

Tax Planning Under The Flat Tax/X-Tax

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This paper considers the possibilities for tax planning (or tax avoidance) that arise under a consumption tax, in particular in the context of the (somewhat misnamed) flat-tax or x-tax. The issue is whether such a tax will produce the same sort of undesirable behavioral effects and tax planning that bedevil the current income tax.¹ If so, this would reduce or eliminate the principal reason for switching to a consumption tax.

Part I provides a summary of the conclusions. Part II provides background concerning consumption taxes. Part III provides a brief description of the flat-tax/x-tax. Part IV discusses several fundamental structural issues of the tax, and the basic tax planning opportunities presented by these structures. Part V discusses additional tax planning opportunities that would permanently reduce tax revenues under the tax. This part focuses on income shifting as a result of transactions between corporations, between individuals, between individuals and business entities, between partners and within partnerships, and between financial businesses and nonfinancial businesses. Part VI discusses deferral (as opposed to permanent avoidance) of tax revenues payable under the tax. Part VII provides conclusions.

I. Summary of Conclusions

The flat-tax/x-tax, just like the present income tax, will be subject to various types of tax avoidance transactions. These transactions include:

¹ See, e.g., Bankman (1999), Schler (2002).

(a) Fraud. A flat-tax/x-tax will attract a certain amount of fraudulent behavior. This is true today of the European VAT, and will no doubt be true of any similar tax adopted in the U.S.

(b) Legal shifting of income to tax exempt taxpayers. The basic structure of the flat-tax/x-tax includes tax-exempt persons (e.g., small business and financial institutions). As a result, the tax has the potential to give rise to “legal” tax avoidance transactions in which income is shifted from taxable entities to those persons. Such transactions might involve, for example, financial instruments or partnership transactions. Enormous effort in the statute and regulations will be required in order to minimize such “legal” shifting of income, and such efforts may or may not be successful.

(c) Intercompany pricing issues. Under the flat-tax/x-tax, in many situations, unduly high or low pricing between related parties can greatly affect the combined tax liability of the parties. It is very difficult if not impossible for the IRS to police these transactions that depend on the valuation of assets.

(d) Unknown loopholes. Under any tax system, creative taxpayers will make every effort to discover unintended loopholes, and there will be a constant race by taxpayers to take advantage of those loopholes before the government can close them. It is as yet impossible to predict what those loopholes might be in the flat tax/x-tax, but based on experience, they are sure to exist. This problem may be exacerbated under the flat-tax/x-tax as compared to current law, because in any new system, the government and taxpayers will be starting "fresh". In other words, while the current Code and tax regulations have been revised innumerable times to stop tax avoidance transactions, this cycle will be starting anew with an entirely new system.

These possibilities for tax avoidance under the flat-tax/x-tax will require that the new tax system contain numerous anti-abuse rules. The need for such anti-abuse rules is further demonstrated by the fact that European countries have in recent years been forced to adopt anti-abuse rules concerning their VAT systems. The need for such anti-abuse rules, and the uncertain effectiveness of such rules, may reduce the benefits of the conversion to a flat-tax/x-tax.

In addition, the flat-tax/x-tax contains the unique feature that it permits any business taxpayer to defer its tax liability indefinitely in a variety of completely legal ways. These techniques will require the taxpayer to pay additional tax (i.e., with an interest factor) in the future, and therefore in theory will not reduce the present value of the tax liability of the business.

The two authors of this paper disagree on the implications of these conclusions. As to tax avoidance transactions, Bankman believes that, notwithstanding the vulnerabilities described in this paper, the possibilities for tax avoidance under the flat-tax/x-tax are less than under current law, and that such possibilities should not preclude the adoption of the flat-tax/x-tax. Schler believes that the possibilities for tax avoidance under the flat-tax/x-tax, and the unknowable risk of tax avoidance under such a new system, are major problems and are in themselves sufficient reason not to adopt the tax.

As to tax deferral transactions, Bankman is not concerned about such transactions because, assuming constant effective tax rates over time, they do not reduce the present value of resulting tax liabilities. In addition, he sees no reason to believe that tomorrow's effective tax rate will be higher or lower than today's effective tax rate. Schler believes that the possibility of deferral of tax liability (even without reduction in the present value of such liability) has the potential to greatly reduce government revenues for years to come. Moreover, any number of events might happen in

the future (e.g., discovery of new tax shelters) that might prevent the deferred tax from ever being paid. As a result, Schler believes that the possibility of deferral is itself an independent reason not to adopt the flat-tax/x-tax.

II. Background

An increasing number of academics and practitioners (including Bankman but most definitely not including Schler) now favor replacing the income tax with a consumption tax. In general, support for consumption taxes is primarily based on administrative concerns. In ideal forms, the tax bases for income and consumption taxes are quite similar.² However, implementation of an ideal income tax is thought impossible.³ In contrast, most scholars believe that it would be possible to levy a (relatively) pure consumption tax.

A consumption tax has also gained favor in political circles. The party that is sympathetic to such a tax now controls both the executive and legislative branches of the federal government. The current administration strongly supports a reduction in the tax on capital, has announced its intention to support significant tax reform, and has appointed a tax reform panel that, among other proposals, is believed to be studying, among other proposals, the replacement of the income tax with a consumption tax.

² See, generally, Bankman & Weisbach (2005).

³ Such a tax would require tax on annual changes in investment value and would raise obvious liquidity and valuation issues. While it would be possible to devise an economically similar and more easily implemented proxy for this annual tax, see Auerbach & Bradford _____, adoption of this proxy would itself be a major reform for which there is no political (and not much scholarly) support. In addition, the current income tax has other features that many consider to be flaws (such as lack of inflation offset and dissimilar treatment of debt and equity) that cannot be remedied without major reform. The flaws in the income tax are said to discourage and distort investment in real assets and lead to much nonproductive tax planning.

Notwithstanding these developments, the adoption of a consumption tax seems unlikely, at least in the near term. Wholesale reform would impose significant transition costs and would significantly rearrange tax burdens. Change will be opposed by those that benefit from the current system, those that oppose the shifting of the tax burden as a philosophical matter, and those that are concerned about the unknowable revenue and behavioral consequences of such a massive change in the tax system.

III. Brief Description of the Flat-Tax/X-Tax

The basic flat-tax/x-tax proposal being discussed has the following terms:

1. Businesses are taxed on gross receipts, less cost of inputs for which the seller is subject to the tax, less wages. All costs of inputs, including land and inputs purchased with borrowed funds, are immediately deductible. As a result, there is no concept of tax basis. No deduction is allowed for the cost of inputs from exempt persons.

2. Individuals are taxed on wages at progressive rates. The top individual rate would be the same as the business rate. If an individual is self-employed, that business is taxed under the rules for businesses.

3. Financial transactions and financial instruments are not subject to tax, for either businesses or individuals. Interest is not deductible, and dividends and interest are not included in income. An individual does not have income, gain or loss on personal or investment (i.e., nonbusiness) assets.

4. Imports are not deductible (since the non-U.S. seller is exempt) and exports are not taxable.

IV. General Structural Issues and Tax Planning Opportunities

A. Should We Simply Follow VAT?

The flat-tax/x-tax described above can be thought of as a standard European-style credit-invoice VAT (described further below), except that wages are deducted by businesses and taxed at progressive rates to workers.⁴ In general, businesses are subject to VAT on the difference between their sales and their purchases from other VAT taxpayers.

If a flat-tax/x-tax is to be adopted, it will probably be desirable to adopt the general structure of the European VAT. Implementation of the flat-tax/x-tax raises thousands of small structural issues, some of which will not even be known until the basic system has been adopted. The VAT offers a ready-made template that resolves these issues. This reduces uncertainty and reduces the need for domestic tax authorities to spend time redesigning the wheel, as it were.

However, there are a number of differences between the adoption of a flat-tax/x-tax here and the European style VAT. In addition, some problems that are non-existent or minor under the European style-VAT may be significant under the proposed flat-tax/x-tax.

The first and most obvious difference is that, in Europe and all other developed nations, the VAT is supplemented by an income tax. The presence of an income tax reduces the payoff to some of the ways taxpayers might otherwise reduce VAT liability. For example, some transactions designed to artificially avoid VAT by virtue of the VAT exemption for financial

⁴ Alternatively, the flat-tax/x-tax can be viewed as a tax on cash flow at the business level, with individuals taxed on wages but not on investment income or gains. Legal academics, at least, tended at first to take the latter view and to look at the literatures on those tax bases (rather than on VAT) for analysis of implementation problems and structures. This focus reflected the fact that prior consumption tax proposals were based on cash flow or exemption of investment income; a VAT was thought insufficiently progressive to warrant consideration. Andrews, etc.

transactions would continue to be subject to the income tax.⁵ (Of course, a taxpayer who decides to hide transactions to avoid one would probably do the same to avoid the other).

More significantly, the income tax makes it possible to have a VAT with relatively low rates. Here, the flat-tax/x-tax would replace the income tax, thus requiring a higher flat-tax/x-tax rate here than in Europe. In principle, both here and in Europe, taxpayers have the opportunity and incentive to exploit inconsistent or discontinuous treatment for parties and transactions, and to take advantage of the special rules for small business, financial services and financial instruments. Here, however, the incentives for such actions would be greater than in Europe, because of the higher rate. The higher rate here might both increase the general level of tax avoidance transactions, and might also change the very nature of tax avoidance activities.

Second, wages are taxed at the business level in the European-style VAT (since there is no deduction for wages) but would be taxed at progressive rates at the individual level here. In one key respect, this reduces the differences between the two systems and the significance of the point made in the preceding paragraph. While the nominal VAT rate here would be high relative to Europe, for profitable labor-intensive industries the actual VAT tax paid would be low. A European VAT of 16% on non-reinvested profits plus wages will be greater than a U.S. VAT of 32% on non-reinvested profits after subtracting wages.

Third, Europe has over the years adjusted to the rising rates of its VAT, and many of the costs imposed by the compromises and idiosyncrasies of that system are hidden from view. For example, the financial service sector has adjusted to its disfavored status with respect to business loans and services (because businesses get no VAT credit for purchases from the exempt financial

⁵ See Part IV.H.

services sector), and its favored status with respect to consumer loans and services (because consumers pay no VAT for purchases from that sector). Likewise, the economy as a whole has adjusted to the small business exemption, the elective opt-in features for small business, and so on. Adoption of this system here might impose considerable short-term adjustment costs, as well as the costs of maintaining the discontinuities in that system.

Finally, this nation has been a center for financial innovation and some of that innovation has centered around reducing or avoiding the income tax. It is not just tax shelter promoters who have devoted time and effort to this enterprise: tax lawyers, accountants and tax-savvy executives have done the same.⁶ By most accounts, Europe has devoted less effort to similar enterprise. Nevertheless, even in Europe, constant legislative changes are necessary in order to counter the latest VAT schemes.⁷ Moreover, several recent court decisions have considered VAT avoidance schemes using language remarkably similar to the economic substance and form/substance discussions that appear in the U.S. tax shelter cases.⁸ One wonders what effect a European-style VAT would have on the U.S. army of tax advisers, and vice versa.

⁶ See, e.g., Bankman (1999).

⁷ See proposed Dutch legislation below. The UK has adopted legislation, very similar to the U.S. rules for “listed transactions” and “reportable transactions,” that requires disclosure of schemes whose main purpose is obtaining a tax advantage. This legislation applies to VAT schemes. The scope of the disclosure obligation, as it applies to VAT, was recently expanded in Finance (No 2) Act 2005, effective August 1, 2005, because the existing legislation was not broad enough to pick up all the schemes that were being used by taxpayers. See HM Revenue & Customs, TAIA (Tax Avoidance Impact Assessment): Section 6 and Schedule 1 to, the Finance (No 2) Act 2005, July 22, 2005, available at <<http://www.hmrc.gov.uk/library.htm>>, then going to “VAT/Reference Documents” and then “Tax Avoidance Impact Statements.”

⁸ See Debenhams case (below). See also the Opinion of European Court of Justice Advocate General Poiares Maduro, April 7, 2005, in Halifax plc (case C-255/02) and two other cases, proposing a rule that a deduction for VAT should be disallowed when the only reason for the transaction is to obtain the tax deduction. See also the decision of the European Court of Justice in Emsland-Stärke GmbH and Hauptzollamt Hamburg-Jonas, December 14, 2000, Case C-110/99, in

The effect may be wholly salutary. Faced with the prospect of learning a new set of rules that are more coherent and thus less rewarding to tax planning, most tax professionals may simply leave the field.

However, a much different outcome is possible. Many professionals might turn their attention to tax minimization under the new system, and there is no way to know what they might come up with. Thus far, no more than a handful of U.S. tax professionals have considered how to design around a flat-tax/x-tax style VAT. Unfortunately, as we have seen in the market for tax shelters for income taxes, all it takes is a few inspired and well-placed individuals to find and exploit a weakness in a tax regime.

Moreover, even after a tax regime is fully in place, even the best tax professionals find it impossible to guess the provisions that will provide the basis for the next shelter. Anticipating future problems is particularly difficult here, since no one has ever attempted to draft the flat-tax/x-tax.

It is generally the specific statutory language that creates the loopholes. The real test will come only after the drafting is complete, Congress has gone home, and the regulations have been written. At that point, armies of tax professionals will devote enormous effort to interpreting the specific language in the most taxpayer-favorable ways, and in exploiting any perceived loopholes to the fullest. The biggest single danger of a VAT-style (or any other style) flat-tax/x-tax is the

which the court rejected a VAT refund scheme as abusive. Under the scheme, goods were exported, the exporter received a VAT refund on the export, and the goods were immediately reimported under a preexisting arrangement and became subject to a lower VAT rate than the refund rate. Both ECJ opinions can be found at <<http://www.curia.eu.int/en/transitpage.htm>>, then going to Case Law/Search Form and putting in the case number stated above.

danger presented by flaws that have not yet been identified, or that will not even exist until the specific language is in place.

B. The Credit-Invoice Method

Under the credit-invoice VAT, a VAT credit is only allowable to the business purchaser of an asset if the seller is a business subject to VAT. The seller subject to VAT provides an invoice to the purchaser, which the purchaser uses to claim eligibility for a credit against its own VAT liability. No such invoice may be provided by an exempt seller such as an exempt small business or a foreigner, or an individual selling an asset held for nonbusiness use. As a result, the purchaser obtains no VAT credit for a purchase from such an exempt person. In these cases, if the purchaser resells the asset, the total sale proceeds are subject to VAT with no offsetting credit.

This lack of a credit for a purchase from an exempt seller is necessary for the integrity of the tax system. If a taxable corporation could freely obtain a deduction for buying an asset from an exempt seller (individual, small business, foreigner, or whatever), enormous revenue losses would result.⁹

To be sure, this rule has unfair results and creates traps for the unwary in some cases. For example, suppose an individual buys land for personal use for \$100, and shortly thereafter either sells it to his wholly owned corporation for \$100 or simply contributes it to the corporation. In either case, the corporation will obtain no deduction but will have no basis in the land. If the corporation then sells the land for \$100, the corporation will have \$100 of taxable cash flow. If the corporation then liquidates, everything is as before, except that tax has been paid on \$100 of cash flow.

⁹ Weisbach ()

In addition, this rule creates considerable anomalies. Consider a fully taxable corporation that wishes to buy a house or a car for use by its executives. If it buys a used house or car from an individual, it will get no deduction. If it buys a new house or car from the builder or manufacturer, the house or car will be fully deductible. As a result, there will be incentives for new assets to be sold to corporate users, and used assets (already held by individuals) to be sold to other individuals. This is an uneconomic effect of a credit-invoice VAT.

Notwithstanding these results, if a form of VAT is to be adopted, the credit-invoice rule seems essential to prevent abuse.

C. Why Not a Wage Tax?

The general equivalence between a wage tax and other forms of consumption tax is well documented.¹⁰ Notwithstanding this equivalence, there are a number of reasons why most consumption tax advocates prefer a cash flow tax or the more recent flat-tax/x-tax proposals. First, the cash flow or flat-tax/x-tax gives policymakers the option to levy a transition tax based on existing capital.¹¹ Second, the cash flow or flat-tax/x-tax taxes some returns to capital,¹² and thus reduces the incentive to disguise wage income as returns to capital, or vice versa. In contrast, since only labor is taxed under a wage tax, there is an overwhelming incentive to disguise wages as returns to capital. Finally, the cash flow or flat-tax/x-tax is probably easier to sell politically, since it masks the fact that the effective tax on most capital investments is zero.

¹⁰ See, e.g., Bankman & Weisbach (2005).

¹¹ See Part IV.F.

¹² As an economic matter, a consumption tax exempts a normal return to capital, but not certain extraordinary returns (often referred to as inframarginal returns). See Weisbach (2003) at 208-209. The economic theory and effects of a consumption tax are beyond the scope of this paper.

A flat-tax/x-tax with transition relief eliminates the first reason to eschew a wage tax, since it reduces the size of the transition tax that is collected. An exemption for small business, discussed below,¹³ eliminates part of the tax on returns to capital, and thus part of the second reason to reject a wage tax. However, some returns to capital for larger businesses are still taxed, leaving some reason for rejecting a wage tax – a wage tax will not capture these returns to capital. However, the magnitude and even existence of these kinds of returns is a matter of speculation. At some point, it might be more sensible to abandon the entire edifice of the business end of the flat-tax/x-tax and just levy the wage tax.

D. Deducting All Costs in a Flat-Tax/X-Tax

Under the flat-tax/x-tax, the business level tax is measured by gross receipts less cost of inputs less wages. All inputs are immediately deductible. No attempt is made to determine the relationship of the expenses to the true nature of the business carried on by the entity. Thus, any business may spend money on any nonfinancial asset and deduct the cost of that asset. For example, any business can use its entire free cash flow to buy land and possibly eliminate its tax liability. If it wished to distribute its available funds to its shareholders, it could borrow money to buy the land.

As a theoretical matter, there is nothing wrong with this, since the buyer of the land obtains the tax credit only if the seller has taxable flat-tax/x-tax receipts. However, this fundamental aspect of the system puts enormous pressure on making sure that there is no “leakage” in the system. When any particular taxpayer can legally wipe out its tax liability at will, the slightest leakage in the system will have enormous revenue consequences to the fisc. To a practitioner

¹³ Part IV.G.

familiar with the recent tax shelter era, this aspect of the tax by itself raises serious questions about its practicality.

E. Possibilities For Fraud

European VAT systems, like the current U.S. income tax, are plagued by fraud.¹⁴ A business may buy inputs from an exempt seller yet provide the tax authorities with a fraudulent credit invoice allegedly from a taxable seller. A business may fraudulently claim that goods were exported and that the proceeds are therefore exempt from VAT, with the costs of inputs deductible, while in fact the goods may have been sold domestically for cash. "Carousel" and "missing trader" arrangements may be created in which an intermediate entity that is subject to VAT provides a "valid" credit invoice to the buyer (which may or may not be part of the scheme and may even be related to the original seller) but then goes out of existence before the tax authorities can collect tax from it. These frauds have become so pervasive that they are distorting official trade statistics.¹⁵

¹⁴ See Commission of the European Communities, Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud, April 16, 2004, COM(2004) 260, available at <http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2004/com2004_0260en01.pdf>; OECD, Consumption Tax Trends: VAT/GST and Excise Rates, Trends and Administration Issues at 76-77 (2004) (describing various estimates of VAT revenue leakage ranging from 4-6% to 17.5% [update for 2005 edition]).

¹⁵ See "Distorted trade data point to massive tax fraud," and "Fraud makes presence felt in trade figures," *Financial Times*, Aug. 10, 2005; "A bit of this, a bit of VAT: the scam that's costing Britain billions," *telegraph.co.uk*, Aug. 15, 2005 (describing carousel schemes and stating that this and similar schemes are so large that the Government admitted it is distorting the UK trade balance); "Taxpayers losing billions in systematic VAT fraud," *Belfast Telegraph Digital*, Aug. 10, 2005 (quoting a UK government official referring to "a systematic criminal attack on the VAT system"); "Court Report Finds VAT Fraud, Possible Terrorist Link", *Tax Notes International*, Aug. 8, 2005, at 489 (generally discussing VAT fraud, and describing confidential German report on VAT fraud said to estimate German revenue loss at 17.6 billion Euro in 2003, representing 11% of annual VAT revenues, and said to conclude that some of the lost revenue ends up in the hands of terrorists and is used to finance their activities).

As suggested above, fraud exists in the income tax as well; witness, for example, evasion in the cash economy. We do not discuss here the relative vulnerability to outright fraud of the existing system and a VAT-like system. Rather, the primary focus of this paper is the susceptibility of the flat-tax/x-tax to tax planning that is either legal or close enough to be legal to be carried out under the color of law. This is the category that would encompass most recent tax shelters, for example.

F. Transition Relief

Transition relief has been debated for as long as a consumption tax has been proposed. Implementation of a flat-tax/x-tax without transition relief wipes out all existing basis. Taxpayers lose deductions for amortization and pay tax on gross sale proceeds. Such a tax is equivalent to a lump-sum tax on existing capital.

Some (including Bankman) believe that a lack of transition relief is efficient (because the tax on existing capital does not distort incentives for spending such capital) and equitable (because the tax on existing capital makes the tax more progressive). Others argue that a lack of transition relief is inefficient (because as discussed below taxpayers will change behavior to avoid the lump-sum tax) and inequitable (because the tax is applied to consumption out of existing after-tax savings).¹⁶

It seems likely that the pressures in the political process for transition relief will be great, and that the tax if adopted will provide for some transition relief. However, it also seems likely

¹⁶ See, e.g., Weisbach (2003), Shaviro (2000), Bankman (2003).

that any such transition relief will not be theoretically pure, but rather the result of political compromise.¹⁷

If a flat-tax/x-tax is announced without transition relief but with a future effective date, or if the enactment of that tax is anticipated, taxpayers will be able to engage in self-help to create the equivalent of transition relief. Taxpayers will sell loss assets before the effective date to obtain the tax loss. Of course, due to the time value of money, the present system already encourages sale of loss property, but here the incentives will be stronger because the effective date of the new system will present a now-or-never opportunity to cash out losses for tax purposes.

Even more significantly, absent transition relief, taxpayers might also sell nonloss business assets before the effective date (even at a gain) in order to obtain the advantage of the tax basis. If the assets are needed for business purposes, they could be leased back on a temporary basis. After the effective date, the sale proceeds can be reinvested in the purchase of similar assets, with a full deduction to the purchaser. In effect, the existing tax basis of the asset is converted into a net deduction in the same amount. To be sure, the deduction for the purchase under the new system would only be available if the seller at that time had full taxable income on the sale to the purchaser. Nevertheless, the result could be a considerable shifting of assets, as well as taxable income and losses, among business entities both before and after the effective date of the new system.

Transition relief will reduce (but not eliminate) these incentives, but will also complicate the system. Indeed, during the transition period, both current law and the new system will have to

¹⁷ The original Hall-Rabushka and Army versions of the flat tax had no transition relief. However, Hall has recently recommended phasing in the flat tax (and putting a more progressive rate structure on the flat tax) over 10 years. Hall (2005).

be maintained. This dual system is likely to be much more complex and expensive to maintain than present law. In still other respects, the effect of transition relief will be ambiguous.

Transition relief will reduce the total take of the system on nonwage income and thus reduce the incentive to game the system, but transition relief will also require higher rates on wages (since there is little or no tax on capital) and thus increase such incentive.

G. Small Business Exception

It would not be sensible to treat each small individual business (e.g. granny rental) as a separate business.¹⁸ As a result, some have concluded that the tax should follow the European VAT model and have a small business exemption.¹⁹

The loss from existing small business may be manageable, since small business is barely in the tax base today, due in large part to the (illegal) nonreporting of cash receipts.²⁰ However, some taxpayers may be unwilling to engage in this sort of illegal self-help and thus may be reluctant to hide cash receipts, may be reluctant to move into the small business sector. The small business exemption would both remove the psychic cost of evasion, as well as the tax that is now paid in that sector. As a result, this already-favored sector seems certain to grow even larger. The European experience may not be wholly representative here because, as noted above, in Europe the VAT is supplemented by an income tax, with respect to which small business is not exempt.

On the other hand, here, as in Europe, some small businesses that supply goods and services to non-exempt business will elect into the flat-tax/x-tax system. In that way, their sales

¹⁸ Weisbach (2002, 2005), Feld (1995).

¹⁹ See, e.g., Weisbach ().

²⁰ Weisbach (2002), Bankman (2004).

can be deducted by their customers and they can deduct the cost of their supplies. This may be more desirable than selling nondeductible goods to their customers, with neither party receiving a deduction for the cost of supplies.

With respect to more passive investments, such as real property, or businesses whose primary asset consists of real property, the small business exception in at least one respect seems problematic. This is because it exempts not only ongoing profits but past appreciation. Consider, for example, the individual who purchased rental real property for \$100 and now finds the property worth \$400. The small business exemption would forgive the \$300 of gain realized under an income tax. There is no efficiency-based or equitable reason for this forgiveness. This result is exacerbated by the fact that if the small business had both gain and loss property, it would sell the loss property before the effective date of the new rules and claim the tax loss, then claim the small business exemption and sell the gain property thereafter on a tax free basis. Perhaps the gain property could be sold under the small business exemption even if the business intended shortly thereafter to elect out of the small business exemption for the reasons stated above.

Unfortunately, there is no practical way to tax the existing appreciation in assets under a small business regime. The reason for this is that absent a requirement that all property be valued as of the date of enactment, it will be impossible to separate out post-enactment appreciation from pre-enactment appreciation.

If a small business exemption is adopted, there will be a need for aggregation rules. Otherwise, businesses too large for the exemption will be broken into pieces, each piece eligible for the exemption. These aggregation rules may need to be quite complex, similar to the rules previously used under the Code to prevent the creation of multiple surtax exemptions. Similarly,

complex rules will be needed to deal with small businesses that grow out of eligibility for the small business exemption.

One effect of the small business exemption is to create a two-track economy. The non-exempt sector is discouraged from purchasing goods or services from the exempt sector because of the nondeductibility of the purchase. Consequently, an exempt business may have a good that a non-exempt business wants, but the extra cost arising from the lack of deduction may preclude a sale. On the other hand, an exempt purchaser incurs no such penalty for purchasing from another exempt business.²¹

H. Financial Transactions

Under the flat-tax/x-tax as originally proposed, financial transactions are excluded from the system. This creates a number of problems and anomalies.

1. Forward Contracts For Goods

A forward contract for the purchase or sale of property is a financial asset excluded from the system. This itself creates distortions between economically equivalent transactions. For example, an airline desiring to lock in its future cost of fuel can either enter into forward purchase contracts at the fixed price, or else enter into separate swaps or puts and calls on the price of fuel that would have the same net effect. In the former case, the deductible input is the airline's cost of fuel purchased under the contract at the predetermined price. In the latter case, the deductible input is the actual subsequent market price at which the fuel is purchased, with the hedging gain or loss outside the tax system.

²¹ For example, since no deduction is allowed to a taxable business for imported goods, imports are relatively more attractive to an exempt business purchaser than to a nonexempt business purchaser.

Even more anomalously, suppose the airline enters into the forward contract to buy the fuel at, say, \$2 per gallon. If fuel costs \$2.50 at the time, the airline could close out or sell the contract for \$.50 in cash, spend \$2.50 to buy fuel on the market, and deduct \$2.50. If fuel costs \$1.50 at the time, the airline would take delivery under the contract and deduct \$2.00. From the point of view of the airline, this is the best of both worlds. However, if the counterparty is taxable, there is in principle no loss to the tax system. Here, if the counterparty paid \$.50 to close out the contract, the \$.50 would not be deductible, and the counterparty would then have taxable receipts of \$2.50 on the sale of the fuel at market price.

Consider the example where a business taxpayer enters into offsetting long and short forward contracts for delivery of goods with third parties.²² The business taxpayer can settle the favorable side of the straddle for cash and report the gain as realized from a financial transaction and therefore nontaxable, while delivery can be executed on the loss transaction, producing a deductible loss. If the counterparty is a business taxpayer, the opposite results arise to the counterparty and there is no loss to the tax system. However, if the counterparty is a nonbusiness taxpayer, and the business taxpayer is still permitted to claim the deduction, unlimited deductions (with no offsetting income and no economic substance) could be created in this manner. Adoption of a credit-invoice VAT prevents this result. In order to recognize losses, the first business taxpayer would have to enter into a transaction with a second business taxpayer. In that case, offsetting transactions that produced financial gains and real losses to the first taxpayer would produce financial losses and real gains to the second taxpayer. The transactions would no longer produce net losses in the business sector, although shifting of income and loss would still arise.

²² Weisbach ().

Suppose, though, a profitable corporation enters into a forward contract with an individual for purchase of goods for \$100, the value of goods falls to \$60, and the individual sells the now-favorable contract to another business for \$40. The corporation elects to take delivery under the contract. The other business purchases the goods for \$60 and sells them for \$100. The corporation immediately sells the goods for \$60. Does the corporation get a \$40 deductible loss, equal to the difference between the \$100 in paid for the goods and the \$60 it received for the goods? If so, \$40 has apparently leaked out of the tax system. This leakage could exist even without any economic effect on the corporation, if the corporation has entered into an offsetting contract with an individual that produces a \$40 gain that is treated as a non-taxable financial gain.

The answer presumably is to allow the corporation the loss, but to require the \$40 that the other business paid to purchase the contract to be non-deductible, because the contract was paid to a party outside the tax system. The other business would then recognize \$40 of gain (the \$100 received for the property less its deductible cost of \$60). More generally, the rule would have to be that whenever a taxpayer purchased or entered into a forward contract or similar contract with a nontaxpayer relating to the delivery of goods, any payment made to the nontaxpayer to purchase or enter into the contract would be nondeductible (just as would the price of the goods themselves if paid to a nontaxpayer).

On the other hand, when a non-taxpayer pays a taxpayer to enter into or assume a contract, the payment must count in the taxable receipts of the taxpayer. Otherwise, a nontaxpayer individual with a built-in loss of \$100 on a supply contract could pay a taxpayer \$100 to assume liability on the contract, and the taxpayer would have a loss of \$100 on fulfillment of the contract. The individual would have shifted its own nondeductible loss into a deductible loss for the

taxpayer. To avoid this result, the taxpayer must have taxable receipts of \$100 from the individual. This is an anomalous result in light of the fact that the taxpayer cannot deduct a payment to an individual to assume the taxpayer's obligation under a contract.

2. Mergers and Acquisitions

The exclusion for financial transactions would impact the merger & acquisition market. A stock purchase would be a financial transaction, exempt to the seller and nondeductible to the buyer (who would in effect take the underlying assets with a zero basis). An asset purchase would be fully deductible to the buyer and fully taxable to the seller. This would exacerbate the illogical differences that exist today between various forms of equivalent transactions. As to transactions that are tax-free reorganizations under current law, under the new system, stock transfers would always be tax-free, but rules would be needed for, say, an asset transfer pursuant to a forward merger that qualifies as a tax-free "A" reorganization today. Thus, a flat-tax/x-tax will not eliminate the complexities of the reorganization rules.

To be sure, to the extent that the flat-tax/x-tax is adopted in pristine form and is invulnerable to shelter-like schemes, then regardless of how the merger is structured, the present value of all deductions in the tax system will be unchanged. The differences in form will, however, greatly affect the timing of tax receipts, which may be an independent problem.²³

3. Installment Sales

The exclusion of financial transactions is also a problem with installment sales to consumers.²⁴ The days of low-interest financing of sales by automobile manufacturers to

²³ See Part VI.

²⁴ Bradford (___); Weisbach (___).

consumers would be over. The new paradigm would be low sales prices accompanied by high-interest financing. A \$20,000 car might be sold to an individual for \$16,000 under an installment contract that requires excessive interest of \$4,000. The business would benefit by the understatement of non-financial receipts by \$4,000 (and would not be taxed on the interest). The purchaser would be indifferent.

4. Expenses of Financial Transactions

The fact that receipts from financial transactions are not taxable means that salaries and other inputs allocable to such transactions would not be deductible. For example, a business could not deduct the portion of the salaries of its employees allocable to its financial transactions. This raises obvious allocation issues.²⁵ For example, salaries of employees that work on corporate transactions would have to be allocated between asset purchases and sales (deductible salary) and stock purchases and sales (nondeductible salary). An additional problem would arise for forward contracts that may be settled in cash or by delivery of goods, since it is not known at the time the contract is entered into whether the contract will be closed out in the form of a financial or a real transaction.

Of course, even though salaries paid with respect to financial transactions would not be deductible, the employee would be taxable on his wages. This would provide a strong incentive for financial institutions to pay wages in a nontaxable manner, since there is no offsetting loss of a tax deduction.²⁶

²⁵ [consider efficiency related issues if expenses relate to loans made to other businesses]

²⁶ For example, consider a hedge fund or other investment partnership that compensates its investment manager with a profits interest in the fund. Under the flat-tax/x-tax, no one is taxed on the profits of the fund. As a result, unless the manager is taxable (unlike today) on the receipt of the profits interest, the compensation will permanently escape taxation under the flat-tax/x-tax.

5. Determining What is a Financial Transaction.

The exclusion from tax of receipts attributable to financial transactions creates an enormous incentive for businesses to characterize receipts from consumers or other tax-exempt persons in this manner. For example, major UK department store chains have recently told customers that when they purchase goods by credit card for the same price as the cash price, a portion of the purchase price is attributable to a “card handling fee”. The retailers then took the position that the card handling fee was exempt from VAT. This position was recently rejected by the UK Court of Appeal.²⁷ Similar issues are certain to arise in under the flat-tax/x-tax..

6. Conclusions

It is difficult to come up with an easy solution to these sorts of problems. One might, for example, reject any use of financial products that is designed to shift income. The flat-tax/x-tax would need doctrines like economic substance, business purpose, sham transaction and so on, and the equivalent of statutes such as section 482. It would also need record-keeping requirements, since financial transactions otherwise would not appear in any tax records. It is difficult to know how the record-keeping requirement should be worded. In theory, at least, any financial contract would have to be reported or at least kept by the taxpayer for discovery on audit.

Of course, we already suffer under these doctrines and statutes under present law, and contracts are already subject to discovery under present law. To the (unknowable) extent to which income shifting as a result of the exclusion of financial products from the tax base is no greater

²⁷ HMRC v Debenhams Retail PLC, [2005] EWCA Civ 892 (July 18, 2005) (the charge slip stated that 2.5% of the retail price would go to Debenhams Card Handling Services Ltd., a wholly owned subsidiary). This case can be found at <<http://www.bailii.org/ew/cases/EWCA/Civ/>> and going to Debenhams under the alphabetical listing of cases. The arrangement is reported to be worth about £300 million per year in UK revenues and to have been adopted by more than 70 retailers. International Tax Review, Weekly News, August 1, 2005.

than the income shifting under present law, there would be no net cost in this area. However, this single issue could eliminate some portion of the simplification otherwise offered by the flat-tax/x-tax.

In the past, European VAT systems had few anti-abuse provisions preventing the shifting of income of real transactions into income from financial transactions, and vice versa.²⁸ This is less true today. As noted above, U.S. anti-shelter doctrines have been incorporated in at least some European VAT regimes.

I. Refundability of Losses

Losses under present law may be used (with considerable restrictions) to offset present, past or future tax liability but do not otherwise generate tax refunds. Losses are not “refundable”. For a company that will not pay tax or has not paid tax on other sources of income, the tax treatment of risky investments is therefore asymmetric: the government shares in gains but not losses. The restriction on losses presumably discourages some investment and raises the cost of other investment, as the situs of investment shifts to companies that have other sources of income and so can “use” the loss. Loss restrictions certainly impose transactional costs, as taxpayers attempt end-runs around the loss restriction rules, and the law responds with yet more complex rules and doctrines. Whether loss restrictions can be defended as a useful safeguard to the fisc is discussed briefly below.

The flat tax as originally proposed generally followed present law in this regard, except that if unused losses were carried over, the amount of the loss carryover would increase by a below-market interest rate. However, preliminary study has shown that it will be difficult and

²⁸ Weisbach ().

costly to enforce loss restrictions under a flat-tax/x-tax. Because of this, and because of the way in which loss restrictions discourage or raise the cost of risky investment, some have argued that losses under a flat-tax/x-tax ought to be refundable. The argument is supported by the fact that the European-style VAT is refundable. This suggests that as a political and prudential manner, refundability could be part of the flat-tax/x-tax.

There are several potential problems with refundability. The first is simply political: is it reasonable to assume that Congress would approve a refundable system? The fact that the European VAT is refundable may be irrelevant because it does not allow a deduction for wages. As a result, few companies will show a net loss for the year. In contrast, under the flat-tax/x-tax, wages are deductible and taxed to the employees. Here, a business might well get a refund in excess of taxes it paid. If, as proposed, the wage tax is progressive but business is taxed at the highest rate, the refund may exceed the sum of business and employee taxes paid.

To illustrate, consider first the operation of the European and flat-tax/x-tax if all taxable transactions were subject to a 30% rate. Assume the business pays out \$100 in wages and nothing for supplies to create a product, and then sells the product for only \$10.

Under the European VAT, the business gets no deduction for the cost of labor and pays VAT on \$10 receipts. At 30%, total payment is \$3. Under the flat-tax/x-tax, the business deducts the \$100 and shows a loss of \$90 and so gets a refund of \$27. However, employees show \$100 of wages and pay tax of \$30. The net result is the same – \$10 of net income and \$3 of tax receipts. However, in one case the business pays the \$3. In the other, employees are taxed and the business gets the refund. As a matter of economics, it may not matter how the net \$3 is collected.

Politically, though, the fact that employees are taxed while their unprofitable business gets what appears to be a subsidy from the government may be deemed insupportable.

If wages are taxed at a lower rate than business income, the political problems increase. There is also a net loss to the fisc, and a potential for tax-related planning and mischief. Assume, for example, that under the flat-tax/x-tax the wage rate on at least some employees is only 15%. Now, under that system, the business still gets a deduction for 27x but the wages only produce 15x in taxes. The fisc loses 12x as a result of the wage deduction. There is an obvious temptation for family-owned businesses to overstate wages.

This same temptation exists under current law and under the flat-tax/x-tax with respect to profitable companies. All refundability does is extend this temptation. This technique would then benefit taxpayers with unprofitable businesses, and taxpayers with profitable businesses could then use this technique even when, due to overpayment of wages, their business becomes unprofitable. To be sure, so long as the flat-tax/x-tax retains a small business exception, taxpayers who are eligible for that exemption would have no incentive to increase taxable wages with no tax benefit to the small business.

Refundability also means that, even aside from wages, almost any business can achieve not only a zero tax rate (as discussed above), but a cash refund from the government. Any business can obtain any size refund if it can find enough cash (including borrowed cash) to buy sufficient business assets. The asset can, for example, be land subject to a long term net lease, which would provide good security for a lending bank. The business deducts the cost of the asset, and, if this creates a loss, obtains a cash refund from the government. For example, a start-up company might have a small amount of equity, borrow money and buy the land, obtain the tax refund, then

dividend the tax refund to its shareholders. If the business makes money, the government will eventually get its refund back with the equivalent of interest. If the business breaks even or loses money, it will have no assets after paying off the debt, and the government will be out of luck.²⁹

Refundability also makes the system more vulnerable to unrelated loopholes. Suppose, for example, that a company for some reason finds itself with an ability to manufacture losses – perhaps the company has been set up for just this purpose – and that it will take some months for Congress or the tax authorities to close that loophole. Under current law, exploiting that flaw would require a separate scheme to transfer losses and finding a profitable company that is willing to take part in that scheme and pay for those losses. Under a refundable loss regime, those subsequent steps would be unnecessary, and the cash would be collected directly from the government.

Likewise, refundability makes the system much more vulnerable to fraudulent invoices. Not only will such fraud permit a business to wipe out the tax liability on its real income, but it will permit the business to obtain “real cash” from the government. This is analogous to fraudulent returns today that claim tax refunds based on refundable credits, such as the earned income tax credit.

On balance, one of us (Bankman) would opt for refundability. The other (Schler) would not because he believes that, given the likelihood of abuse, such a system would be like giving taxpayers access to an ATM machine that permitted unlimited daily withdrawals from the fisc.

²⁹ It does not seem that the government could make up this loss by denying the deduction to the lender for its loss. First, the lender might not have a loss, since the business might have just enough money to pay off the lender in full. Second, if lender was not altogether exempt from tax as a financial institution, the loss would be a real economic loss that would economically offset income on other profitable loans of the lender, and it is difficult to see how the loss could be denied.

Ultimately, refundability, like all other details, is a political decision. It is at least possible that a flat-tax/x-tax will not have refundability. Thus, Part V.A of this paper includes a discussion of techniques that could be used in a nonrefundable system to obtain results similar to refundability by shifting losses from unprofitable businesses to profitable businesses.

V. Tax Planning Under the Flat-Tax/X-Tax

A. Transferability of Corporate Losses

1. Ease of Transfer of Losses

Under the flat-tax/x-tax, absent special restrictive rules, it will be very easy for taxpayers with losses to transfer the benefit of those losses to profitable taxpayers. The simplest way to do this would be leasing transactions, under which the profitable taxpayer buys an asset and leases it to the taxpayer with losses. The profitable taxpayer obtains an immediate deduction for the full cost of the asset, offset in later years by rental income. The taxpayer with losses obtains no immediate deduction, but obtains rental deductions over the life of the lease. Although the present value of all tax deductions in the system has not changed, the actual payment of tax liability has been deferred.³⁰

Indeed, under the flat-tax/x-tax, transfers of tax losses could be made in an even more "efficient" manner than by way of leasing transactions.³¹ Suppose, for example, that a profitable

³⁰ See Part VI for a discussion of this deferral issue.

³¹ Other techniques might also be possible. For example, suppose the loss corporation prepays rent of \$100 to a newly formed foreign corporation, with the foreign corporation assuming an obligation to acquire an airplane and lease it to the loss corporation under a long term net lease. The foreign corporation would not be taxable on this payment, since the corporation is not engaged in business in the U.S. A profitable corporation buys the stock of the foreign corporation for the small equity cost of the airplane. The lessee agrees to the substitution of the profitable corporation as the lessor. The profitable corporation liquidates the foreign corporation, treats the liquidation as a nontaxable financial transaction, buys the airplane with the cash, and claims a deduction for the cost of the airplane. If this works, the profitable corporation has a deduction without any material

corporation has \$10 in taxable cash flow and a corporation with losses has \$10 and wishes to buy an asset. The profitable corporation can use the \$10 to buy the asset needed by the corporation with losses and then contribute that asset to a newly-formed subsidiary. It can then sell the stock of the subsidiary to the loss corporation. The profitable corporation presumably gets a deduction for the purchase but is not taxable on the stock sale, since stock is a financial asset. The profitable corporation now has the same cash of \$10 it started with, except it now has no tax liability and no further entanglement with the loss corporation. The asset presumably has a zero basis in the subsidiary so will generate \$10 of income to the subsidiary or (if the subsidiary is liquidated) to the loss corporation. If, as is supposed, the loss corporation has otherwise unusable losses, the additional income is of no consequence. The result is an upfront and permanent shift of the tax deduction from the loss corporation to the profitable corporation, in contrast to a lease transaction in which the tax shift reverses over time as rent is paid.

This technique would work equally well if the profitable corporation owns an existing asset (for which it has deducted the purchase price) that it wishes to sell to a loss corporation. The profitable corporation can do so in a tax-free manner by contributing the asset to a subsidiary and selling the stock of the subsidiary. The subsidiary, again, will have a zero basis in the asset and recognize gain on the sale of the asset or the income stream produced by the asset. But so long as the subsidiary is purchased by a corporation with losses, that gain can be recognized tax-free.

outlay of cash. However, the deduction should not be allowed because the foreign corporation upon its liquidation is transferring cash to the profitable corporation in exchange for the latter's assumption of liabilities, and the profitable corporation should not be entitled to deduct the payment it makes to satisfy those liabilities without including in income the payment it receives.

In either of these variations, the profitable corporation can now either distribute the cash sale proceeds to its shareholders, or reinvest the cash in an asset that it will retain identical to the asset that it had just sold, or even reinvest the cash in an asset which it will immediately resell using the same technique. In fact, the profitable corporation could do the same transaction again and again (obtaining another tax deduction each time). The profitable corporation could go further and repeat the same transaction any number of times, generating a tax deduction and no offsetting income each time, by rolling over the sale proceeds indefinitely.

Other techniques for shifting losses would also be possible.³²

2. Possible Solutions

If losses are refundable, there would be no reason for a loss corporation to engage in a transaction to shift its losses to a profitable corporation. Assuming refundability of losses is rejected, it is difficult to justify unlimited “self-help refundability” through loss shifting.

The issue here can be viewed as how much nontax “substance” is required in order to shift losses from one taxpayer to another. Historically, leasing has required some (small) amount of substance, except for the days of “safe harbor leasing”. While the existing rules for leasing could be retained, this would do nothing to prevent the types of loss shifting that result from transfers of assets to corporate subsidiaries and sale of the stock of the subsidiaries.³³

³² Other techniques would also be possible. For example, since sale proceeds are taxable but interest is not, a profitable corporation could sell goods on the installment basis to a corporation with losses for a low price and a high interest rate. Likewise, since purchase price is deductible but interest is not, a loss corporation could sell goods to a profitable corporation for a high price and a low interest rate.

³³ In general, these loss shifting transactions result from a shifting of assets already within the corporate system, since a profitable corporation only obtains its deduction by buying an asset from a taxpaying entity. The normative concern may be less if the deduction to the profitable corporation results in an additional asset coming into corporation solution. This would arise if,

It does not seem possible to prevent this type of loss shifting by adopting the complicated set of anti-loss-shifting rules found in our present tax system. These rules would not apply to the transactions described above, at least not without significant modification.

Another possibility is to subject the transactions above, and similar transactions, to the kinds of doctrines now used to attack tax shelters, such as economic substance, business purpose, or step transaction. Reporting requirements could also be imposed on these transactions. However, just as today, these doctrines would be relatively easy to avoid. In particular, property could be contributed to a subsidiary without any advance planning of the sale of the stock of that subsidiary to a loss corporation. Since the stock of the subsidiary would carry with it an embedded tax liability (underlying property with zero basis and no deduction upon purchase of the stock), it might be expected that only businesses with unusable losses would purchase the stock of the subsidiary. More generally, if anti-shelter rules were adopted, the complexity-related costs of the current anti-tax shelter rules would in this context actually increase with the shift to the flat-tax/x-tax.

Alternatively, a contribution of assets to a subsidiary might be treated as a sale of the assets. The contributing party (which would have a zero basis in business assets) would recognize income equal to the fair market value of the property and the subsidiary would receive a deduction

instead of buying the asset in question from another taxpayer, the profitable corporation paid its employees the same amount to create the asset, such as a patent. In that case, the deduction may be viewed as more in keeping with the principles of cash flow taxation.

However, it is never possible to say whether a purchase of an asset from another corporation indirectly causes the latter corporation to acquire an asset from outside the corporate tax system. Moreover, the flat-tax/x-tax allows deductions solely on the basis that an asset is purchased from another taxpayer, without regard to whether a new asset has entered the corporate tax system. As a result, this distinction may not be valid.

in like amount for its issuance (or deemed issuance) of stock to purchase the property. This rule would prevent the tax-free sales described above, since the profitable corporation would now recognize income upon contributing the property to the subsidiary.³⁴ However, the rule also would discourage the transfer of property to subsidiaries in normal business transactions. It is for this reason that present law does not treat these transactions in this manner. The rule would also require taxpayers to value, and authorities to monitor the value of, all property so transferred.³⁵

Finally, all sales of stock of subsidiaries could be treated as sales of the underlying assets, with income to the seller and a deduction to the buyer. However, this would be an enormous change from existing law, and would either (1) prevent an enormous number of ordinary business transactions that are now accomplished as tax free reorganizations, or (2) require retention of the enormously complex existing rules for tax free reorganizations. The first alternative is not realistic, and the second would add enormous complexity to the flat-tax/x-tax.

3. Consequences of Transferability of Losses

If losses are transferable, a profitable corporation can in effect buy losses from a loss corporation, and use the losses to obtain a current reduction in its own tax liability. The result is very similar to the loss corporation receiving a direct refund from the government for its tax losses. Thus, transferability of losses can be seen as a way of granting refundability. As noted above,

³⁴ Of course, if the subsidiary already held the asset, the profitable parent corporation could still sell the stock of the subsidiary, rather than the assets of the subsidiary, to a loss corporation.

³⁵ This rule would make it easier, rather than more difficult, to transfer losses where a business with unusable losses contributes property to a subsidiary jointly controlled by a profitable corporation. The loss corporation would recognize gain tax-free and the deduction for the property would go automatically to the subsidiary. However, this result may not be troublesome, since a similar result could be obtained in these circumstances simply having the subsidiary purchase property from the loss corporation.

Bankman and Schler differ on the merits of such refundability. Schler believes that transferability, like refundability, will lead to permanent revenue losses as well as timing benefits that greatly reduce tax revenues. He thus finds transferability undesirable even if it does not lead to unproductive tax-engineered transactions. Bankman finds transferability bad only to the extent it leads to unproductive tax-engineered transactions or it provides a form of undesirable refundability (for example, refundability of losses realized by foreign persons).

B. Partnerships in the Flat-Tax/X-Tax World

Partnerships and other flow-through entities are an important part of the present economic landscape. Moreover, because of their flow-through nature, such entities have played a critical role in many tax shelters. It is important, therefore, to consider the utility and dangers of importing the rules for pass-through entities into a flat-tax/x-tax.

1. Should Partnerships Continue to Exist?

In general, the partnership provisions contained in the Code do not seem well suited to the flat-tax/x-tax. First, and most generally, those provisions are enormously complex. In addition, the partnership rules are contained in hundreds of pages of very technical regulations. All of those regulations are based on the existing income tax, and would have to be rewritten to reflect an entirely new tax system. The retention of such complexity, and the need to rewrite these regulations, would considerably reduce any simplification benefits of a flat-tax/x-tax.

Second, much of the complexity of the existing rules arises from the differences between so-called "book capital accounts" and "tax capital accounts". Those accounts reflect, respectively, the fair market value and tax basis of property contributed to a partnership. Thus, under a set of

very complicated rules,³⁶ gain or loss on the sale of property that has a tax basis that differs from its fair market value is generally allocated to the partner who contributed that property. A similar provision applies when a new partner buys into a partnership that already holds appreciated or depreciated property. The magnitude of the resulting adjustments would be greatly increased by the flat-tax/x-tax, because the tax basis of all partnership assets would be zero.

Third, some features of current law simply would not fit within a flat-tax/x-tax framework. For example, operating income from appreciated property contributed by a partner (in contrast to gain on a sale of the property) is not specially allocated to the contributing partner, most probably because it is difficult to trace the source of operating income. Instead, the non-contributing partner is given a disproportionate share of the depreciation deductions thrown off by the property. Under a flat-tax/x-tax, however, the contributed property will have no basis and thus generate no tax depreciation. In order to prevent misallocation of income, elective and very complicated provisions under current law that provide for fictitious depreciation deductions would have to be made mandatory.

Finally, the Code now treats a partnership in some respects as an entity and in other respects as an aggregate of assets held by the individual partners. This approach does not fit the structure of the flat-tax/x-tax. Consider, for example, the sale of partnership interests. Under the flat-tax/x-tax, either (1) a partnership interest would have to be treated as a financial asset, with no gain or loss on the sale of the interest, or (2) a sale and purchase of a partnership interest would be treated as a sale and purchase of the underlying assets, taxable to the seller and deductible to the buyer.

³⁶ Code § 704(c).

The first approach would make the partnership particularly susceptible to income-shifting. Any time a partnership was about to sell an appreciated asset, with taxable gain to be passed through to the partners, a partner could avoid this tax by first selling the partnership interest on a tax-free basis. More generally, under current law, nontaxation of appreciated property and other forms of built-in gain, along with misallocation of income for tax purposes, is offset at the time of sale. A partner whose interest has gone up in value but has avoided recognition of income will recognize that income upon sale. The advantages of non-recognition are offset (though not on a present value basis) upon sale. If a partnership interest is treated as a financial asset, this offset would not occur.³⁷

The second approach also raises the possibility of income shifting. The partner would start off with a zero basis for his interest. Suppose the partnership delayed reinvesting current taxable cash flow, and the partner then sells his interest. The partner would recognize gain on the cash flow that was not reinvested and (because of the no-basis rule) gain again when he sells his interest. This result could be avoided only by either (1) allocating a part of the sale price to the current value of the cash deposits, and treating this part of the sale price as tax exempt investment income, or (2) specially importing the concept of basis into the flat-tax/x-tax. Either of these approaches would be quite complex. In addition, some variation of alternative (1) would be necessary for the buyer in any event, since the buyer should not obtain a greater deduction for buying a partnership interest than if it had bought the underlying assets directly.

³⁷ As discussed in Part V.A.1, this same problem as to built-in gain (although not misallocated income) arises in the flat-tax/x-tax if a corporation can sell the stock of a subsidiary on a tax-free basis.

For these and other reasons (including those described below), there is good reason to believe that under the flat-tax/x-tax, as under the European VAT, partnerships would be treated as separate (rather than pass-through) taxable entities.

On the other hand, if the concept of pass-through partnerships is eliminated, suppose that two loss corporations create a profitable 50/50 joint venture. It could be viewed as quite unfair if the joint venture was subject to tax even though the partners had plenty of losses to shelter the income of the venture. The same is true if the joint venture were generating losses and corporate partners were profitable.

Another difficulty with eliminating the concept of partnerships is that the flow-through nature of present partnership taxation can (at least in theory) be replicated by contractual provisions outside of partnership.³⁸ To be sure, the government could rely on existing doctrines (such as substance over form) to recharacterize the relationship as a partnership. The difficulty with this approach is that the boundaries of partnership are unclear as a conceptual matter and hard (and expensive) to police as a practical matter.

³⁸ Consider, for example, a hypothetical joint venture to operate a new airline between a profitable financing company which leases aircraft and an airline with unusable net operating losses. Under the existing partnership rules, the lessor might contribute its planes to the venture, with the airline agreeing to staff the venture and use its existing facilities to book the flights. Losses might be certain in the early years of the venture. The partnership agreement might allocate all initial losses to the finance company, including those attributable to depreciation, and allocate gains first to offset prior loss allocations and then between the partners in various tranches.

Suppose the VAT were applied at the entity level, and losses were non-refundable. Now formation of a separate entity would be undesirable as it would delay and perhaps forfeit the tax benefit attributable to the losses in the early years. Instead, the parties could structure a very similar economic arrangement solely through the use of contractual provisions, although they could not replicate the legal governance features of partnership law. In this case, however, the finance company could use the deductions for the planes against its own income.

Eliminating tax partnerships would also pose transition problems. Suppose, for example, that immediately prior to enactment of a flat-tax/x-tax, a profitable corporation had contributed property with a basis of \$100 and a value of \$400 to a 50/50 partnership with a loss corporation, and that property is sold for \$400 after enactment. The first \$300 of gain on the sale of the property (here, all the gain) would be taxed to the profitable corporation.³⁹ If tax is now collected at an entity level, that tax is now borne by the co-venturers. If we assume the venture pays tax at the maximum rate, there is no loss of tax revenue to the government. However, the liability for the tax shifts from the profitable corporation to the venture, which is 50% owned by the loss corporation. This would greatly upset the settled expectations of the parties. Alternatively, if the property had been contributed by the loss corporation, the expectation would have been that there would be no tax to either party on the sale of the property. If partnerships were eliminated under the flat-tax/x-tax, the entity would bear a new tax liability that would be shared by the co-venturers. This would be even more upsetting to the parties.

If the flat-tax/x-tax is adopted with transition relief, and contributed property were to receive a carryover basis, elimination of partnerships could also reduce government revenues. Consider, for example, the reverse situation as that described immediately above: the loss corporation contributes property with a basis of \$400 and value of \$100 immediately prior to enactment and the property is sold after enactment for \$100. Assume the entity itself has \$300 of income aside from this loss. Under current law, the \$300 income of the entity is split 50/50, but the \$300 loss on the property sticks with the loss corporation. Assuming the loss corporation has sufficient preexisting losses, none of the loss on the asset produces a tax benefit, and the

³⁹ Section 704(c).

government collects tax from the profitable corporation on income of 150x. If partnerships were eliminated, the entire \$300 loss on the property reduces entity-level income of \$300, and so the government does not collect any tax on the income of the entity.

2. Partnership Tax Shelters in a Flat-Tax/X-Tax World

As an analytic matter, the flat tax would seem to offer little opportunity for shelter. It adopts a consistent cash flow regime, and, under plausible assumptions, it imposes a zero rate on most investments.

On the other hand, a flat-tax/x-tax regime might in reality give rise to considerable opportunity to shelter income. A partnership will have income (gross receipts) and deductions (costs of inputs and wages). If the existing partnership rules are continued, just as today a partnership could allocate deductions to a partner that could use deductions, and income to a tax-exempt partner (or a partner with losses).⁴⁰ Similarly, taxable cash flow as determined under the flat-tax/x-tax might be allocated to a tax-exempt or loss partner, even though the economic benefit of the cash flow might remain with the taxable partner. Today, such allocations are subject to the rules concerning “substantial economic effect”. Such rules would have to be continued. Nevertheless, if a loophole could be found in those rules, which is certainly not without historical

⁴⁰ To some extent, the problem would be less than today. For example, today a partnership can allocate investment gains to a foreign partner and investment losses to a U.S. partner, resulting in a deduction to the U.S. partner and no taxable income to the foreign partner. Under the flat-tax/x-tax, all investment gains and losses are exempt from tax, so there is no benefit to such a shift. Moreover, if business income were artificially allocated to a foreign partner, and business losses to a domestic partner, as discussed below it would be necessary to tax the foreign partner as if it earned the business income directly.

precedent,⁴¹ completely artificial tax deductions can be created for taxable partners, or economic profits of taxable partners can be allocated to tax exempt or loss partners for tax purposes.

In addition, whether or not a partnership interest is a financial asset, a pass-through partnership regime allows for the situation where prepaid income is allocated to a tax-exempt or loss partner, then a taxable partner buys the partnership interest, then the corresponding deduction is allowed to the partnership and passed through to the taxable partner. This problem is illustrated by the lease-strip shelters of the early 1990's.⁴²

More generally, it must be noted that in the past, taxpayers have exploited ambiguities and inconsistencies in the existing partnership regulations to create tax shelters, and the regulations (and statute) have had to be constantly updated to shut down various perceived abuses. If an entirely new set of partnership regulations was required to reflect the flat-tax/x-tax, this cycle

⁴¹ See, e.g., *Castle Harbour v Comm'r*, 342 F. Supp.2d 94 (D. Conn. 2004), in which taxable income was artificially allocated to a foreign bank. See Karen C. Burke, *Castle Harbour: Economic Substance and the Overall-Tax-Effect Test*, Tax Notes, May 30, 2005, at 1163.

⁴² See Bankman (1999). As a variation of those transactions, assume a profitable corporation enters into a partnership with a loss corporation. The partnership is funded with a \$1 billion contribution from the profitable corporation. On December 30, the partnership contractually agrees to lease aircraft for substantially their entire useful lives. In return, the lessees prepay \$1 billion. The partnership agreement allocates the entire sum to the loss corporation and its capital account is increased by that amount. The loss corporation, however, is required under the agreement to bear the cost of purchasing \$1 billion worth of aircraft for use in the lease. The \$1 billion expense, when incurred, will reduce the loss corporation's capital account back to zero. On December 31, the loss corporation sells its interest to a subsidiary of the profitable corporation. On January 1, the partnership purchases the planes and deducts the \$1 billion expense; the deduction flows through to the profitable corporation subsidiary.

The same result could be obtained if the loss corporation were replaced by a tax-exempt entity, such as a foreign person. Moreover, similar shelters are possible any time a payment is made to a non-taxable person in exchange for future goods and services, and the non-taxable person's responsibilities are assumed by a taxable person.

would start again from the beginning, and taxpayers would no doubt have many opportunities to take advantage of unintended results in the new regulations for many years to come.

To be sure, the particular problem of lease strips described above has apparently been resolved under present law.⁴³ While the issues are a bit different under the flat-tax/x-tax,⁴⁴ the prepayment problem could be solved by importing the result, if not the reasoning, into that latter tax. Alternatively, a prepayment could be recharacterized in the theoretically correct manner as a loan,⁴⁵ although this would require guidelines to determine when the recharacterization will be required.⁴⁶

Moreover, even if lease strip and prepayment problems are solved, this will do nothing to prevent the next tax shelter involving partnership allocations. If partnerships are retained, it will be essential to retain (if not also expand) the partnership anti-abuse doctrines now in the Code.

⁴³ See, e.g., Notice 2003-55, 2003-34 I.R.B. 395; *Andantech L.L.C. v. Commissioner*, Nos. 02-1213; 02-1215, (D.C. Cir. June 17, 2003), 2003 U.S. App. LEXIS 11908, aff'g in part and remanding for reconsideration of other issues T.C. Memo 2002-97 (2002).; *Nicole Rose v. Commissioner*, 320 F.3d 282 (2d Cir. 2002), aff'g per curiam, 17 T.C. 328 (2001). Query, though, whether the recent decision in *TIFD III-E*, 342 F. Supp 2d 94 (2004), together with other recent taxpayer victories, casts doubt about the government's ability to recast lease-strip transactions.

⁴⁴ The treatment relied upon by the taxpayer – acceleration of rental income – was clearly inconsistent with the income tax base but not inconsistent with the cash flow tax base.

⁴⁵ The proper treatment is to treat a prepayment as a loan, which is repaid with interest, followed by a payment of the loan amount plus interest to the party providing goods and services. (Weisbach () applies the same analysis in a different context.) Deemed interest on the loan is outside the system. The deemed payment of the loan plus deemed interest is included at the time the expense for the goods and services is incurred. This would defer the inclusion of income until after the exempt party exits the scene, leaving the income, as well as the expense, with the profitable corporation.

⁴⁶ It will be impractical and unnecessary to adopt it for run-of-the mill transactions. If it is required only for transactions that are tax motivated, doctrines such as business purpose or economic substance will continue to be needed. If it is required in any transaction that mixes taxable and non-taxable persons, this will catch nonabusive business transactions with non-taxable persons.

Among other things, this might require a rule that if a partnership has a tax exempt partner, the partnership must meet stringent rules concerning allocations of income and deduction that are applicable today in some situations to prevent abusive allocations to tax exempt entities.⁴⁷

One additional possibility is to limit the categories of persons that are permitted to be partners in a partnership, in order to reduce the potential for abuse. For example, flow-through treatment could be precluded for any venture with a partner that is nontaxable by status, such as a small business. A domestic loss corporation might be permitted as a partner on the ground that there is less concern about income shifting between domestic entities. An individual could also be permitted as a partner, with his interest in the partnership being treated in the same manner as a taxable sole proprietorship.⁴⁸ Likewise, a foreign partner might be allowed if the partner's interest in the partnership was treated in the same manner as if the partner carried on the underlying business directly. However, this would raise significant issues.⁴⁹

In conclusion, if the concept of partnerships is retained under the flat-tax/x-tax, all the existing complexities of the partnership rules will have to be retained, including the large number of anti-abuse rules contained in the Code and in the partnership tax regulations. In addition, it may be necessary to exclude tax-exempt persons as partners altogether. Even so, it may be impossible to prevent partnership tax shelters under the flat-tax/x-tax

⁴⁷ Code §§ 168(h)(6), 514(c)(9)(E).

⁴⁸ Individual sole proprietorships raise other issues, discussed below, but the relevant point here is that an individual's interest in a business partnership does not raise any additional issues.

⁴⁹ For example, if the partnership had domestic business losses and foreign business income, rules would be needed to prevent allocation of the losses to U.S. partners and the income to foreign partners. This issue also arises today.

C. Income Shifting Between Financial Institutions and Nonfinancial Affiliates

Because financial institutions would not be subject to the flat-tax/x-tax, there would be considerable incentive for a financial institution to shift its deductions to its affiliates. For example, instead of the institution buying or leasing a building from a third party, the institution might cause an affiliate to buy the building (fully deductible) and lease it to the financial institution. Aside from the timing benefit of having the deduction in (rather than outside) the tax system, the rent might be a below-market rent, resulting in a permanent shift of income from the taxable to nontaxable sector.⁵⁰ Endless variations are possible. For example, a bank might sell the rights to its name to a trademark affiliate for a high price (deductible to the affiliate, exempt to the bank), then license it back from the affiliate for a relatively low annual payment stream. The inability of the IRS to police intercompany pricing under section 482 makes it likely that attempts by taxpayers along these lines would succeed.

D. Income Shifting and Other Transactions Between Individuals and Companies

1. Transfers of Property From Individuals to Corporations

Under the flat-tax/x-tax model, a business would not receive a deduction for the purchase of personal property from an individual. In addition, the corporation will have a zero basis for the property. This rule prevents the combination of tax-free receipts at the individual level and deductible payments to the business sector. This rule also means that the value of the property at the time of the contribution has no tax significance.

⁵⁰ The Dutch government recently introduced legislation to stop this abuse. Ruben de Wie, Dutch Officials Propose Transfer Pricing Tactics to Combat VAT Avoidance, Tax Notes International, May 23, 2005, at 634.

From this rule, it necessarily follows that a business cannot be allowed to deduct a contribution of personal property from an individual shareholder. Such a deduction would provide a way around the no-deduction for purchase rule. An individual could transfer property to a wholly-owned subsidiary and immediately have the subsidiary sell the property to another business. The deduction generated by the contribution would offset the sale proceeds. The subsidiary could then distribute the sale proceeds tax-free. Meanwhile, the transaction would generate a deduction for the purchasing business. The net result would be a business deduction with no tax on the individual.

The rule disallowing the business a deduction for contributed property may seem anomalous. After all, the shareholder could sell the property to a taxable third party with no taxable gain, contribute the sale proceeds to the business, and have the business buy the property from the third party for the same price. The business would be entitled to a deduction in that case. However, in that case, this deduction is offset by the fact that the third party would have no deduction for the purchase from the individual shareholder, but would have income on the resale to the business.

Of course, if the taxable third party has losses, this is yet another way of shifting those losses to the business. Moreover, this transaction raises valuation issues, since the only effect of an increased sale/resale price of the property is an increased deduction for the business. The individual is untaxed on the sale to the loss corporation, and the loss corporation has losses to shelter its proceeds on the sale to the business.

Finally, in order to shift deductions to his business, an individual could sell the property tax-free (perhaps to another individual) and contribute the proceeds to his business. The business

would use the cash to buy property from a taxable person, thus starting off life with deductions equal to the amount of such contributions. This would occur even if there were no transition relief for corporations, so that all assets previously held by corporations received a zero basis. No tax would be due from the corporate sector until distributions (i.e., taxable cash flow) exceeded the fair market value of contributed cash proceeds. Adding full transition relief to this rule would give corporations a tax shield (comprised of basis and deductions) greater than they now have.⁵¹

2. Transfers of Property From Corporations to Individual Shareholders

Suppose a corporation sells or rents property to an individual shareholder that the individual will not use in a business. The corporation will have a taxable sales or rental receipt. Likewise, suppose the corporation distributes such property to an individual shareholder. The distribution must be treated as a deemed sale, generating income to the company, or else all tax would be avoided if property were distributed to a nontaxable shareholder.

In both of these situations, the incentive will be to minimize the sale price, rental price or deemed sale price, in order to reduce the taxable income to the corporation. The shareholder will be indifferent from a tax point of view, since (in the case where he acquires the property) he will not be taxed on a later sale of the property and (in the case where he rents the property) he cannot deduct any rent paid to the corporation. The IRS will have extreme difficulty in enforcing proper valuation in these situations, making this area ripe for abuse. The incentive to minimize the sale

⁵¹ For example, assume that individuals hold assets with \$20 of basis and \$50 of value. If they sell half of those assets and contribute the proceeds to corporations, and there is no transition relief, corporations start life with deductions of \$25. No tax would then be due until corporate distributions exceeded this amount, so the first \$25 of consumption would be tax-free. Note that the problem here is not the deduction given to corporations but the exemption of the individually-held assets from tax. Individuals could alternatively keep all the assets and consume the \$25 of sale proceeds tax-free. If corporations receive full transition relief, they could distribute an additional amount tax-free equal to the existing tax basis of their assets.

and rental prices also exists today. However, in the case of a sale, the incentive under the flat-tax/x-tax will be greater than today, because today a reduced sale price will result in additional taxable gain to the shareholder on a later sale of the property, which will not be the case under the flat-tax/x-tax.

3. "Untaxed" Fringe Benefits

Under the flat-tax/x-tax, in some situations a company will have a greater incentive than today to improperly allow its shareholder/employee to use corporate assets without reporting wage income to the individual. For example, suppose that the individual shareholder needs a car for personal use, and company has the cash that is needed to buy the car. Assume the only practical choices are (1) the company pays the cash to the individual as salary, (2) the company pays the cash to the individual as a dividend, or (3) the company buys the car and allows the individual to use it without consideration. The first two alternatives result in no tax savings, while the third results in a tax saving from the deduction of the cost of the car. The same incentive exists under present law to choose the third alternative. However, the immediate deduction of the car results in a greater tax savings under the flat-tax/x-tax, so (for any given percentage above zero of likelihood that the technique will work) the expected tax savings as a result of the technique has increased. As a result, the incentive for improper tax reporting has increased.

On the other hand, in other factual situations, the choice may be between (1) the company buying a car that will be used by the shareholder, or (2) the company buying another business asset for its own business use. In that situation, under both the flat-tax/x-tax and the current system, the company obtains the same tax benefit under either alternative, and the shareholder obtains the same benefit (tax-free use of a car) under alternative (1) as compared to alternative (2). As a result,

in this situation, the incentive for alternative (1) is the same under the current system and under the flat-tax/x-tax.

4. Recharacterization of Wages as Business Income and Vice Versa

Many owner-employees will have some ability to recharacterize wage income as business income, or to recharacterize business income as wage income, by setting the size of their salaries as either too low or too high. Even employees who do not have an ownership interest in their employer could form independent contracting companies, in the hope of recharacterizing current wage income into business income.

If employees and businesses are subject to tax at the same rate, there generally will be no advantage on a present value basis to changing the label given a distribution from a business. Neither the characterization of distributions as wages or dividends, nor the timing of the distributions, will affect the present value of net tax liability.⁵²

Recharacterizing wages as business profits, which can be invested on a tax-deferred basis, might be desirable, however, if the business wishes to defer taxes, even without reducing the present value of its tax liability. Such recharacterization will be even more desirable, and reduce the present value of tax liability, if the business is tax exempt, if the business tax can be partially evaded (through the provision of in-kind services or other means), if the business has the

⁵² Suppose, for example, that a corporation earns \$100 from the services of its owner-employee, that the prevailing interest rate is 10% and that the business and individual tax rate is 30%. If the corporation pays out all \$100 as wages, it pays no tax and the owner-employee has \$70. If the employee invested that sum for one year, she has \$77. If the corporation paid no wages (treating the \$100 as receipts) and invested the \$100 (wiping out the tax due on the \$100), it would have \$110 the following year. If it paid the \$110 out as dividend, it would pay \$33 tax, leaving \$77 for the employee. The same result would obtain if the corporation characterized the \$110 payment in year 2 as wages. In that case, the employee would pay the \$33 tax and again have \$77 to consume.

opportunities to earn a very high return and is otherwise capital constrained, if tax rates are thought likely to fall, or if (perhaps due to the continued existence of payroll taxes) the marginal rates on wages exceed the marginal rates on dividends. On the other hand, recharacterizing business profits as wages would be desirable for those individuals who are in a lower marginal tax bracket than the business, or if tax rates were thought likely to rise.

The IRS has great difficulty under present law policing the proper amount of compensation to be paid to a shareholder of a closely held business.⁵³ It is not clear that the flat-tax/x-tax makes this problem worse. However, it is also not clear that the flat-tax/x-tax reduces this problem.

5. Sole Proprietorships

Today, it is sometimes necessary to distinguish the personal, investment and business assets (and activities) of an individual. The nature of an asset or activity can affect whether a loss is deductible at all, and the capital or ordinary nature of any taxable income, gain or loss.

Under a flat-tax/x-tax, the distinction will be solely between business and nonbusiness activities. Nonbusiness activities will be completely exempt from tax, while business activities will be subject to the flat-tax/x-tax unless the small business exemption applies. Thus the distinction will be even more important than under existing law, and there will be considerable incentive on the part of an individual to categorize his activities as investment activities. Given the elusive nature of the distinction in many cases, this area will be very hard for the tax authorities to police. This issue has a large potential for revenue loss.

In addition, if an individual is in a business, and the small business exemption does not apply, the business activities will have to be viewed in effect as operated through a sole

⁵³ See, e.g., Bittker & Loken.

proprietorship that is subject to the flat-tax/x-tax. Moreover, transactions between the proprietorship and the individual will need to be treated in the same manner as transactions between an individual and his corporation. For example, if an individual converts an asset from business use to investment (or personal) use, the proprietorship should be subject to the flat-tax/x-tax as if it had sold the asset to the individual for its fair market value. Otherwise, the value of the asset will permanently leave the taxable tax base. Individuals are not likely to volunteer this tax. In some cases the individual will rely on the small business exemption. In other cases, the incentive at a minimum will be to place an extremely low value on the asset. An even more aggressive individual might buy an asset, claim it is a business asset, deduct it under the flat-tax/x-tax, then quietly begin using it for personal use, then sell it and claim it is an exempt personal asset.

On the other hand, suppose an individual buys a home for \$100, lives in it, then moves out and converts it into rental property. As noted above, this should be treated as a sale to the sole proprietorship. The individual is exempt, but the proprietorship gets no deduction for the purchase of the house. If the small business exemption does not apply, the proprietorship obtains a zero basis for the house, the rental income is fully taxable, and any proceeds of the sale of the house are fully taxable to the proprietorship. Even if the sale is for the individual's original purchase price of \$100, the full \$100 is taxable to the proprietorship. In fact, the individual cannot even avoid this disastrous result by moving back into the house. As discussed in the preceding paragraph, this would be a taxable sale to the individual for the value of the house, for which the proprietorship is subject to flat-tax/x-tax.

E. Income Shifting Among Individuals

Under present law, the progressive rate structure creates an incentive to shift income to low bracket family members or friends. The flat-tax/x-tax also provides for progressive rates (more so under the x-tax and revised flat tax than the original flat tax) and so would produce the same incentives. In one respect, the program of income shifting under the flat-tax/x-tax might be worse than under present law. The reason is that under present law, a high bracket taxpayer who wishes to shift taxable income must generally part with cash or other assets. As a result, income is generally shifted only among family members who pool resources, or from a high bracket individual to a lower bracket person to whom the high bracket individual in any event wishes to make a gift. Under the flat-tax/x-tax, a high bracket individual might shift income to a lower bracket individual under conditions in which the income is recouped through a non-taxable financial transaction. This would turn income-shifting into a transaction without real consequences and in theory at least, greatly expand the incentive to income-shift.

Consider, for example, a business that is about to distribute funds as either wages or dividends to a high bracket employee/employee owner. The recipient convinces the business to put a low-bracket friend on the payroll and to distribute the funds to the friend. The high-bracket employee recoups the funds through a financial transaction. For example, the high bracket employee loans the low bracket friend money at a usurious interest rate.

Overall, though, the flat-tax/x-tax would probably reduce the incentive to income shift. Many, if not most, income shifting schemes involve shifting income from capital. Under the flat-tax/x-tax, return to capital is at least nominally taxed at a flat rate and under plausible assumptions that rate is zero.

VI. Will a Flat-Tax/X-Tax Lead to Undesirable Deferral of Tax?

It is clear that under the flat-tax/x-tax, all business taxpayers will be able to defer all of their tax liability for the indefinite future, in a completely legal manner. Shareholders of a business that uses these techniques can then in effect take out the cash, tax-free, by simply selling their equity interests to a third-party.

A. Strategies For Deferring Tax Liability

A business can defer its tax liability indefinitely by merely reinvesting all its profits in a deductible manner each year. There is no limit on the ability of the business to do so. For example, the business can use its profits to buy vacant land, to buy assets already subject to a net lease, or to buy property that it will lease to another taxpayer with tax losses. If the business desires to distribute its cash profits to its shareholders, it can borrow the equivalent amount of money so that it has enough funds for both the reinvestment and the distribution.

A shareholder/employee of a closely held business can also minimize the current combined tax liability of the corporation and its shareholder by (1) minimizing the salary the business pays to the shareholder, and (2) using the resulting (increased) pretax profit of the business to buy deductible assets.

In addition, the closely held business could use strategies to reinvest its earnings in a deductible manner that go beyond the strategies available to a large public corporation. For example, the business might buy a house from a taxable seller and lease it to the shareholder. The business would obtain a tax deduction for the full purchase price. This strategy converts a personal expense of the shareholder into a deductible expense of the business (offset in future years by rental income and gain on a later sale of the house). If the shareholder wished to move, the

corporation would sell the house at a taxable gain and buy a new house with deductible purchase price. This would allow a tax-free "rollover" as long as the new house cost as much as the sale price of the old house.

B. Results of Deferral of Tax Liability

On a current basis, these strategies will have the effect of allowing the free shifting of current losses among taxpayers. Moreover, current deductions may tend to migrate to taxpayers that have the greatest current use for the deductions.

Nevertheless, under these strategies for deferring tax liability, the amount of income subject to tax will increase with the period of deferral and accumulation of capital. In present value terms, then, assuming monies are ever withdrawn, the total tax liability should remain unchanged. The timing of tax payments, however, would be deferred. Moreover, deferred tax on the build-up of capital inside the business sector may be lost due to changes in the political climate (for example, an administration may issues a tax holiday on withdrawals) or loopholes in the system.⁵⁴

C. Implications of Ability to Defer Tax Liability

Bankman is comfortable with the possibility of deferral of tax liability under the flat-tax/x-tax. He sees no reason to believe that taxpayers will prefer to leave money in the business sector, subject to future tax, as opposed to paying tax today and then investing the money on a tax-free basis in financial assets. The choice is essentially one between a Roth IRA and a traditional IRA. He believes that the possibility that the government will reduce tax on the

⁵⁴ E.g., as discussed in Part V.D.2, a permanent loss to the tax system would arise if the closely held corporation leased the house to the shareholder/employee at a below-market rent. It would be difficult if not impossible for the IRS to enforce a fair rent in this situation.

eventual distribution of funds from the business sector is offset by the possibility that the government will increase the tax on that distribution. The net incentives for a risk adverse taxpayer might well be to pull funds out of the sector sooner than would otherwise be the case in a no-tax world.⁵⁵ As for the government and social welfare, Bankman also does not see any reason to favor one set of equal present value tax payments over another. Bankman would change his mind if he believed as a matter of political economy (or felt in his gut) that the government would behave more responsibly, or favor policies more to his liking, with current as opposed to future revenue.

Schler believes that the ability to freely defer tax liability is a fundamental flaw in the flat-tax/x-tax, and is sufficient reason in itself to reject the tax. He believes that taxpayers will invariably prefer to postpone tax, even at the "theoretical" expense of paying more tax later.

He also believes that this incentive to defer tax will be further increased by the possibility that in future years there will be tax holidays, newly discovered loopholes in the system, or (in the case of closely held corporations) non arm's length transactions with their shareholders. In fact, the discovery in a future year of a single tax shelter that "works" as a technical matter might permit the elimination of a substantial part of the deferred tax liability in the system before the government could shut down the shelter. In any of those situations, the deferral of tax liability will result not only in deferral, but in a reduced present value of tax liability.

As a result, Schler believes that the flat-tax/x-tax will dramatically reduce government revenues for years to come. The net result will be a forced reduction on government spending, an

⁵⁵ A more complete analysis would have to take into account the possibility (less likely, in Bankman's view) that the government might raise taxes not by increasing the tax on the business sector but by instituting a tax on financial returns.

increase in an already large deficit, or, most likely, some combination of both. Moreover, Schler believes that even if it is not clear that taxpayers will act in this manner, the risk that they will do so, and the risk that they could begin doing so at any time in the future, makes the adoption of the flat-tax/x-tax an enormous gamble on future tax revenues.

VII. Conclusions

The flat tax/x-tax will present considerable opportunities for tax planning. Some of these opportunities will lead to schemes that resemble today's tax shelters. The flat tax/x-tax will clearly require rules similar to the anti-abuse provisions of current law. Moreover, while some of the general avenues for tax planning under a flat-tax/x-tax can be seen today, other forms of tax planning are certain to arise after specific legislation is enacted, and after the practitioner community has the opportunity and incentive to minimize taxes under the new law.

While the authors agree that the flat tax/x-tax presents opportunities for socially unproductive tax planning, they disagree on the relative vulnerability of the flat tax/x-tax and income tax to this form of behavior. Bankman believes that, notwithstanding the areas of vulnerability outlined in this article, the flat tax/x-tax offers fewer opportunities for tax planning than present law. Schler believes that the full deductibility of costs makes the flat tax/x-tax particularly vulnerable to tax minimizing schemes and that, even aside from policy objections to the flat tax, this vulnerability is reason enough not to adopt the flat tax/x-tax.

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