capital gains treatment, the shareholder would have to take into account the transition rules with respect to repeal of the capital gains provisions.

In general, distributions with respect to stock acquired in a taxable transaction after the effective date would be subject to the new rules, and would reduce basis and not constitute income (unless such distributions exceeded the shareholder's basis). However, in those cases where the transferee acquired the stock after the effective date without recognition of gain by the transferor, current law will continue to apply to distributions from pre-effective date accumulated earnings and profits.

Distributions after the effective date would be deemed to be made first from the shareholder's distributable share of the corporation's post-effective date income and then from pre-effective date earnings and profits. Distributions in excess of these amounts would be applied against and reduce the shareholder's basis in his stock. Amounts in excess of the shareholder's basis generally would be considered income.

In order to avoid indefinite retention of such a dual system of taxation, the special treatment of pre-effective date earnings and profits would cease after a specified number of years following the effective date of integration. Distributions received after such date, regardless of source, first would be applied against basis and would be income to the shareholder to the extent they exceed basis.

Pre-integration accumulated earnings and profits remaining after this date may not escape taxation completely at the shareholder level, since such earnings may be reflected in the gain recognized on a subsequent taxable transfer of the stock, (such as a sale or a transfer by gift or at death), or may be taxed as a distribution in excess of basis. Before fixing the cut-off date for this provision an effort should be made to determine quantitatively the extent of the benefit to the shareholders of the deferral of such taxation.

An alternative proposal was considered in an attempt to preserve the ordinary income character of distributions from pre-effective date earnings. This proposal would treat a shareholder as receiving a "deemed dividend" (spread ratably over a 10-year or longer period) in an amount equal to the lesser of the excess of the fair market value of the share of stock as of the effective date over its adjusted basis, or the share's pro-rata portion of undistributed earnings and profits as of such date. This proposal was rejected because of its complexity and because of the likelihood of substantial liquidity problems for certain shareholders.

<u>Carryovers and Carrybacks</u>

The carryover or carryback of items of income, deduction, and credit between taxable years to which the corporate income tax applies, and taxable years to which it does not, must be considered for purposes of the transition rules. To the extent practicable, an attempt should be made to treat such items in a manner that reflects the impact of the corporate income tax as in effect when such items are earned or incurred. In following this approach, however, no attempt should be made to depart from the general rules requiring that an item of income or loss be recognized before it is taken into account in computing gross income. Accordingly, unrecognized appreciation or decline in value of corporate assets (or stock of the corporation) attributable to the pre-effective date period should not be "triggered" or recognized solely by reason of the shift to full integration.

In general, certain deductions and credits may carryback to a preceding taxable year or carryover to a subsequent taxable year because of a limitation on the amount of such deduction or credit that the taxpayer may claim for the taxable year in which the deduction is incurred or the credit earned. Thus, for example, a net operating loss carryback or carryover arises because the taxpayer's deductions exceed his gross income. Capital loss deductions are limited to capital gains, deductions for charitable contributions are limited to a certain percentage of income, and the investment tax credit is limited to a percentage of the tax due. Also, the recapture as ordinary income, after the effective date, of deductions allowed and other amounts of income upon which tax has previously been deferred in pre-effective date years, has the effect of shifting that income to post-effective date years.

If income sheltered by a deduction (or income that would have been sheltered had the deduction been utilized in an earlier year) had been distributed as a taxable dividend, the net after-tax effect on the shareholder of the deferral or acceleration of a deduction will vary, depending on his marginal tax bracket. In general, if the shareholder is in a lower bracket, he may realize more total after-tax income if the deduction is utilized at the corporate level in a pre-effective date year to which the corporate tax applies and the tax savings at the corporate level is distributed as a dividend; if the taxpayer is in a higher bracket he may realize more total after-tax income if the deduction is utilized in computing his distributable share of taxable income after integration. In order to best approximate the net result that would occur if such items could be used in the year incurred or earned, unused deductions and credits incurred or earned in pre-effective date years should be given an unlimited carryback to earlier years of the corporation. In order to avoid windfalls from receiving refunds earlier than under current law, interest could be charged on the refund.

Deductions that could not be absorbed in pre-effective date years would be allowed to be carried in full to post-effective date years, subject to current limits on the number of succeeding taxable years to which the item may be carried. In general, however, deductions carried over from a pre-effective date year should not flow through to the shareholders, either directly or indirectly, for use in offsetting the shareholder's income from other sources, but should be available only as deductions at the corporate level in order to determine the shareholder's pro-rata share of corporate income. This will avoid retroactive integration with respect to such deductions, since the deduction would not flow through when incurred, and will also avoid possible abuses by means of trafficking in loss corporations. Ordinary income upon which tax was deferred in pre-effective years should continue to be subject to recapture as ordinary income.

Generally, the carryover to a post-integration year of a tax credit earned in a pre-effective date taxable year will result in a windfall for the shareholder. If the credit had been used to offset corporate income tax in the year in which it was earned, the amount representing the tax at the corporate level offset by the credit would have been taxable to the shareholder, either when distributed as a dividend or when realized by means of sale of the stock. Accordingly, a rule should be devised by which the tax benefit of a credit carryover approxiamtes the benefit that would result if the amount of the credit first offset a hypothetical corporate tax and then was distributed to the shareholder as a taxable dividend (or, perhaps, realized as capital gain).

In general, no losses incurred or available credits earned in post-effective date years will carry back to pre-effective date years, since such items will flow through to the shareholders after the effective date of integration.

Under present law, certain taxpayers, such as regulated investment companies, real estate investment trusts, and personal holding companies, receive a dividends-paid deduction for a taxable year even though the distribution is actually made in a subsequent year. Such distributions in post-effective date years should be allowed to relate back to the extent provided by current law, for the purpose of determining the corporate tax liability for the appropriate pre-effective date year. The distribution would be considered to be out of pre-effective date earnings and profits (whether or not it exceeds the amount in such account) and taxable to the shareholders as a dividend from that source.

Rules will have to be provided to insure that, if an investment tax credit earned by a corporation in a pre-effective date taxable year is subject to recapture because of an early disposition of the property, the credit also is recaptured, either from the corporation or the shareholders. This could be accomplished at the corporate level by imposing an excise tax on the transfer or other recapture event in an amount equal to the appropriate income tax recapture.

Flow-Through of Corporate Capital Gains

During the phase-out period for capital gains, the net capital gain or net capital loss for taxable years after the effective date of corporate integration should be computed at the corporate level with respect to sales or exchanges of capital assets or section 1231 property by the corporation. The character of such net capital gain or net capital loss should be flowed through to the shareholders.

Flow-Through of Tax-Exempt Interest

If the character of capital gains is to flow through to shareholders, consistency would require that the character of any remaining tax-exempt interest received or accrued by a corporation after the effective date of corporate integration from any State or municipal bonds that are grandfathered should also flow through as tax-exempt interest to the shareholders. (Since corporate distributions will be tax-free, the tax-free character of the interest would be preserved by not reducing the shareholder's basis by the amount of the distribution attributable to such interest.) Generally, under present law, State and municipal bond interest is received tax-free by the corporation but is taxable as a dividend when distributed to shareholders. The 1976 Tax Reform Act, however, provides that, in certain cases, the character of tax-exempt interest distributed by a regulated investment company flows through as tax-exempt interest to its shareholders. 7/ In the event that it is determined that the tax-exempt character of State and municipal bond interest received by all corporations should not flow-through to shareholders (i.e., that distributions of such amounts should reduce basis), an exception should be made for regulated investment companies that have relied on the flow-through provisions of the 1976 Tax Reform Act.

Unique Corporate Taxpayers

The provisions of the tax code relating to taxation of insurance companies and other unique corporate taxpayers will have to be examined to determine what adjustments, if any, are required to take into account the effect of corporate integration on the special rules applying to such taxpayers.

The determination of appropriate transitional rules will depend on the nature of any changes made to the basic provisions.

Business and Investment Income, Both Individual and Corporate

In general, the repeal of code provisions that provide an incentive for certain business-related expenditures or investments in specific assets should be structured to minimize the losses to persons who made such expenditures or investments prior to the effective date of the new law. The principal technique to effectuate this policy would be to grandfather actions taken under current law. For example, any repeal of a tax credit (such as the investment tax credit) and any requirement that an expenditure that is currently deductible (such as soil and water conservation expenditures) must be capitalized should be prospective only. [8/] Subject to the rules prescribed above for corporations, unused tax credits earned in pre-effective date years should be available as a carryover to taxable years after the effective date to the extent allowed under current law. The repeal of special provisions allowing accelerated amortization or depreciation of certain assets generally should apply only with respect to expenditures made or assets placed in service after a specific cutoff date. The revision of the general depreciation and depletion rules should apply to property placed in service, or expenditure made, after an effective date. Thus, for example, buildings would continue to be depreciable in the manner prescribed by current law only in the hands of their current owners. A taxpayer who acquires a building and places it in service after the effective date would be subject to the new rules. Although this could result in capital losses for the current owners, the grandfathering of the asset itself could, particularly in the case of buildings, delay the effect of the new rules for an unacceptable period.

The deduction for local property taxes on personal residences should be phased out, by allowing deduction of a percentage of such taxes which declines over a period of years.

The exclusion from gross income of interest on State and municipal bonds and certain earnings on life insurance policies should continue to apply to such interest and earnings on bonds and insurance policies that are outstanding as of the effective date.

If the adoption of the accretion income tax system results in the repeal of certain provisions of current law that allow the non-recognition of gain (or loss) on sales or exchanges of particular assets, such repeal should be effective immediately, with no grandfather clause. It is unlikely that the original decision to invest in such assets depended on an opportunity to make a subsequent tax-free change in investment. An exception may be appropriate, however, with respect to a repeal of the provision that excludes from gross income the value of a building constructed by a lessee that becomes the property of the lessor upon a termination of the lease. A grandfather clause should apply current law to the termination of a lease entered into before the effective date.

The proposal will allow an adjustment to the basis of an asset to prevent the taxation of "gain" which is attributable to inflation, and does not reflect an increase in real value of the asset sold by the taxpayer. The inflation adjustment should be applied with respect to inflation occurring in taxable years after the effective date. Making such an adjustment retroactive would result in a substantial windfall for taxpayers.

Other Individual Income

Under an accretion income tax system, several kinds of compensation and other items previously excluded would be included in gross income, and deductions for a number of expenditures that can be considered personal in nature would be disallowed.

Employee Compensation

Such items as earnings on pension plan reserves allocable to the employee, certain health and life insurance premiums paid by the employer, certain disability benefits, unemployment benefits, and subsidized compensation would be included in gross income.

It may be presumed that existing employment contracts were negotiated on the basis that such items (other than unemployment compensation) would be excluded from the employee's gross income, particularly in those cases where the exclusion reflects a policy of encouraging that particular type of compensation. The inclusion of such items in income in the absence of special transitional rules could create cash flow problems or other hardships for employees under such contracts. For example, a worker who is required to include in income the amount of his employer's health insurance plan contribution may have to pay the tax on this amount from what was previously "take home" pay if he cannot renegotiate his contract.

This problem can best be solved by an effective date provision that would apply the new rules to compensation paid in taxable years beginning after the effective date of the basic tax reform program. However, the tax-free status of items paid pursuant to binding employment contracts in effect on the date of enactment would continue for the life of the contract or a specified period, such as three years, whichever is less. The length of this period should reflect the general length of industry-wide contracts. Special rules for military personnel could be devised to grandfather servicemen through their current enlistment or term of service. Earnings of a qualified pension plan allocable to the employee that are attributable to periods before the effective date would not be included in the gross income of the employee until such time as they would be included under present law (i.e., generally, upon distribution to the employee). Earnings attributable to periods after the effective date (as extended with respect to binding contracts) would be included in gross income when paid or accrued. As under present law, payments from the pension plan made to an employee after the effective date will be allocated between the employee's tax-paid basis in the plan, which will be returned to him tax-free, and amounts not previously taxed, which will be included in gross income.

Generally, unemployment compensation that will be included in gross income under the proposal will not represent a return of a tax-paid basis to the recipient, since the "premiums", or employer contributions, with respect to such compensation were not included in his gross income. Thus, it would not be inequitable to include the full amount of such compensation in gross income after the general effective date.

Nonbusiness Expenditures

Under an accretion income tax system, certain nonbusiness expenditures such as small casualty losses, medical and dental expenses, and political contributions will cease being deductible. Generally, the repeal of the deductibility of these expenses can be effective immediately. If the deduction for alimony is repealed pursuant to the enactment of an accretion tax, alimony payable under court decrees or agreements currently in effect could be grandfathered. If the medical expense deduction is to be replaced by a catastrophic insurance program, repeal of the deduction should coincide with the effective date of the program.

Other Items Previously Excluded

The inclusion in gross income of social security retirement benefits (OASI payments) presents significant transition problems, since such payments will represent to some extent a return of previous after-tax contributions by persons currently (or formerly) employed, and will also effectively reduce the anticipated retirement income of many persons. Persons currently receiving benefits (and possibly persons with only a specified number of years remaining before eligibility) should be grandfathered, *i.e.*, the receipt of their benefits should continue to be tax free. Such persons would very likely be unable to make alternative arrangements to supplement their retirement income in order to maintain their anticipated level of disposable income. For other persons who retire in the future, a statutory formula will have to be devised to allocate benefits between after-tax employee contributions, which would be returned tax free, and employer and post-effective date employee contributions, which portion would be taxable.

The inclusion in gross income of scholarships, fellowships and means tested cash and in-kind government grants, does not appear to present any transitional problems, since, generally, the amounts of these items were not bargained for by the recipient, and do not represent a return of a tax paid basis.

Treatment of Gifts and Transfers at Death as Recognition Events

Under the proposal, gifts and transfers at death will be treated as recognition events. Thus, in general, the excess of the fair market value of the asset transferred over its adjusted basis in the hands of the donor or decedent will be included in the gross income of the donor or decedent. There appear to be no transition problems if this rule is made to apply only to transfers after an effective date.

## 5. Transition to a Cash Flow Tax System

### Introduction

This section presents a proposal for transition from the current system to a cash flow expenditure tax of the type discussed in Chapter 4. The problems involved in a transition to a cash flow tax would be considerable, and all of the alternative methods considered have major shortcomings. Presentation of this proposal includes discussion of administrative difficulties and some possible distributive inequities, and an explanation of why certain alternative plans were rejected.

In summary, the proposed transition scheme would maintain both an income tax and a cash flow tax for 10 years before total conversion to the cash flow tax. During the transition period, individuals would compute their tax liability under both systems and would be required to pay the higher of the two taxes. The corporat e income tax would be retained for the interim and would be discontinued immediately after the effective date. Unrealized capital gains earned prior to full adoption of the cash flow tax would be "flushed" out of the system through a recognition date at the end of the 10-year period when they would be taxed at the current capital gains rates. Payment of taxes on past capital gains could be deferred with a low interest charge to prevent forced liquidation of small business.

The transition program outlined here would not fully realize the goals of transition presented below. It would, however, mitigate the redistribution of wealth that would result from immediate adoption of a cash flow tax and would simplify the tax system by eliminating, within a reasonable period of time, the need to keep the personal and business income tax records currently required.

## Goals of Transition

The main objectives of a program of transition to a cash flow tax are: (1) prevention of immediate or long-term redistribution of economic welfare and (2) simplicity and administrative ease. Although some changes in consumption opportunities would be inevitable in a tax change as major as the one proposed, the proper transition program should be able to minimize large redistributions among taxpayers in ability to consume immediately and in the future. In particular, this program should prevent heavy additional tax liabilities (in present value terms) for any clearly identifiable group of taxpayers. For purposes of simplicity, transition rules should eliminate the present income tax system and its recordkeeping requirements as soon as possible and, if possible, avoid measuring current accumulated wealth and and annual changes in individuals' total wealth positions in the transition period, as well as afterwards.

Under a fully operative cash flow tax system, the principal records for tax purposes consist only of cash flow transactions for business activities, net deposit and withdrawal in each qualified account plus the usual wage and salary data.

## Distribution Issues

Two distribution issues are important in a transition to the cash flow tax: (1) treatment of untaxed income before the effective date, and (2) changes in the distribution of after-tax consumption.

Equitable treatment of income untaxed before the effective date would require that an individual who had unrealized capital gains at the time of the adoption of the new system be treated in the same way as the individual who realized the capital gain before the effective date. The practical problems involved in realizing this goal influence the specifics of the transition proposal discussed below.

The treatment of past accumulated income that has been taxed poses a more difficult problem of equity. Because a cash flow tax is equivalent to exempting income from capital from tax, a higher tax rate on income from labor would be required under a cash flow tax system in order to maintain the same tax revenue. Thus, the short-term effect of a cash flow tax would be a higher after-tax rate of return from ownership of monetary or physical assets and a lower after-tax wage rate. The exact distributive consequences of this change would depend upon how past accumulated wealth is allowed to enter the system.

There are two alternative ways, both consistent with the logic of a cash flow tax, to allow past accumulated wealth to enter the system. The most generous to owners of capital is to define existing wealth as tax prepaid assets under the new system. All future returns from such assets, as well as return of principal, would not be reported as income or subject to tax. The second way is to define existing wealth as current, untaxed income. In this case, the return of principal would be taxed, but the present value of tax liability would not increase as assets earn accrued interest. The tax liability, although increasing in nominal value with future earnings, would be deferred until the gains were realized.

Table 6-1 illustrates the tax treatment, under an income tax and under the two alternative methods of transition to a cash flow tax, of consumption out of $100 of past accumulated assets for different times at which wealth is withdrawn for consumption. Time 1 represents potential consumption in the first year after the effective date. Time 2 represents potential consumption at a time in the future when the asset has doubled in value if untaxed. Time 3 represents potential consumption at a time in the future when the asset has quadrupled in value if untaxed. A tax rate of 50 percent is assumed.

Table 6-1

Potential Consumption Out of Accumulated Wealth Under Different Tax Rules

Initial Wealth = $100
Assets Double in Value Between Each Pair of Time Periods if Untaxed

| | Income Tax | Cash Flow Tax; Asset Prepaid | Cash Flow Tax; Asset in Initial Income |
|---|---|---|---|
| Time 1 | $100 | $100 | $50 |
| Time 2 | $150 | $200 | $100 |
| Time 3 | $200 | $400 | $200 |

Under an income tax, the asset could be withdrawn and consumed tax free, but future accumulation would be taxed.[9/] Under the cash flow tax, with the asset defined as tax prepaid, the asset would be allowed to accumulate tax free and could also be withdrawn and consumed tax free. Under the cash flow tax, with the asset value initially included in the tax base, consumption from the asset would be taxed upon withdrawal, but the rate of accumulation of the asset would not be affected by the tax.

A transition to a cash flow tax with assets initially defined as prepaid would increase the welfare of owners of capital assets. The after-tax consumption of these taxpayers would increase under the new system unless they consumed all of their wealth within the first year after the effective date, in which case consumption would be unchanged. If assets were initially included in the tax base, however, the after-tax consumption of owners of capital assets would decrease if they chose to consume a large portion of their wealth in the early years after the effective date. Inclusion of assets in the base would increase after-tax consumption relative to an income tax for owners of capital assets who deferred consumption out of accumulated wealth for a long period. [10/]

As Table 6-1 illustrates, initial definition of assets as prepaid or included in the base would make a big difference in tax liability.

Inclusion of accumulated assets in the tax base seems very unfair to older persons who are about to consume out of accumulated wealth during the retirement period. On the other hand, prepaid designation would greatly benefit all owners of monetary and physical assets by redistributing after-tax dollars from labor to capital. Although returns from capital would be nontaxable under a fully operational cash flow tax, past accumulation of capital occurred under a different tax system, where individuals did not anticipate a sharp rise in the after-tax return to capital. Thus, tax prepaid treatment of capital assets may be viewed as inequitable.

The distribution problem caused by defining existing captital assets as prepaid would be reduced over time. The incentive to savings under a cash flow tax should raise the rate of capital formation, increasing the amount of investment and eventually lowering before-tax returns to capital and raising before-tax wages. However, in the first few years after transition, higher tax rates on labor income would not be matched by a corresponding increase in before-tax wages.

For certain types of capital assets, the appropriate rule for transition definition is clear. Investments in owner-occupied houses and other consumer durables are treated very similarly to prepaid investments under the current system, and they should be defined as prepaid assets for purposes of transition to a cash flow tax. The accrued value of employer funded pension plans should be treated in the same manner as qualified accounts becuase the contributions were exempt from tax under the old system and the receipts were fully taxable.

Designation of past accumulated assets as prepaid assets would be the easier transition to administer. There would be no need to measure existing wealth, and the only change to the present system would be to eliminate capital income from the tax base. Prepaid assets could be freely converted to qualified assets to enable the individual to average his tax base over time. An individual converting a prepaid to a qualified asset would be able to take an immediate tax deduction, but would become liable for taxes upon withdrawal of principal and subsequent earnings from the qualified account.[11/] If assets were initially defined to be part of an individual's tax base, it would be necessary to value them on the effective date. Individuals would have an incentive to understate their initial asset positions. Assets not initailly accounted for could be deposited in qualified accounts in subsequent years, enabling an individual to take a deduction against other income.

A Preliminary Transition Proposal

All assets would be defined initially as prepaid assets. For a period of 10 years, the existing income tax would be maintained, and individuals would file returns for both systems and would pay the higher of the two computed taxes. [12/] For most taxpayers, the cash flow tax would be higher. However, for persons with large amounts of capital income relative to labor income, the income tax would be higher.

The corporate profits tax would be retained throughout the transition period. Theoretically, stockholders paying the cash flow tax should receive their corporate earnings gross of corporate tax during the interim period. However, without full corporate integration, whereby all earnings would be attributed to individual stockholders, it would be practically impossible to determine what part of a corporation's earnings should be attributed to individuals paying the consumption tax and what part, to individuals paying the income tax. It is likely that ownership of corporate shares would be concentrated among individuals who would be subject to the income tax during the interim period. For reasons of simplicity, therefore, the corporate tax would be retained for the transition period and would be eliminated immediately afterward.

All sales of corporate stock purchased before the beginning of the transition period, by individuals paying under either tax base, would be subject to a capital gains tax at the existing favorable rates. The reason for this provision is that capital gains earned but not realized before the interim period should be taxed as if they were income realized at the effective date. 13/

A recognition date would be required at the end of the transition period to account for all remaining untaxed capital gains. Under a fully operational cash flow tax system, under which assets would be defined as prepaid and no records of current and past corporate earnings and profits would be kept, it would be impossible to distinguish between distributions that were dividends out of current income and distributions that were return of accumulated capital. The dividends would not be subject to tax under the new law. Distributing past earnings would be a way of returning to the individual his accumulated capital gains tax free. In order to eliminate the need for corporate records for income tax purposes on the final day of the transition period, it would be necessary to have a single day of recognition for past gains.

It would be possible to develop a method of final capital gains tax assessed on the recognition date be paid over a long period at a low interest rate, to avoid forced liquidation of small firms with few owners.

The advantage of the transition proposal outlined here are the following: 1. It would enable all of the simplifying features of cash flow tax to be in full operation after 10 years, including elimination of required income tax records.

2. It would allow consumption out of past accumulated earnings to be exactly the same as it would have been under the income tax during the first years after the effective date. 3. It would provide for appropriate and consistent taxation of income earned before the effective date. 4. By gradual elimination of taxes on income earned from past accumulated capital, this proposal would mitigate the redistribution of wealth to current asset owners that would occur after immediate full adoption of a cash flow tax. The major disadvantages of this transition program are that it would require a recognition date that would impose a large one-time administrative cost on the system, and it would require some taxpayers to fill out two sets of tax forms for a period of 10 years, a temporary departure from the long-term goal of low administrative costs.

Alternative Transition Plans

One alternative plan would be to adopt the new tax system immediately, designating all assets as prepaid, without a recognition date to "flush out" past capital gains. Although this plan would be the simplest one, it would give too great an economic advantage to individuals with unrealized capital gains and would cause too large a transfer of future after-tax consumption to present asset owners.

Another transition plan would be to adopt the cash flow tax immediately and designate all assets as current income. This would require valuing all wealth on the effective date and imposition of an effective one-time wealth tax. Such an approach would be harsh on older persons planning to live off accumulated capital in the early years after the effective date.

A second, more complicated option would allow prepaid treatment of assets but, in exchange for the elimination of taxes on future capital income, would impose an initial wealth tax related to an individual's personal circumstances. For example, the initial tax could be based on age and wealth, with higher rates for persons with more wealth and lower rates for older people. 14/ Although it might provide a transition program that approximates distributive neutrality, such a plan would be even greater departure from the goal of simplicity.

A third option would allow three types of assets: prepaid, as defined above, qualified, as defined above, and a Type 3, which would treat assets as defined under the current system. In principle, we would like people to be able to consume out of Type 3 assets tax free and to invest in prepaid and qualified assets only out of savings from current income. In effect, this plan would initiate cash flow taxation on current earnings only and would treat pre-effective date earnings exactly as they are treated under the current system, including the same treatment of post-effective date capital accumulation from pre-effective date wealth. This plan would be extremely difficult to administer. Not only would individuals have to keep books for three types of assets, but also total annual wealth changes would have to be measured (valuation of unsold assets would not be a problem because even if too high a value were imputed, raising both measured wealth and saving, consumption would remain unchanged) in order to arrive at a measure of annual consumption. Treatment of corporate income under this system would also be complicated, because some investments in corporate stock would come from all three types of assets.

Under this transition alternative, Type 3 assets would be subject to a transfer tax and converted to prepaid assets at death. Eventually, Type 3 assets would disappear from the system, and the complete cash flow tax would be in operation. Alternatively, all Type 3 assets could be designated prepaid after a fixed number of years.

Although the three asset plan has the advantage of treating owners of capital exactly as they would have been treated under the income tax and changing the rules only for new capital, [15] its administrative complexity is so great as to discourage serious consideration.

## Footnotes

1/ The exact change in the rate of tax on capital income earned in corporations by different individuals will depend on the fraction of corporate income currently paid out in dividends, the current average holding period of assets before realizing capital gains, and the individual's tax brackets. While the current corporate income tax does not distinguish between owners in different tax brackets, integration, which attributes all corporate earnings to the individual owners would tax <u>all</u> earnings from corporate capital at each individual owner's marginal tax rate.

2/ The taxpayer can, in fact, avoid this problem by selling his shares before the effective date at the current lower capital gains rate and then buying them back. However, one other objective of transition rules, discussed in the next section, should be to avoid encouraging market transactions just prior to the effective date.

3/ For example, workers damaged by employment reductions in industries with increasing imports due to trade liberalization are eligible for trade adjustment assistance.

4/ Note that is is not clear just what is meant by an "existing asset" in this context; a building is greatly affected by, e.g., maintenance and improvement expenditures over time.

5/ The appropriate rule may be to allow no depreciation at all.

6/ Section 1231 property is generally certain property used in the taxpayer's trade or business. If gains exceed losses for a taxable year, the net gains from section 1231 property are taxed at capital gains rates; if losses from section 1231 property exceed gains, the net losses are treated as ordinary losses.

7/ In the case of a subchapter S corporation, the character of net capital gains flow through to the shareholder. The character of tax-exempt interest does not.

8/ Expenditures made pursuant to binding contracts entered into before the effective date should also be grandfathered.

9/ The income tax computation assumes a full accretion tax, under which all returns to capital are taxed as accrued at full rates. Thus, the rate of accumulation under the income tax would be cut in half. Under the present law, taxation of capital gains is deferred until realization and then taxed at only one-half the regular rate. For example, if the asset is realized at time 3, after-tax income would be $325. It should be noted, however, that if the asset is corporate stock, profits are taxed at a rate of 48 percent every year. If the corporation is not reducing its tax base substantially through accelerated depreciation or the investment tax credit, then, combining the corporate and personal taxes, the capital income of the corporate shareholder may be taxed under current law at an even higher rate than the rate on ordinary income.

10/ For example, if the before-tax interest rate were 10 percent, wealth would quadruple in 15 years. With the 50 percent tax rate used in Table 1, wealth holders would be better off under the consumption tax, even if their assets were initially defined as income, if they deferred consumption out of wealth for at least 15 years.

11/ A wealthy person could appear to "shelter" his current labor income by converting prepaid assets into qualified assets, deducting the deposits in qualified assets from current labor income. However, this practice would not reduce the present value of his tax base, because he would have to pay a tax on the principal and accumulated interest whenever the qualified asset is liquidated for consumption.

12/ It is possible that only wealthy people should be required to fill out an income tax return. The main reason for retaining the income tax would be to tax accumulated past capital for an interim period of time, to mitigate the inequitable distribution effects of a transiotn to prepaid treatments of assets. It is likely that only people with significant amounts of past accumulated capital would have a higher liability under the income tax. The requirement to file an income tax return might be limited to taxpayers reporting an adjusted gross income above a certain minimum level (for example, $20,000 or more) in any of several years before the effective date.

13/ Technically speaking, individuals paying the cash flow tax during the interim period should not have to pay capital gains tax between the first day of the interim period and the time an asset is sold. One way to avoid this would be to adjust the basis upwards to conform to interest that would have been earned on a typical investment after the beginning of the interim period. By doing this, the present value of capital gains tax paid, for assets growing at that interest rate, would be the same as if the gain were realized on the effective date.

14/ Because the wealth of older persons would be subject to the accessions tax sooner, it would not be necessary for equity to tax it on the effective date.

15/ The three asset plan can be viewed as a sophisticated form of "gradfathering."