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RECOVERY OF PRE-ENACTMENT BASIS UNDER A CONSUMPTION TAX: THE USA TAX SYSTEM

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Abstract

This article suggests that the rules for recovery of pre-enactment basis under the USA Tax System's individual tax may be deficient because they create income tax savings (dis)incentives for many taxpayers, encourage costly financial manipulations, and may not provide an appropriate level of protection for pre-enactment investments.

SPECIAL REPORT

TAX ANALYSTS

RECOVERY OF PRE-ENACTMENT BASIS UNDER A CONSUMPTION TAX: THE USA TAX SYSTEM

by Louis Kaplow

Louis Kaplow is a professor of law at Harvard Law School and a research associate at the National Bureau of Economic Research. This article suggests that the rules for recovery of pre-enactment basis under the USA Tax System's individual tax may be deficient because they create income tax savings (dis)incentives for many taxpayers, encourage costly financial manipulations, and may not provide an appropriate level of protection for pre-enactment investments. He is grateful for comments by participants at a Harvard Law School workshop on the proposal and for suggestions on previous drafts from William Andrews, David Bradford, and Alvin Warren.

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I. Question Addressed; Summary of Conclusions

The USA Tax System is one of the many prominent tax reforms now under discussion.[1] The proposal involves an individual tax with an Unlimited Savings Allowance (USA), making it a form of cash-flow consumption tax, and a business tax that is tantamount to a subtraction-method VAT. I will consider only the individual tax and, to keep matters simple, will focus only on pre-enactment basis in financial assets.[2]

To illustrate the issues, consider two taxpayers, Consumer and Saver. Each earns the same amount the periods before and after enactment of the USA Tax, and they are otherwise identical in every respect.[3] In the period before enactment, Saver invests $10,000 of her earnings in a financial asset (bank account, stocks, bonds) whereas Consumer spends every penny. In the period

[1]A detailed discussion of the proposal, including the relevant individual basis transition provisions, appears in "USA Tax System: Description and Explanation of the Unlimited Savings Allowance Income Tax System," *Tax Notes*, Special Supplement, Mar. 10, 1995, p. 1482 (hereinafter USA Tax Explanation); basis provisions are discussed in detail at 1515-18, 1565-68. The legislative version is S. 722, 104th Cong., 1st Sess. (introduced April 25, 1995). Most rules pertaining to basis recovery appear in subchapter B of the bill. *See particularly*

(Footnote 1 continued in next column.)

section 52 (basic computation rules for savings deduction and net includable withdrawal income), section 57 (general basis account). An explanation of many of the mechanics, including the operation of the general basis account, appears in Alvin Warren, "The Proposal for an 'Unlimited Savings Allowance,'" *Tax Notes*, Aug. 28, 1995, p. 1103, and William D. Andrews, "More on the Unlimited Savings Allowance," *Tax Notes*, (forthcoming).

[2]I thus ignore loans, tax-exempt interest, business activities, retirement accounts, and other complicating features. In addition, the discussion will refer only to the pre-enactment basis in assets, ignoring the gain portion. I also will not consider the complications arising from financial assets whose principal is reduced through principal repayments over time. The discussion will, however, have obvious implications for all these subjects. *See* section V, *infra*.

A more thorough exposition of my views on transitions generally, with applications to tax transitions, appears in Louis Kaplow, "An Economic Analysis of Legal Transitions," 99 *Harvard Law Review* 509 (1986), and "Government Relief for Risk Associated with Government Action," 94 *Scandinavian Journal of Economics* 525 (1992). The seminal paper on tax transitions is Michael J. Graetz, "Legal Transitions: The Case of Retroactivity in Income Tax Revision," 126 *University of Pennsylvania Law Review* 47 (1977); his analysis of the transition to a consumption tax appears as "Implementing a Progressive Consumption Tax," 92 *Harvard Law Review* 1575, 1649-59 (1979). For a discussion of additional transition issues raised by recent consumption tax proposals but not addressed here (many pertaining to the business tax and to general equilibrium effects on prices and interest rates), see David F. Bradford, "Consumption Taxes: Some Fundamental Transition Issues," (forthcoming 1995). *See also* Shounak Sarkar and George R. Zodrow, "Transitional Issues in Moving to a Direct Consumption Tax," 46 *National Tax Journal* 359 (1993).

[3]By "enactment," I mean the effective date. The "periods" might be viewed as brief, say a year, or they could be substantial, referring to the decade before retirement and the decade after.

after enactment, Saver liquidates the investment and consumes the proceeds (along with any interest or other earnings).

If an income tax prevailed throughout both time periods, Saver and Consumer would pay the same tax in the initial period and Saver would pay an additional tax in the later period on her investment earnings. If a cash-flow consumption tax prevailed throughout, only Consumer would pay tax on the $10,000 in the initial period, and Saver would pay tax on the $10,000 plus any earnings in the later period. (As is familiar, the present value of Consumer's and Saver's tax liabilities are the same under the consumption tax, so that Saver is treated more favorably — less unfavorably — than under the income tax.)

Now consider the transition from an income tax to a consumption tax. With an income tax in the initial period and a consumption tax in the latter period (and no transition rule protecting pre-enactment basis), Saver would pay tax on the $10,000 twice: once in the initial period, under the income tax, when the income is earned, and again in the later period, under the consumption tax, when the $10,000 is spent. One way to describe the problem is that Saver's $10,000 basis in her asset gets lost in the shuffle. By contrast, Consumer, having no pre-enactment savings, loses nothing in the transition. Such a transition to a consumption tax, therefore, is extremely harsh on savers relative to similarly situated consumers.

The question I consider is how a USA Tax enthusiast — or, more generally, one who favors a quick move to a consumption tax regime — should craft rules for basis recovery. That is, I do not attempt to justify or criticize the enactment of a personal consumption tax, but simply take as given that such a tax, or something like it, is desirable.

Proponents of a consumption tax usually favor it over an income tax for some combination of three reasons: savings incentives (whether because more savings are viewed as desirable per se or because the income tax is seen to involve an inefficient distortion), simplicity in tax compliance and administration, and equity as between savers and consumers. Assessment of individual basis recovery under the transition to a consumption tax includes a number of dimensions, each of which involves some but not all of these justifications.

1. **What, if any, real behavior should be a prerequisite to basis recovery?** One approach would provide a level of basis recovery that was independent of taxpayers' real behavior. For example, if taxpayers were permitted simply to amortize their total pre-enactment basis over a fixed number of years, then their post-enactment savings and consumption incentives would be unaffected by basis recovery. The USA Tax permits those with pre-enactment basis under $50,000 to amortize their total basis — that is, take deductions for it — over three years. All other taxpayers (and thus the bulk of pre-enactment basis) are subject to a complicated regime that requires, among other things (see item 2), that one be a *net dis-saver* to be permitted deductions for basis.[4] The result is that taxpayers with significant pre-enactment basis will, to a substantial extent and for a significant period of time, be treated *as if they were still governed by the income tax* with regard to their dis-saving decisions. (Under a consumption tax, drawing down savings for purposes of consumption gives rise to immediate tax; under an income tax, no tax is triggered. The USA Tax provides the latter treatment as long as pre-enactment basis remains.) This result should be disturbing to a proponent who believes that savings incentives are important.

> ***The USA Tax falls substantially short of achieving many commonly advanced objectives.***

2. **To what extent should tax treatment depend upon financial manipulations that have no real substance?** Almost everyone (except underemployed accountants, brokers, and lawyers) would favor eliminating complex and arbitrary requirements that are readily circumvented by financial manipulations. Unfortunately, the USA Tax's transition rules erect numerous hurdles to basis recovery, which most taxpayers will avoid to a great extent, but only by undertaking wasteful transactions. This problem arises because the proposal allows basis recovery only to the extent basis has been "extracted" from old assets through financial transactions. This result runs contrary to many proponents' desire to reduce transaction costs imposed by the tax system.

3. **How much basis recovery should be allowed?** One could provide full and immediate recovery of basis (as by an immediate deduction for pre-enactment basis), no recovery (ignoring pre-enactment basis, with the resulting "double tax" on Saver), or a range of intermediate approaches. The USA Tax takes a compromise route which, as will be discussed, may be less generous than is appropriate from the point of view of a consumption tax advocate who is concerned with savings incentives or has particular views about the equitable treatment of savers versus consumers.

As is apparent from this brief summary, the USA Tax falls substantially short of achieving many commonly advanced objectives due to the manner in which it provides (or fails to provide) for recovery of individuals' pre-enactment basis in assets. Nonetheless, these problems are quite remediable.

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[4]By net dis-saving, I mean consuming more than current earned income. For example, if under the USA Tax, an individual earns $30,000 and consumes $31,000, with the $1,000 corresponding to interest on a bank account (the balance of which is supplied by prior savings), the expenditure of the additional $1,000 in interest would involve a withdrawal that is subject to tax (unless protected by available basis). My term net dis-saving includes such a withdrawal.

II. Behavioral Requirements for Basis Recovery

For taxpayers with significant pre-enactment basis, there are two requirements under the USA Tax for such basis to reduce current tax paid. First, the basis must be in usable form, which is to say that the asset to which basis was originally attached must have been sold in a manner that extracts the basis from the asset. The details of these mechanics and the problems they pose are described in section III. As foreshadowed in the introduction, however, it will usually be possible for skillful taxpayers to overcome this hurdle through financial manipulations.

Second, basis reduces tax only in years of net dis-saving and only to the extent of net dis-saving. This can be seen in the following illustration.

- Taxpayer Reinvest sells an asset with pre-enactment basis and market value of $1,000 and invests the proceeds in another asset. Reinvest finances all current consumption out of current earnings. (Reinvest may be a net saver or one who consumes all of earnings and no more.) Reinvest receives no current deduction; rather, the $1,000 basis moves into a general basis account, which may be used later, when Reinvest becomes a net dis-saver.
- Taxpayer Sellspend sells an identical asset and decides to consume the proceeds now, rather than reinvesting to save the proceeds for later consumption. The $1,000 of consumption will be tax-free. The $1,000 basis will be permitted as a full, present deduction to offset the tax otherwise due on current consumption. (If only $500 had been consumed, it would be tax-free and the other $500 of basis would move into the general basis account.)

Consider, now, the incentives and equity implications of this treatment. The basic effects can be illustrated with a simple, extreme case. Suppose that a taxpayer goes on a binge in the first post-enactment year. She sells everything she owns and consumes it immediately. She gets a full, immediate write-off for all pre-enactment basis. She is treated more generously than if she did anything less drastic — that is, if she did less dis-saving. This result should be viewed as perverse from the perspective of one who favors a consumption tax on the ground that it would increase savings.

To analyze the effects more precisely, consider two groups of taxpayers in a given post-enactment year, each of whom has unused basis. Those who are planning to be *net dis-savers face what is essentially income tax treatment at the margin.* If such an individual consumes an additional dollar today rather than saving it for the future, there is no tax resulting from this dis-saving, just as under an income tax but in contrast to ordinary cash-flow consumption tax treatment. If instead he waits until a future year to consume the dollar, at the time of consumption he will pay tax on the investment earnings but not the principal because basis recovery will be allowed then, again just as under an income tax but in contrast to consumption tax treatment. Essentially, by consuming more today, the taxpayer accelerates basis recovery to the present, which is profitable because of the time value of money.

The extent of this incentive for current consumption will depend upon the amount of deferral involved. For a taxpayer whose basis account is nearly expired and who expects to remain in net dis-saving mode, like one who has been retired for many post-enactment years, the deferral effect will be modest. But for one who will not exhaust his basis account for a decade or more, the lost value from the deferral could easily exceed half the tax savings that would be obtained from present basis recovery.

The theme that emerges is that the basis recovery system of the USA Tax is designed to reward immediate consumption over savings.

By contrast, individuals planning to be net savers (or in a neutral position, neither saving nor spending) will face no such incentive at the margin. An added dollar saved has no effect on basis; nor does it delay basis recovery, which will occur when there is net dis-saving in either case.[5] Although there is no marginal incentive to dis-save, a taxpayer who would otherwise, under a pure consumption tax, have been a net saver might choose to be a net dis-saver instead under the USA Tax. Under a pure consumption tax, one who saves a net of $1,000 receives a current deduction of that amount; one who dis-saves a net of $1,000 is taxed on an additional $1,000. Under the USA Tax, the former is true but, when there is pre-enactment basis to recover, the latter is not. Thus, the incentive to switch from being a net saver to a net dis-saver is greater under the USA Tax than under a pure consumption tax. Here, the total treatment is a mix of consumption tax

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[5]The argument in the text oversimplifies in one important respect. Individuals might behave strategically in light of the basis recovery rules. Consider a taxpayer who planned to engage in modest net savings over a period of many years. Under the USA Tax, if he had pre-enactment basis, he might instead create intentional consumption fluctuations, bunching consumption activity in, say, even numbered years, compensating by additional savings in odd numbered years. The total consumption over the time period may be the same, but the tax treatment would differ: the alternating process would allow the taxpayer to recover basis in the high consumption years. Thus, in aggregate, less of the taxpayer's consumption would be taxed in the short run (achieving a deferral advantage because of a reduced basis account). The incentives for careful year-end planning (calculating a complete return, to determine whether one has been a net saver or net dis-saver) are apparent. If sufficient gaming occurred, the income-tax incentives described in the text would be muted and the problems instead would be short-term consumption distortion and additional transaction costs incurred in circumventing the USA Tax's rules. (The problem noted here is similar to that addressed in IRC section 1231, which examines five-year periods to limit such manipulation; a similar approach could be employed in the present context if one wished to obtain the results described, and criticized, in the text.)

treatment for the saving alternative and income tax treatment for the dis-saving alternative. Although only a minority of would-be savers may thus change their behavior, the effect on savings for those who change may be large.

The theme that emerges is that the basis recovery system of the USA Tax is designed to reward immediate consumption over savings.[6] It is a familiar maxim of tax policy analysis that a consumption tax is equivalent in effect to an income tax that gives an immediate deduction for basis. (Indeed, the Unlimited Savings Account is designed precisely in this manner.) From this maxim, one can state a corollary for financial assets: An income tax is equivalent to a consumption tax that delays the deduction for basis until ultimate liquidation — that is, liquidation that is used for additional consumption. To the extent of the period over which pre-enactment basis remains (which will be decades for many taxpayers) and to the extent net dis-saving is contemplated, the USA Tax indirectly implements an income tax system along the lines of this corollary.

The explanatory materials produced in conjunction with the USA Tax proposal provide an extensive discussion of the basis recovery provisions and contrast them with a system proposed by Aaron and Galper that would provide recovery whenever assets with pre-enactment basis were sold (without the additional requirement of dis-saving).[7] To explain the contrast, a series of examples are offered. The proponents explain that their system differs from the more generous alternative in that the USA Tax denies basis recovery when there is reinvestment — that is, when no new savings are created. What this rationale overlooks is that both systems do provide basis recovery when there is net dis-saving. Thus, the criticized alternative provides basis recovery independent of whether there is consumption whereas *the USA Tax forces taxpayers to consume their savings rather than keep them invested if they wish to benefit from basis recovery*. Put another way, the USA Tax is relatively more generous to dis-savers in comparison to savers or to individuals who maintain their prior savings intact. In seeking to avoid rewarding those who reinvest the proceeds from liquidated assets but do not save more, the USA Tax has the effect of rewarding those who consume their savings rather than keeping them intact.[8]

If one wishes to avoid providing income tax incentives to many taxpayers under the consumption tax, one must extend basis recovery on equal terms to both savers and spenders. There are a number of ways to accomplish this. One possibility would be to provide basis recovery upon (only) the condition that old assets are sold.[9] Alternatively, one could delay basis recovery but allow interest on basis accounts, preserving in present value terms the incentive effect of allowing an earlier deduction.[10] These options would also have the effect of being more generous with regard to old basis. At the other end of the spectrum, one could make basis recovery independent of the saving/dis-saving decision by denying basis recovery altogether, which would be less generous than under the USA Tax.

There is also an unlimited range of intermediate and simple alternatives. Notably, one can provide amortization of pre-enactment basis over a specified time period. Note that such treatment would mean that the extent of basis recovery in a year would be entirely independent of a taxpayer's behavior. As a result, the relative treatment of savers and spenders would, for all taxpayers and from day one, be as under a pure, fully implemented consumption tax. Moreover, one could choose an amortization schedule, as described in section IV, to spread the costs over any period desired and to provide any level of protection required (by deciding the extent to which interest or indexing would be allowed on basis accounts). In particular, one could pick a schedule that would mimic the average treatment provided under the USA Tax proposal; this would produce the same revenue effects and level of protection but wholly eliminate the income tax treatment of dis-savers with pre-enactment basis.[11]

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[6]I say "designed" without meaning to attribute intent. Perhaps the consequences were not fully appreciated. Or perhaps the results were seen as unavoidable because it was thought that the audience for the proposal was too unsophisticated to appreciate the problem. The proponents' proffered arguments are discussed in the text to follow.

[7]The test summarizes the discussion in the USA Tax Explanation, *supra* note 1, at 1567-68, which refers to the approach suggested by Henry J. Aaron and Harvey Galper, *Assessing Tax Reform* (1985).

[8]As another statement of the same point, see USA Tax Explanation, *supra* note 1, at 1566, the explanation presents an example of a person who (1) earns $100,000, (2) puts the $100,000 into a CD, and (3) spends $100,000 of old savings

(Footnote 8 continued in next column.)

(and there is $100,000 of basis "available"). It is objected that some alternative approaches would impose no tax. But suppose that person X did (1) and (2) and person Y did (3). Under the USA Tax, each would owe no tax. It is unclear what logic of increasing national savings requires a different result when their activities are combined.

[9]Such a rule would encourage taxpayers to turn over their entire portfolio immediately, thereby providing the equivalent of full, immediate basis recovery. In that case, it would be better to provide the basis recovery independent of realization events, as discussed in section III.

Under such basis recovery schemes and others discussed in the text below, substantial basis recovery in a given year may produce deductions in excess of current consumption; to preserve economic neutrality, it would be necessary to allow refundability or to permit a carry-over to future years, with interest. This complication would not affect most taxpayers under likely amortization schemes and thus will not be considered further.

[10]*See* the proposal of Aaron and Galper, *supra* note 7.

[11]More precisely, such a scheme would provide the same average level of protection; for taxpayers who otherwise would consume early, protection would be less generous, and for those who otherwise would consume later, protection would be more generous. As will be discussed in section IV, the resulting treatment might be viewed as more equitable from a consumption tax perspective whereas the treatment in the USA Tax might be viewed as more equitable from an income tax perspective.

III. Mechanics of Basis Recovery

The preceding section analyzed the USA Tax System's requirement that there be net dis-saving as a prerequisite to basis recovery. In addition, there is an array of mechanical requirements concerning realization. The purpose of these requirements is unclear. At first blush, they appear to imitate the treatment that would have been provided under an income tax. But these requirements will largely be circumvented through financial manipulation.

The reasons that these requirements can be circumvented should be familiar: pre-enactment basis is like an unrealized tax loss; it can only be used when realized, so there is every incentive to devise realization events as soon as possible.[12] To illustrate the problem, begin with a simple example.

> A taxpayer holds two pre-enactment assets, each having a value of $1,000 and a basis of $500. She wishes to consume $1,000 from her savings. That is, she plans to engage in net dis-saving.

First, she obviously would sell these assets rather than other assets with a lower basis. (Under a consumption tax, assets purchased after enactment will have a basis of zero.) Thus, the incentive to sell assets selectively will remain. Second, and more important, she would be unwise simply to sell $1,000 of these assets (all of one, half of each, or whatever). If she did, she would have $1,000 of consumption from the assets but only $500 of "available" basis, producing a net of $500 in taxable consumption. Instead, she should sell *both* assets, realizing $2,000 and making available the full $1,000 of basis. Half the proceeds could be consumed and the other half reinvested. The net result would be that the $1,000 of basis would offset the entire $1,000 of current consumption. Thus, a taxpayer engaging in or anticipating being in a position of net dis-saving will have an incentive to sell many or all of her assets right away, to make basis available.[13]

Interestingly, the USA Tax proposal provides what might be called "deemed realization" treatment for bank accounts. Rather than forcing taxpayers to close their accounts and transfer the assets into new accounts to "extract" the basis to make it "available," they are permitted simply to transfer such accounts' basis into their general basis accounts, making that basis available immediately for use against any net dis-saving. Such treatment is not provided for other assets, although it could be. Moreover, rather complex and restrictive treatment is provided for other types of accounts, notably brokerage accounts. For assets in such accounts, realization is not sufficient to extract the basis. Rather, the basis will be attached to the brokerage account itself, and withdrawals from such accounts are deemed to be first from gain and last from basis.[14] (No rationale for this stacking rule appears in the explanatory materials.) The effect is that basis recovery may be substantially delayed, unless of course the taxpayer has the sense to liquidate the entire account (using the proceeds to open a new account and make new, substitute investments), which would move the basis into the general basis account and thus make it available to offset any net dis-saving.

After enactment of the USA Tax, accountants and brokers will be extremely busy for perhaps a few years as taxpayers with significant basis in pre-enactment assets churn as much of their portfolios as possible.

The lesson from these examples is clear. After enactment of the USA Tax, accountants and brokers will be extremely busy for perhaps a few years as taxpayers with significant basis in pre-enactment assets churn as much of their portfolios as possible. The net result will be to produce an outcome close to one of deemed realization, but with the disadvantage of incurring far higher transaction costs.

Some basis will be stuck, as with illiquid assets. But the incentives for realization will often be huge.

> Suppose, for example, that realization would allow basis recovery 10 years sooner than otherwise, that basis is half the value of the asset, the interest rate is 10 percent, and the tax rate is 40 percent (as under the USA Tax). The value of immediate realization in this case would exceed 12 percent of the value of the asset,[15] so the taxpayer would be willing to expend — that is, to waste — up to that amount to achieve the tax savings.

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[12]The primary limit upon realizing tax losses under the present income tax is that capital losses are only allowed to the extent of capital gains. Under the USA Tax, the primary limit is that described in section II: one may only take tax write-offs to the extent of net dis-saving.

A possible caveat to the argument that taxpayers profit by extracting basis quickly would arise if the taxpayer might be near death and the USA Tax effectively extinguished the general basis account upon death but not basis retained in individual assets. (The current proposal appears to be silent, implying that this might be the case, but in working out details one might expect more parallel treatment.) In any event, for most taxpayers this would be a small consideration, and for taxpayers near death with large unused balances in their general basis accounts, there would then be a substantial consumption incentive, for "you can't take it [a general basis account] with you."

[13]To be sure, the taxpayer will have less basis available for later years. But, due to the time value of money, as discussed in section II, it is advantageous to use basis sooner rather than later. Again, the reasoning parallels the incentive to realize tax losses early.

[14]*See* USA Tax Explanation, *supra* note 1, at 1518-19; S. 722, section 56.

[15]An immediate deduction of basis equal to half the value of the asset, at a 40 percent tax rate, would be worth 20 percent of the value of the asset. Ten years of deferral at a 10 percent interest rate would reduce the value of the deduction to 7.7 percent of the value of the asset, a reduction of 12.3 percent of the asset's value.

This suggests that not that much basis will remain stuck and that potentially enormous amounts of resources will be dissipated due to these rules.

It seems that it would be a simple matter to permit deemed realization for all assets — simple, that is, relative to the alternative contained in the USA Tax.[16] For many assets, the computations would be easy. Moreover, the USA Tax requires these computations in any event. For brokerage accounts, such computations are necessary (as well as a subsequent system of annual record keeping for assets in accounts and the accounts themselves). And even when basis information is not needed immediately under the USA Tax, it surely will be used later, at the time of ultimate realization.[17] Although paperwork is readily deferred, it is usually better in the long run to locate records sooner rather than later. To avoid the crunch of a "national basis year," a system of deemed realization could be optional. Most taxpayers would elect the option, at least as soon as net dis-saving was contemplated. Costs would be involved. But the alternative is to provide a large inducement for taxpayers to sell all of their assets, even when transaction costs are quite large. The cost of determining one's basis would be but a trivial fraction of the total transaction costs of all but the simplest of liquidations.

IV. Extent of Basis Recovery

Focusing on those with significant savings, the USA Tax permits basis recovery only after there have been relevant realization events with respect to pre-enactment assets and only to the extent there is net dis-saving. These requirements have been criticized with respect to post-enactment savings incentives and complexity. In this section, I address the *extent* of basis recovery that is entailed in these provisions. In characterizing the USA Tax on this dimension, it suffices to observe that, for many taxpayers with significant basis in pre-enactment assets, basis recovery will be substantially delayed. Certainly for middle-aged workers who intend to be net savers for an additional decade or two, the delay in basis recovery will reduce its value greatly (by half or more) relative to a system that provided for immediate deductibility. (I note here that the USA Tax does not provide interest on basis or index it for inflation.) Even a taxpayer already in retirement, who expects to dis-save for the remainder of his life, would recover basis only gradually. The question, therefore, is whether permitting such delayed basis recovery is appropriate, compared to faster recovery (in the limit, immediate recovery) or slower recovery (in the limit, no recovery at all).

A realistic enactment scenario for the USA Tax would involve a significant decrease in net savings (the capital stock) during the pre-enactment period.

Consider, first, the matter of *tax equity*. Although it is often difficult to say much about equity without explicitly identifying one's principle of distributive justice, in this context some progress is possible.[18] Clearly, any plausible norm consistently applied to the pre- and post-enactment periods would not favor the double-taxation of pre-enactment savings that results if no basis recovery is provided. As noted in the opening illustration, if *either* an income tax or a consumption tax existed throughout the two periods, there would be only single taxation of the $10,000. Thus, one might think that both proponents of the USA Tax and defenders of the income tax would favor transition relief.[19]

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[16]The optimal auditing strategy may differ from that at present. For example, a taxpayer may declare a large basis in one year that, depending upon the other rules, may not be recovered until later. Audit may be appropriate at the earlier point because that is when the claim on future tax liability is made and when the records will be around. Under the USA Tax proposal in its current form, there are similar issues, for many realizations will involve basis in an asset that goes into the general basis account and is of no significance until subsequent years with net dis-saving. Moreover, under the current tax system, taxpayers regularly claim the benefits of basis from prior (often distant past) years. If, after implementation, most taxpayers declared basis in the early years, procedures for documentation might be established that would produce a more reliable and readily audited paper trail than is available under the existing income tax.

[17]There are also carryovers for gifts. S. 722, section 74.

[18]The arguments in the text, it should be noted, do not take the form of "protecting expectations" or "reliance" per se. Such arguments, as many have noted, tend to be circular, as they depend upon what legal protection one was entitled to expect before a reform. *See* Kaplow (1986), *supra* note 2, at 522-27 (making the argument and citing previous discussions). Moreover, such arguments are not grounded in an explicit theory of distributive justice. In one respect, they are akin to process arguments, based upon concerns about whether government will behave properly; thus, they are suggestive of the efficiency argument addressed below.

The text also does not address the distributive incidence of the extent of protection for pre-enactment basis. This is because the problems identified all arise independently of distributive effects. That is, one can consider individuals who have the same earnings profile over time but who make different savings decisions. With regard to the generational incidence, one can similarly compare savers and spenders of the same cohort. Different decisions about the transition will have different effects across generations and income groups, but it is useful to consider these issues separately. (To an extent, they can be addressed separately, by adjusting tax rates, social security provisions, and the like.) Alternatively, one might view the transition to a consumption tax as an opportunity to lighten the relative burden on the younger generation by failing fully to protect basis, held disproportionately by the older generation; the motivation might be (crudely) to offset opposing changes in recent decades in social security and deficit policy that increase the relative burden on the younger generation. *See* Bradford, *supra* note 2.

[19]An important caveat is that a substantial amount of pre-enactment basis will have arisen in manners that many deem suspect. Notably, the step-up of basis provided by IRC section 1014 gives taxpayers a market-value basis even if no tax has ever been paid. Denying recovery to such basis — or,

(Footnote 19 continued on next page.)

There remains the question of the extent (timing) of relief. It might appear that the realization/consumption approach of the USA Tax provides "complete" protection: under an income tax an individual would not recover basis until realization and would not benefit fully from basis until the time of ultimate consumption (for if the proceeds from a liquidated investment are reinvested, there is no deduction of old basis from current consumption but instead new basis in the subsequent investment; untaxed consumption is not permitted until there is dis-saving).[20] Similarly, it is the case that those whose basis recovery is worth less because they do not begin dis-saving for a long period of time are likely to benefit more than those who dis-save earlier from any increase in the after-tax rate of return resulting from a consumption tax.[21] These views are correct, however, only if one's criterion of tax equity is met by treating taxpayers, with respect to their pre-enactment savings, as if an income tax continued to govern them, which is in substance an income tax norm.[22]

If, however, one takes into account the consumption tax treatment that is otherwise available post-enactment, the USA Tax's level of protection appears to be incomplete.

> To see the problem, consider two taxpayers who save for the long term. Early and Late are otherwise identical. Early decides to save an extra $10,000 just before enactment of the USA Tax. Late takes a big vacation instead and saves the extra $10,000 just after enactment (when Early is on vacation). Early will pay tax on the $10,000 and not recover the basis for a long time. Late, who saves after enactment of the consumption tax, gets an immediate deduction, which has a present value substantially in excess of Early's delayed basis recovery.

If one wishes these two taxpayers to be treated equally, Early would need an immediate deduction for pre-enactment basis.[23]

Next, examine the *efficiency* of various degrees of basis recovery. Providing no recovery at all amounts to a capital levy on pre-enactment assets. (Similarly, partial basis recovery would constitute a lesser capital levy.) Superficially, this may appear to be efficient:

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more generally, limiting recovery to a level below what otherwise would be viewed as appropriate protection — might be seen as appropriate as a matter of tax equity. (The incentive effects for taxpayers who hold such assets pre-enactment would nonetheless be as described below.)

[20] Income equals consumption plus savings. If a taxpayer liquidates one asset and purchases another, there is no net dis-saving, so income would equal consumption (as when a taxpayer consumes all her earnings and keeps the amount of savings unchanged). (This statement ignores taxation of previously unrealized gain or loss.) When there is net dis-saving, the savings component of income is negative, so income subject to tax is less than consumption.

It also should be noted that if one considered individual ownership of physical, depreciable assets (or, analogously, financial assets that were subject to partial principal repayments over time), delaying basis recovery until realization would be less generous than under an income tax. To that extent, there would be a considerable incentive to sell such assets immediately post-enactment, purchasing other such assets whose cost would be deductible in full immediately. There remains the question of how the pre-enactment basis would be recovered; the discussion in the text of financial assets would be applicable in this case. (The treatment of physical assets under the USA Tax is not directly parallel to that of financial assets because the former would be viewed as part of a business, subject to the business tax rules. Nonetheless, similar pre-enactment basis questions would arise.)

[21] Under a consumption tax, the effective after-tax rate of return is equal to the before-tax rate, rather than being reduced by the marginal tax rate, as under an income tax. Thus, if interest rates were unchanged upon implementation of a consumption tax, the effective rate of return would rise; indeed, the argument that there would be a greater marginal incentive to save depends upon there being some increase in the effective rate of return. (If interest rates fell by the amount of the marginal tax rate, there would be no change in the rate of return.) *See* note 23, *infra.*

[22] This is the norm implicit in the discussion of basis and transition in Andrews, *supra* note 1. One could argue that the norm is only incidentally an income tax norm; rather, it is primarily a backward-looking norm, preserving income tax

(Footnote 22 continued in next column.)

treatment only because the income tax happens to be the system that existed before enactment of the consumption tax. One must, however, look further to the reason behind this norm. After all, the complete transaction might be seen as saving under the income tax and dis-saving under the consumption tax. If one wants a single, consistent norm to apply to the entire transaction (to avoid the double-tax problem), one could instead adopt the consumption tax norm, which is the approach described in the text. The argument for choosing the income tax norm may be one that looks to reliance and expectations, but that approach has problems of circularity. *See* note 18, *infra.* The argument for the consumption tax norm is that the decision to implement the consumption tax to replace the income tax embodies a judgment favoring the consumption tax norm. Moreover, the actual correlation between reduced value of basis recovery due to delay and gain as a result of a higher effective interest rate will be poor, as explained in note 23, *infra.*

[23] Arguably, one who favored a consumption tax would believe that Early should be treated even better than this because Early saved somewhat earlier than Late; providing an immediate deduction for Early's basis plus for interest on that basis would produce a result equal in present value to that which would have prevailed if the consumption tax had existed a period earlier. This illustration suggests that the question of basis recovery is related to that of when the consumption tax really takes effect. Full, immediate basis recovery might be seen as retroactively extending the consumption tax to pre-enactment behavior, but the preceding point in this note indicates that this is not entirely true. Moreover, for a consumption tax advocate who is motivated by the equity of a consumption tax's relative treatment of savers and consumers, it is not clear why extending what is believed to be a superior result would be seen as undesirable, rather than beneficial.

The present discussion ignores the interesting price index problem posed by the fact that the net after-tax interest rate may differ after the transition to a consumption tax. (Some details and references appear in Kaplow (1986), *supra* note 2,

(Footnote 23 continued on next page.)

revenue is raised without distorting behavior, for pre-enactment assets were created in the past, which is immune to present incentives.[24] But most analysts oppose capital levies across the board because of a concern that they will be anticipated and a fear that they will be repeated. It is recognized that it is essential to capital formation (savings) that the government credibly commit *not* to engage in such behavior. Thus, if capital levies are undesirable, the failure to provide basis recovery is similarly problematic.[25]

This abstract argument can be made quite concrete if one considers the realistic probability that enactment of the USA Tax, or anything like it, will not be an unanticipated shock, but rather will be preceded by a period during which taxpayers would understand that enactment was a serious prospect.[26] In addition, suppose that it is not expected that there will be full, immediate basis recovery or an economic equivalent; instead, the present value of the basis recovery that is anticipated falls considerably short of complete protection (as is the case with the actual USA Tax proposal). Individuals would have a substantial incentive to defer much of their savings during this period. (They get basis recovery a year or two later if they wait, but perhaps decades later if they do not.) Moreover, individuals would be encouraged to dip into previous savings to go on consumption binges.[27] The reason is that this acceleration of consumption would be greatly

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at 611-12 n. 322.) If the net after-tax interest rate is higher, those planning to consume later will gain relative to those who plan to consume earlier. This may benefit some holders of pre-enactment assets with basis. *See* Bradford, *supra* note 2. The incentive effects described below — including the benefit to those who purchase an asset just after enactment rather than just before — are unaffected by this consideration. Moreover, the equity as between two such taxpayers is unaffected, because if the resulting after-tax interest rate were higher, both would benefit similarly. Put another way, a favorable shift in after-tax interest rates tends to benefit those who, relative to others similarly situated (with respect to age and income) will save relatively more, not those who happen to save pre- rather than post-enactment. Moreover, the extent of any benefit will be greater for those with longer savings horizons — so the youthful high savers will benefit more than retirees who had saved a lot in the past — even though the former will tend to have little pre-enactment basis whereas the latter may have significant pre-enactment basis. Thus, the correlation between any benefit due to changes in the after-tax interest rate and the extent to which lesser basis recovery is detrimental will be quite poor.

As a final test of intuition on this equity issue, imagine that the transition took place in two steps. (1) The income tax is converted into a wage tax by no longer taxing the return to capital. This would raise the after-tax return to capital in the same manner as would the full transition to a consumption tax, thereby benefiting savers. Indeed, this change in the relative treatment of savers is the primary objective of many consumption tax advocates. It seems hard to argue, from their perspective, that this gain to savers would warrant some sort of "windfall" tax — say, in the form of a capital levy on pre-enactment basis. (One could argue about the appropriate treatment of unrealized gains, but the present discussion is concerned only with pre-enactment basis.) (2) The wage tax is converted into a consumption tax. This would not affect the net return to savers but would involve some levy on pre-enactment capital unless full protection, equivalent to an immediate deduction, was provided.

[24]Similar logic explains the often expressed objection to the Tax Reform Act of 1986's reduction of the corporate tax rate combined with repeal of the investment tax credit and reduction in the generosity of accelerated depreciation. The logic is that this would be a windfall gain to old capital: new investment is subject to the same or a higher effective tax, but old investment, which previously benefited from the tax credit and accelerated depreciation, now gets the benefit of being subject to lower marginal tax rates. As a result, many favored a windfall recapture tax, although none was enacted. *See, e.g.*, George R. Zodrow, "The Windfall Recapture Tax: Issues of Theory and Design," 16 *Public Finance Quarterly* 387 (1988). To take this view (but not to favor analogous transition protection against windfall losses when tax rates are raised, which few in fact favor) involves a fallacy analogous to the one discussed in the text.

[25]In my more general treatment of transitions, I argue that protection of pre-reform investment is generally inefficient. *See* Kaplow (1986, 1992), *supra* note 2. But the reasoning I offer is that, in other contexts, the anticipatory effects on investment would tend to be desirable, taking as given that the reform is desirable. (For example, the prospect that pollution regulation will apply to pre-existing sources will tend to discourage investment in pollution-intensive technology pre-enactment.) By contrast, anticipating a capital levy will discourage capital investment, which both reduces (or, in the extreme, eliminates) the prospect of raising revenue through the capital levy and also results in distortion of economic activity by discouraging otherwise efficient capital investment. (The decision to implement a consumption tax presumably does not reflect a view that pre-enactment savings are undesirable.) *See id.* (1986) at 611-14.

[26]Tax legislation is often given an effective date retroactive to "announcement," perhaps taken to be the introduction of legislation or the time of a committee report. Nonetheless, as consideration spans a few years and more than one session of Congress, such dates are continually slipped back. Surely with a tax reform as substantial as the USA Tax, one would not expect enactment shortly after the initial introduction, and there inevitably will be a period — a year or a few years — during which enactment will have a significant probability but that will not be covered by the retroactive effective date. (The argument in the text does imply that, if the tax is enacted without full, immediate basis recovery, or an economic equivalent, an effective date possibly many years preceding enactment may be efficient with regard to its effect on savings and the capital stock.)

[27]Depending on the treatment of consumer durables, borrowing, and other details, this incentive could be massive, as consumers may convert financial assets to consumption or other assets subject to different treatment and may borrow beyond their present savings. If consumers accomplished pre-enactment withdrawals through cash hoarding that was undetected (see the anti-abuse rule in S. 722, section 58(b)), they would effectively have provided full basis recovery for themselves. Unlike reductions in savings and binges, such activity would not constitute a significant economic distortion. Implementing any system short of full basis recovery requires that one is able to prevent taxpayers from engineering this sort of complete circumvention.

rewarded because of the full basis recovery for subsequent replenishment of savings that is denied to preexisting basis. (Recall the example of taxpayers Early and Late.) It follows, therefore, that a realistic enactment scenario for the USA Tax would involve a significant *decrease* in net savings (the capital stock) during the pre-enactment period.[28] (Combining this point with that in section II produces a picture that should be quite disturbing to consumption tax proponents who are concerned with savings: a possibly substantial reduction in national savings in the period before enactment is combined with retention of income tax savings (dis)incentives for many taxpayers for a long period after enactment.)

By contrast, consider the pre-enactment incentives of full, immediate basis recovery. The reluctance to save and incentive to engage in consumption binges funded by past savings would be averted. Moreover, as noted in the equity discussion, one who increased savings pre-enactment (taxpayer Early) would have almost full consumption tax treatment for such savings. (There would not be an immediate deduction, but basis recovery would be delayed only until enactment, rather than for many years or decades afterward.) As a consequence, incentives for increased savings would kick in (although not completely) even before enactment.

The question of the appropriate extent of basis recovery in the transition from an income tax to a consumption tax is a complicated one, and I would not expect consensus to be readily achievable on this dimension. The preceding discussion suggests that the case for more substantial basis recovery may be stronger than first appears, particularly from the perspective of a consumption tax advocate who is concerned with savings incentives or who has strong views about the equitable treatment of savers versus consumers. Two additional points are worth noting.

First, the extent of basis recovery need not be tied up with the problem of revenue loss in the early years of enactment. Proponents of the USA Tax and other consumption tax proposals are no doubt concerned that full, immediate basis recovery would result in a large, up-front revenue loss that would make the proposal politically infeasible. But this part of the problem is largely cosmetic; it can be addressed by delaying basis recovery while permitting basis accounts to earn interest. In that way, there would be no immediate, huge revenue loss but the present value of basis would be protected, the economic equivalent to full protection from the taxpayer's perspective.[29] (Even indexing basis for inflation would accomplish much of this result, because a substantial portion of nominal interest is merely compensation for inflation.) But one adopting such a tactic should not be deceived: the present value of the revenue loss will be the same as with full, immediate basis recovery. The government's obligation to provide tax offsets to the extent of basis could be viewed as a form of government debt no different than if the government had incurred the revenue loss immediately, financing the current shortfall with conventional borrowing.[30]

Second, one can provide protection to any degree one likes, independently of how the issues addressed here are resolved. For example, one could provide that all basis be amortized over N years; N could be 1, 3 (as under the USA Tax for those with little pre-enactment basis), 10, or 30. Moreover, for any amortization schedule, one could provide any degree of interest or indexing one wished. Thus, there are both a number of degrees of freedom and a number of ways to accomplish (package) economically equivalent results.[31]

V. Conclusions

In brief, the questions posed and answers suggested here are as follows:

1. What, if any, real behavior should be a prerequisite to basis recovery? The USA Tax requires taxpayers with significant pre-enactment basis to be net dis-savers if they wish current deductions for basis. Thus, many taxpayers will face the same savings (dis)incentives as they do under the income tax, at least over the period during which some pre-enactment basis remains unused. An alternative that provided basis deductions that were independent of savings decisions, as by use of an amortization schedule, would result in all taxpayers from the outset

[28]The savings disincentive due to anticipation of subsequent more favorable treatment of savings is similar to the investment disincentive resulting from an expectation that an investment tax credit will become effective at some time in the not-too-distant future.

[29]This statement and others like it are, of course, approximate, depending upon whether a taxpayer remains in the same bracket (which is likely under the USA Tax because middle- and high-income taxpayers face a flat rate), whether tax rates change, and other matters.

[30]Many readers will recall the proposals to substitute for current IRA's similar accounts that would deny the current deduction but provide for future exemption. The present value of the tax deductions would be the same, but the revenue loss would be in the future. (Similarly, excessive attention to the current deficit or the five-year scoring window makes expansion of IRA's look more costly than is the case because part of the cost of the current deduction would be covered by higher future tax revenues that fall outside the planning horizon.)

[31]I consider only some basic options, including that incorporated in the USA Tax and the alternatives directly considered in the materials accompanying the proposal, along with some simple additions that seem attractive. Past consumption tax proposals, such as by the Treasury and the Meade Commission, have employed phase-ins with great complexity involved for a substantial period of time. *See* Graetz (1979), *supra* note 2, at 1653-55. If one wants an arbitrary compromise, a simple amortization scheme seems preferable on administrative grounds. I would also note that the preceding analysis suggests that using a delayed effective date to provide transitional relief, after which the new tax would go into effect with no explicit protection of pre-enactment basis, might be a particularly bad idea because of the extent of adverse incentives that would be created in the interim.

facing the marginal treatment associated with a pure, fully implemented consumption tax. Moreover, such a schedule could be as generous or stingy toward basis recovery as desired — for example, replicating the generosity of the current USA Tax proposal.

2. **To what extent should tax treatment depend upon financial manipulations that have no real substance?** The USA Tax's transition rules require realization events of various sorts as a further prerequisite to basis recovery. Such rules, which might appear to delay basis recovery, would be largely circumvented through financial manipulations, with the result that the primary effect of these rules will be to impose needless transaction costs. A system of deemed realization — which allows basis recovery without requiring actual realization — would avoid such costs without much affecting the substantive results.[32]

3. **How much basis recovery should be allowed?** The USA Tax takes a compromise route that in many cases will defer basis recovery substantially. It is suggested that more generous treatment may be appropriate from the point of view of a consumption tax advocate who is concerned with savings incentives or who believes in certain equity norms with respect to the relative treatment of savers and consumers. In particular, incomplete basis recovery may create substantial pre-enactment incentives for dis-saving. One could provide more generous treatment directly, as through an immediate and full basis deduction, or spread basis recovery (and the corresponding revenue loss) over any number of years, as through an amortization schedule that permitted interest on or allowed indexing of unamortized basis.

The transition to a consumption tax, if one is to be enacted, involves many difficult decisions. Those concerning recovery of pre-enactment basis under an individual consumption tax are of two sorts. One concerns the extent of recovery; some thoughts have been offered here, but the issue remains conceptually and politically complex. Whatever degree of recovery is ultimately deemed appropriate, there is a further set of design issues. This discussion has suggested that in important respects — with regard to marginal incentives and complexity — the USA Tax System currently embodies undesirable alternatives from the perspective of a consumption tax advocate concerned with savings incentives and reducing tax-induced transaction costs. These problems can largely be remedied in a straightforward manner.

Finally, I note that whereas the current article is expressly confined to recovery of pre-enactment basis in financial assets under the individual tax, the analysis has many broader applications.

- The incentives for dis-saving created by the general basis account exist regardless of whether the balance is due to pre-enactment basis or other sources. (Under the USA Tax, tax-exempt income and some borrowing would augment the general basis account.)
- The conceptual analysis is applicable to pre-enactment borrowing as well. *In this respect, it is important to emphasize that whatever treatment is provided for basis, it should be provided for net basis — that is basis in pre-enactment assets net of pre-enactment liabilities.* Although a full discussion of borrowing is beyond the scope of this inquiry, it should be noted that the USA Tax, unlike a pure cash-flow consumption tax, provides a different system for liabilities than for assets, the details of which (both for individuals and business entities) take some account of transition issues involving pre-enactment borrowing.
- Some of the analysis also is applicable to the business tax.

But these and other applications each raise their own issues, both in principle and with regard to the proposed USA Tax treatment, so the reader is cautioned about extending the present discussion to other contexts. Moreover, because of the interaction of these other features with the treatment of pre-enactment basis in financial assets under the individual tax, a further caveat is in order even concerning the questions directly addressed here.

[32]Such a system would also make more transparent how one should forecast the revenue effects of the proposal. In its current form, a forecaster who was instructed to ignore behavioral responses might assume that the recovery of much basis would be significantly later than actually would be the case.