Chapter 6

TRANSITION CONSIDERATIONS

INTRODUCTION

Major changes in the tax code such as would accompany a switch to either the comprehensive income tax or the cash flow tax 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 suggests possible solutions to problems arising from transition to both the comprehensive income tax and the cash flow tax. It outlines the major wealth changes that can be expected under a switch to either of the two model taxes, and discusses the relevant equity criteria to be applied in the design of transition rules. Instruments for ameliorating 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. Transition rules to be applied to specific changes in the tax law included in the model comprehensive income tax in chapter 3 are considered. Special problems of transition to a cash flow tax are discussed also, and a plan is suggested for transition to the cash flow proposal described in chapter 4.

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 altered 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 accrues. For example, increases in net worth in the form of capital gains are not taxed before 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 would be especially severe if the current tax system were changed to a consumption base. Under a consumption base, purchases of assets would be deductible from tax and sales of assets not reinvested would be fully taxable. Under the current tax system, both the income used to purchase 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 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 assets were allowed to treat those assets as tax-prepaid, they would receive a gain to the extent they planned 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-pretaxed.

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 different from changes in the price of assets. In the case of capital gains tax, for example, the change in an individual's tax liability for gains that have arisen by reason of a past increase in asset values 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 assets.

In most cases, carryover problems could be handled by special rules that define the amount of income attributable to increases in asset values not realized before the effective date of implementation of the new law. Changes in the definition of an individual's past income would alter asset prices only if they provided an incentive for pre-effective date sales of existing assets. For example, if, under the new system, past capital gains were taxed at a higher rate than under the old system, an incentive might 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 the comprehensive income tax, 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 asset basis for inflation (or deflation); 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 alter both the average rate of taxation 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 would be different for changes in the average level of taxation of the associated returns and changes in the relative rates of taxation on different assets. A change in the average rate of taxation on all income from investment, while it would affect the future net return from wealth or accumulated past earnings, would not be likely in itself to change individual asset prices significantly. For any single asset, an increase 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), would not tend to change. On the other hand, an increase in the relative rate of taxation on any single asset generally would lead to a fall in the price of that asset, because net after-tax earnings would 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 return 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 cost 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 taxation on profits from real estate is increased. The increase in tax will drive down the after-tax rents received by owners. Because 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. However, for the interim before supply changes restore equilibrium, after-tax returns would be lowered by the price change.

Thus, the immediate effect of the change in the rate of taxation would be 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 would depend both on the time required for adjustment to final equilibrium and the extent to which future increases in the gross rentals (from the decline in housing supply) were anticipated in the marketplace. 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 would alter its price by lowering the present value of the future return flow. For example, if interest from municipal bonds became subject to tax, the net after-tax earnings of holders of municipal bonds would fall, lowering the value of those claims. New purchasers of municipal bonds would 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 would be greater for bonds with a longer time to maturity.

The effect of corporate integration on the price of assets is less certain. If the corporate income tax is viewed as a tax on the earnings of corporate equity shareholders, integration would increase the rate of taxation on income from investment of high-bracket shareholders and lower the rate of taxation 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 were altered by integration, those assets could 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 rate of taxation on capital income in industries and for types of claims currently receiving relatively favorable tax treatment would likely cause some changes in asset prices. Immediate asset price changes generally would 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 the supply of which can only be altered slowly (e.g., buildings and some mineral investments) than for those the supply of which can be changed quickly.

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

The Equity Issues

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 would create potential inequities to the extent that individuals who made commitments in response to provisions of the existing law suffer unanticipated losses (or receive unanticipated 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 attributable to an earlier period, when 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 comprehensive income tax. At present, capital gains are subject to lower tax rates than dividends, especially when realization is deferred for a long period 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 types of investment 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 have to assume. To subject shareholders of low-dividend corporations to the same rate of taxation as they would have paid if income accumulated in the form of capital gains before the effective date had 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 the integration proposal presented in chapter 3, 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 the appreciation of his shares that occurred before the effective date. 2/ The taxpayer would, in effect, be taxed too heavily on that income, because 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 on the gains attributable to that income; after integration, he would be liable for the tax on ordinary income at the full rate. Thus, in the absence of transition rules, he would be subject to a higher tax on income in the form of capital gains accrued before, but not recognized until after, the effective date of the new law than on income earned in a similar way under a consistent application of either present law or the comprehensive income tax.

The most desirable solution to the problem of equity posed 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 accrued before the effective date are computed according to the old law and tax liabilities on income accrued 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 complete change in the tax system, if unexpected, would cause losses in asset value to investors in previously tax-favored sectors. Imposition of such losses may be viewed as unfair, especially since past government policy explicitly encouraged investment in those assets.

For example, as between individuals in a given tax bracket one of whom held State and local bonds producing a lower interest rate because such interest was tax-exempt and the other of whom held taxable Treasury bonds producing higher interest but the same after-tax return, it seems reasonable to compensate the holder of the State and local bonds for the loss suffered upon removal of the tax exemption 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 <u>higher</u> 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 justice requires compensation for such wealth changes 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 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 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 losses upon end of the subsidy is unwarranted.

The discussion above suggests that a case can be made both for and against compensation of individuals for losses in asset values caused by radical changes in tax policy. Because the asset 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 unanticipated losses and gains resulting from adoption of a comprehensive tax base would be moderated. Two possible design features, grandfathering existing assets and phasing in the new rules slowly, are discussed next.

INSTRUMENTS FOR AMELIORATING TRANSITION PROBLEMS

Objectives

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 either to buy or to 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 assetholders from loss 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 disenfranchising 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 taxation on income from real estate investments. A grandfather clause that exempts existing buildings only so 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 so. 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 mitigated by the anticipated increase in after-tax profits to current investors (because of the decline in housing supply).

The effect of grandfathering on asset prices for fixed-interest securities is less certain. For example, if existing municipal bonds were grandfathered, annual interest received net of tax would be unchanged. However, the value of the tax saving from owning municipal bonds would change for two reasons. First, there would be no new tax-exempt municipal bond issues under the new rules; with fewer available tax-exempt bonds, the price of tax-exempt securities will rise, as will the marginal tax bracket at which such securities offer a net advantage. Second, the other changes in the tax system which would enable marginal tax rates in the highest brackets to fall, would reduce the gain from tax exemptions, driving down the demand for, and the price of tax-exempt securities. As demand and supply will both fall, it is not clear in what direction the price of the grandfathered securities would change, though the price change would be smaller than if the new rules were adopted immediately for all tax-exempt securities.

One problem of grandfathering is that it can provide an unanticipated 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 change in taxation. For example, changes in the tax treatment of pensions would not be 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 would not be 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 asset values is to introduce the new rules gradually. For example, taxation of interest on currently tax-exempt State and local bonds could 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 asset value changes, but it would reduce their magnitude by delaying tax liability changes.

Assuming that the market incentives under the new law are preferable to the incentives under the current law, phasing in poses distinct disadvantages. Phasing in would delay application of the new rules, thus reducing the present value of the economic changes that would be encouraged and which are an important objective of the new rules. Phasing in also may introduce substantial complexity. The length of the phase-in period would depend on the desired balance of the gains in efficiency and simplicity from changing the tax system against the distributive inequities resulting from imposition of asset value changes on some investors.

Combination of Phasing In and Grandfathering. A possible variant on 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 assets when new assets would be taxed more heavily under the new tax law would raise the market price of the old assets. By phasing in the new rules for the old assets, it would be possible to moderate the increase in present value of future tax liabilities, while at the same time reduced supply of new assets would raise before-tax returns on both new and existing assets. 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 building 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 would be small. However, tax shelters on new construction would be totally eliminated immediately.

PROPOSED SOLUTIONS TO SELECTED PROBLEMS IN THE TRANSITION TO THE COMPREHENSIVE INCOME TAX

Adoption of the comprehensive income tax 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 the comprehensive income tax, no distinction will be made between capital gains and ordinary income, and losses will be fully deductible against income from other sources. 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 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 continued to meet the current requirements for such treatment. Recognition of capital gain (or loss) on the asset after the effective date would 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.

Both of these systems have been employed in the Tax Reform Act of 1976 in connection with the so-called carry-over basis provisions at death -- the former for securities traded on established markets, and the latter for all other assets.

A number of technical rules relating to transfers and subsequent adjustments to basis would have to be provided. In general, the account should carry over to the transferee in certain tax-free transfers that reflect 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 would 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 would, 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). In general, if the taxpayer's basis in an asset is required to be allocated among several assets (such as is required with respect to a nontaxable stock dividend) the capital gain account should be allocated in a similar manner.

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 qualify as 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 an 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 would continue for at least a generation. (Under the proposal, donors and decedents would be required to recognize gain or loss on the assets transferred, subject to certain exceptions and, thus, the capital gain account would not carry over to a donee 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 equity problems resulting from immediate repeal of the capital gains provisions would remain even if complete repeal were delayed 10 years. The 10-year phase-out period, however, would 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

Under the comprehensive income tax, corporations would not be subject to tax. Instead, shareholders would be taxable on their prorata share of corporate income, or would be allowed to deduct their prorata share of corporate loss. (See the discussion in 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. Other transition problems related to the foreign area are discussed in chapter 3.

Pre-effective Date Retained Earnings. Perhaps the most difficult transition 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. Under corporate integration, distributions made by a corporation to its shareholders would be tax-free to the extent of the shareholder's basis; distributions in excess of the shareholder's basis in his stock would 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 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 accumulated earnings may give the same result as if such earnings had been distributed tax-free, since such income would be taxed directly to the shareholders, without the interposition of corporate tax, and would 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 continue to 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 distribution 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 transition rules outlined above for changes in taxation of capital gains would apply.

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 would 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 (similar to the subchapter S rules). 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. As previously indicated, pre-integration accumulated earnings and profits remaining after this date will not escape taxation completely at the shareholder level, since such earnings will 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 cutoff 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 prorata 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 were 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 because of the shift to full integration.

In general, certain deductions and credits may carry back to a preceding taxable year or carry over 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 would depend 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 in a pre-effective date year in which the corporate tax applies and in which the tax savings at the corporate level are 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. 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 many cases this would benefit the taxpayer because he would receive a tax refund from such carryback earlier than he would under current law. Such benefits could be avoided to a large extent by charging the taxpayer an appropriate amount of interest for advancement of 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 the limits established 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 <u>prorata</u> share of corporate income. This would avoid retroactive integration with respect to such deductions, since the deduction would not flow through when incurred; it also would 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 would 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 approximates 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 would carry back to pre-effective date years, since such items would 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 flow 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 also should flow through as tax-exempt interest to the shareholders. The tax-free character of the interest to shareholders would be preserved by increasing reducing the shareholder's basis by the amount of the interest attributable to him, but not including such interest in taxable income. Distribution would be treated as under the new law -- as a reduction of basis, but not included in income. Thus, such interest, if distributed, would leave both taxable income and basis unchanged.

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 flow through as tax-exempt interest to its shareholders. 7/ If it is determined that the tax-exempt character of State and municipal bond interest received by all corporations should not flow through to shareholders, 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 transition rules will depend on the nature of any changes made to the basic provisions.

Business and Investment Income, 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 developed 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 revised general depreciation and depletion rules should apply to property placed in service or expenditures 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 losses in asset value for the current owners, grandfathering 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 declining percentage of such taxes.

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.

When adoption of the comprehensive income tax results in ending those provisions of current law that allow the nonrecognition of gain (or loss) on sales or exchanges of particular assets, such changes 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 would allow an adjustment to the basis of an asset to prevent the taxation of "gain" that is attributable to inflation and that 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 unanticipated gain for many asset holders.

Other Individual Income

Under the comprehensive income tax, 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.

<u>Employee Compensation</u>. 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. In the absence of special transition rules, the inclusion of such items in income 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 a period of time to allow employers and employees to adjust to the new rules. Thus, the tax-free status of items paid by employers on the date of enactment would continue for a specified period, such as 3 years. Alternatively, the inclusion of these items of income could be phased in over such a period, including one-third after 1 year, two-thirds after 2 years, and the full amount after the third year. 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 this delayed effective date would not be included in the gross income of the employee. However, earnings attributable to periods after that date (as extended with respect to binding contracts) would be included in gross income as accrued.

Generally, unemployment compensation, which would be included in taxable income under the proposal, would 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, the full amount of such compensation should be included in taxable income immediately after the general effective date.

Medical and Casualty Loss Deductions. Under the comprehensive income tax, certain nonbusiness expenditures, such as casualty losses, and medical and dental expenses, would cease being deductible. Generally, the repeal of the deductibility of these expenses could be effective immediately. If the medical expense deduction is replaced by a catastrophic insurance program, or some other program to achieve the same ends, repeal of the deduction should coincide with the effective date of the substitute program.

Charitable Deductions. This provision should be phased in if the deductibility of charitable contributions is eliminated under the model comprehensive income tax. To the extent that direct public subsidies to the affected institutions do not replace the loss in private gifts from removal of the tax incentive for contributions, both employment in and services to beneficiaries of such institutions would decline greatly. A gradual phase-in would increase the extent to which employment losses occur through gradual attrition rather than layoffs and would aid in identifying the types of charitable recipients who might require greater direct public assistance when the deduction is completely ended. One possible method of phase-in would be to allow a declining fraction of contribution to be deductible in the first few years of the effective date.

Other Items Previously Excluded. The inclusion in gross income of scholarships, fellowships, and means-tested cash and in-kind government grants would not appear to present any transition problems because, 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 Retirement Benefits. Under the comprehensive income tax, retirement benefits, including social security benefits and private pensions, will be included in the tax base, while contributions to private pension funds and to social security by both employees and employers will be exempted from any concurrent tax liability. A significant transition problem arises from this feature of the comprehensive income tax. In the absence of special transition rules, currently retired persons would be required to pay tax on the return of private pension contributions that had already been taxed. While the link between contributions and benefits is not so direct for social security, it still would be unfair to include social security benefits in the taxable income of persons who have been retired as of the effective date, again, because these taxpayers have paid tax on the part of income represented by employee social security contributions throughout their working years. Thus, persons retired as of the effective date should not have to pay tax on private retirement benefits which represent a return of contribution or on social security benefits. On the other hand, benefits paid by qualified pension plans that allowed deductibility of post contributions, should remain fully taxable, as under present law.

More complex provisions are required for retirement income of taxpayers who are in the middle of their working years as of the effective date. Such taxpayers will have been taxed on the employee portion of retirement contributions up to the effective date, but not afterwards. Thus, it seems fair that they should pay tax on a fraction of the retirement benefits which represent return of contribution, the fraction bearing some relation to the portion of the contributions that were excluded from taxable income. The general rule proposed is to include in the tax base a fraction of retirement income that represents return of contribution to an employee-funded pension plan. The fraction would depend on age at the effective date, ranging from 0 for taxpayers age 60 or over to 1 for taxpayers age 20 or under. A table could be provided in the tax form relating date of birth to the fraction of such income that is taxable. A similar treatment is proposed for social security benefits.

<u>Treatment of Gifts and Transfers at Death as Recognition Events</u>. Under the proposal, gifts and transfers at death would 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 would be included in the gross income of the donor or decedent.

The portion of such gains attributable to the period before the effective date of any such recognition rule should be exempted. Provisions for such an exemption were made in the Tax Reform Act of 1976 in connection with the carryover basis at death rule. The gains deemed to have accrued after the effective date would be taxable on transfer at the same rates applying to other sources of income.

TRANSITION TO A CASH FLOW TAX SYSTEM

This section presents a proposal for transition from the current system to the model cash flow tax proposed in chapter 4. The problems involved in a transition to the 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 plan would maintain the present tax alongside the 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 corporate income tax would be retained for the interim and would be discontinued immediately at the end of the 10-year period. At that time, 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 which point they would be taxed at the current capital gains rates. Payment of taxes on past capital gains could be deferred, at a low interest charge, to prevent forced liquidation of small businesses.

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 to be realized by the transition rules for the 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 tax system and its recordkeeping requirements promptly and, to the extent possible, avoid measuring current accumulated wealth and any annual changes in individuals' total wealth positions in the transition period, as well as afterward. After transition, the principal records for tax purposes would consist only of cash flow transactions for business activities, net deposits and withdrawals in qualified accounts, the usual wage and salary data, and transfer payments.

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 adoption of the new system be treated in the same way as the individual who realized the capital gains before the effective date. The practical problems involved in achieving 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 the cash flow tax is, in an important sense, equivalent to exempting income from capital from tax, as outlined in chapter 4, a higher tax rate on current wages not saved would be required 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 regarded as tax prepaid and a lower after-tax wage rate. The distributive consequences of this change could be modified if some or all of accumulated wealth were to be treated as if already held in qualified accounts; i.e., subject to tax upon withdrawal for consumption.

If existing wealth were to be regarded as tax-prepaid under the new system, all future returns from such assets, as well as return of principal, would not be subject to tax. On the other hand, if existing wealth were to be regarded as receipts in the first year of the cash flow tax, an equally logical approach, consumption of principal would be taxed, though the present value of tax liability would not increase as assets earned accrued interest, as it would under an income tax.

Table 1 illustrates the tax treatment, under a comprehensive income tax and under the two alternative methods of transition to the cash flow tax, of consumption out of $100 of past accumulated assets for different times at which wealth is withdrawn for consumption. A tax rate of 50 percent is assumed, assessed on annual interest earnings in the case of an income tax.

Table 1

Potential Consumption Out of Accumulated
Wealth Under Different Tax Rules

Initial Wealth = $100
Assets Accumulate at 10 Percent Per Year If Untaxed;
5 Percent Per Year If Taxed

Years After Effective Date	Income Tax	Cash Flow Tax; Asset Tax-Prepaid	Cash Flow Tax; Asset in Initial Receipts
0	$100	$100	$ 50
10	$163	$259	$130
20	$265	$673	$336

Under a comprehensive 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, returns from 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 tax prepaid would increase the welfare of owners of 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 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 asset-holders who deferred consumption out of accumulated wealth for a long period. 10/

As Table 1 illustrates, how past wealth is viewed would make a big difference in the present value of tax liabilities.

Inclusion of accumulated assets in the tax base would be unfair to older persons who are about to consume out of accumulated wealth during the retirement period, if the income from which this wealth was accumulated had been subject to tax during their working years. On the other hand, tax-prepaid designation would greatly benefit all owners of monetary and physical assets by redistributing after-tax dollars from labor to capital. Although returns from assets would in effect be nontaxable under a fully operational cash flow tax, past accumulation of wealth would have 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 for transition purposes may be viewed as inequitable.

The distribution problem caused by defining existing capital assets as prepaid would be reduced over time. The increased incentive to savings provided by the 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 current wages would not be matched by a corresponding increase in before-tax wages.

For certain types of assets, the appropriate rule for transition definition is clear. Under the present system, investments in owner-occupied houses and other consumer durables are treated very similarly to tax-prepaid investments, 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, because the contributions were exempt from tax under the old system and the receipts were fully taxable.

Designation of past accumulated assets as tax-prepaid assets would be the easier transition to administer. There would be no need to measure existing wealth. Tax-prepaid assets could be freely converted to qualified assets to enable the individual to average his tax base over time. An individual converting a tax-prepaid asset 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 defined initially to be part of an individual's tax base, it would be necessary to valuate them on the effective date. Individuals would have an incentive to understate their initial wealth holdings. Assets not initially accounted for could be deposited in qualified accounts in subsequent years, enabling an individual to take a deduction against other receipts.

A Preliminary Transition Proposal

Considering the objectives of basic reform (equity, simplicity, efficiency), it seems best to define all assets initially in transition to the cash flow tax as prepaid assets. For a period of 10 years, the existing tax code would be maintained, with taxpayers filing returns for both tax systems and paying 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 income from assets relative to wages, the current tax would be probably higher.

The corporate income 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 tax under the old law. It is likely that ownership of corporate shares would be concentrated among individuals who would be subject to the current 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 which were accrued but not realized before the interim period should be taxed as if they were income realized at the effective date. 13/ This is not administratively attractive, so for 10 years all capital gains would be taxed on realization, whichever tax base the individual was using.

A recognition date would be required at the end of the transition period to account for all remaining untaxed capital gains. Under the cash flow tax, with assets defined as prepaid and no records of current and past corporate earnings and profits 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 tax-free, the capital gains which had arisen prior to the adoption of the cash flow tax. To eliminate the need for permanent corporate records to capture this past income, it would be necessary to have a single day of recognition for past gains at the end of the transition period.

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

The advantages of the transition proposal outlined here are the following:

1. It would enable all of the simplifying features of a cash flow tax to be in full operation after 10 years, including elimination of tax records required under the present code, but not under the cash flow tax.

2. It would allow consumption out of past accumulated earnings to be exactly the same as it would have been under the current 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 eliminating taxes on returns earned after the effective date from past accumulated assets only on a gradual basis, it would mitigate the redistribution of wealth to current asset owners that would occur after immediate full adoption the 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 simplicity.

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 asset appreciation 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 receipts in the first year. This would require valuating all wealth on the effective date and imposing a one-time wealth tax. Such an approach would be harsh on older persons planning to live off accumulated wealth in the early years after the effective date.

A complicated variation on tax-prepaid treatment of assets would be one under which, in exchange for the elimination of taxes on consumption of assets defined as tax-prepaid, an initial wealth tax related to an individual's personal circumstances would be imposed. 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 persons. 14/ Although it might provide a transition program that approximates distributive neutrality, such a plan would be a significant departure from the goal of simplicity.

A third option would allow three types of assets: tax-prepaid, as defined above; qualified, as defined above; and a third type, which would treat assets as defined under the current system. In principle, it would be desirable for persons to be able to consume out of the third type of 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 total annual wealth changes also would have to be computed, in order to arrive at a measure of annual consumption. (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.) Treatment of corporate income under this system also would be complicated, because some investments in corporate stock would come from all three types of assets.

Under this transition alternative, assets of the third type would be subject to a transfer tax and converted to prepaid assets at death. Eventually, these assets would disappear from the system, and the complete cash flow tax would be in operation. Alternatively, all assets of the third type 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 would change the rules only for new wealth, 15/ its administrative complexity raises very severe problems.

Footnotes

1/ The exact change in the rate of taxation on income earned in corporations for different taxpayers 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 taxpayer's rate bracket. While the current corporate income tax does not distinguish among owners in different tax brackets, integration, which would attribute all corporate earnings to the separate owners, would tax all earnings from corporate capital at each owner's marginal tax rate.

2/ The taxpayer could 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 liberalized trade policies are eligible for trade adjustment assistance.

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

5/ Appropriate depreciation schedules are those that conform most closely to the actual rate of decline in asset values.

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 flows 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 also should be grandfathered.

9/ The income tax computation assumes that all returns to investment would be taxed as accrued at full rates. Thus, the annual percentage rate of after-tax interest 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 sold after 20 years, potential after-tax consumption would be $530, which is computed by multiplying the long-term capital gain of $573 by .75 (the taxpayer is assumed to be in the 50 percent bracket) and adding the return of basis. It should be noted, however, that, if the asset is corporate stock, profits are also subject to an annual corporate tax. Combining the effects of corporate and personal taxes, the income of the asset holders may be taxed under current law at either a higher or lower rate than the rate on wage and salary income, depending on assumptions about the incidence of taxes.

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 included in receipts if they deferred consumption out of wealth for at least 15 years, obtaining a deduction against receipts in the first year by placing the asset in a qualified account.

11/ A wealthy person could appear to "shelter" his current consumption by converting prepaid assets into qualified assets, deducting the deposits in qualified assets from current wage and other receipts. 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 was withdrawn for consumption.

12/ It is possible that only wealthy persons should be required to fill out a return for the current personal income tax. The main reason for retaining the current tax would be to tax returns from past accumulated wealth for an interim period of time to mitigate the inequitable distribution effects of a transition to tax-prepaid treatment of assets. It is likely that only people with significant amounts of wealth would have a higher liability under the current tax. The requirement to file two income tax returns 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 as asset is sold. One way to avoid this would be to adjust the basis upward 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 might be subject to the accessions tax sooner, it might not be necessary for reasons of equity to tax it on the effective date.

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