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INTRODUCTION

As the income gap between the rich and the poor widens, Americans have begun to demand reform.[1] The Occupy Wall Street

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1. *See* Jose Fernando Lopez, *Income Distribution and the Occupy Wall Street Movement*, HUFFINGTON POST (Nov. 8, 2011, 7:32 AM), http://www.huffingtonpost.com/jose-fernando-lopez/cbo-munitions-to-occupy-w_b_1080729.html.

movement is a recent reflection of the public's frustration.[2] The lowering of the effective tax rate for the very rich to 18% in 2008 from 30% in 1995 is often cited as the main cause for the income gap.[3] Tax experts, however, are aware that the drop in effective tax rates for the very rich over the years is only the tip of the iceberg; a much larger problem looms in the non-taxation of unrealized gains.[4] Although the very rich generate a majority of their income from the appreciation of their assets like stocks, business interest, and real estate,[5] the appreciation of that property can only be taxed when realized under the current law.[6] Mark Zuckerberg, a co-founder and chief executive officer of the popular social networking service Facebook, is an example of this phenomenon.[7] Some analysts estimated Mr. Zuckerberg's stake in Facebook to be worth as much as $28 billion before the IPO of the company.[8] Mr. Zuckerberg will not be taxed on his stake in Facebook unless he disposes of his shares.[9] If upon death, Mr. Zuckerberg bequeaths the shares to his heirs, his heirs will only pay tax upon sale of the stock only for the appreciation in value since Mr. Zuckerberg's death.[10]

Some call the realization rule "'the Achilles' heel' of the tax system, 'the root of many tax evils,' and . . . 'the most intractable problem in the income tax.'"[11] One explanation for the rule is the belief

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2. *See id*.

3. *Ultrarich Are Aware of Tax Loophole on Unrealized Gains*, INVESTMENTNEWS (Dec. 4, 2011, 6:01 AM), http://www.investmentnews.com/article/20111204/REG/312049976.

4. *See id.* ("The 800-pound gorilla is unrealized appreciation." (quoting Edward J. McCaffery)).

5. Arthur B. Kennickell, *Ponds and Streams: Wealth and Income in the U.S., 1989 to 2007*, 25–26 (Fed. Reserve Bd., Working Paper No. 2009-13, 2009), *available at* http://www.federalreserve.gov/pubs/feds/2009/200913/200913pap.pdf.

6. *See* Eisner v. Macomber, 252 U.S. 189, 212 (1920).

7. *See* David S. Miller, Op-Ed, *The Zuckerberg Tax*, N.Y. TIMES, Feb. 8, 2012, at A27, *available at* http://www.nytimes.com/2012/02/08/opinion/the-zuckerberg-tax.html.

8. *Id.*

9. *Id.*

10. *Id.*

11. David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549, 1551 (1998) (citing William D. Andrews, *The Achilles' Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S, at 278, 280 (Charls

that unrealized gains cannot be employed for "separate use and benefit" unless realized,[12] but the reality is that there are ways for the wealthy to generate cash for consumption, completely tax-free, without ever needing to dispose of their assets.[13] For example, Mr. Zuckerberg can simply use his stocks as collateral to borrow against, thereby avoiding tax liability while enjoying the fruits of his enormous unrealized wealth.[14] This scenario is even more likely today, when the interest rates for the very rich have plummeted to almost 1%.[15] Mark Zuckerberg's ability to avoid taxes on his enormous wealth is only a very recent example of how the very rich can take advantage of "Tax Planning 101."[16]

Thirty-five years after its first publication, William D. Andrews' seemingly radical approach, adopting a consumption-based tax system to solve the problem with the realization rule,[17] draws renewed interest. The proposal provides simple solutions to the efficiency and equity problems of the realization rule without creating new complications.[18] Unlike other proposals, Andrews' forgotten approach to solving the realization rule puzzle is simple and creates few undesirable consequences.[19] Part I of this Note explores the historical and legal framework of the realization rule and its relation to income. In addition, Part I discusses the equity and efficiency problems of the realization rule and provides legal background for Andrews' proposal. Part II of this Note examines the numerous proposals that have emerged since the adoption of the realization rule. Moreover, Part II uses classic tax policy

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E. Walker & Mark A. Bloomfield eds., 1983); Edward D. Kleinbard & Thomas L. Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, 75 TAXES 788, 789 (1997); Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725, 728 (1992)).

12. Eisner v. Macomber, 252 U.S. 189, 211 (1920).

13. *See* Miller, *supra* note 7.

14. *Id.*

15. *See Ultrarich Are Aware of Tax Loophole on Unrealized Gains*, *supra* note 3.

16. *See* Edward J. McCaffery, *A New Understanding of Tax,* 103 MICH. L. REV. 809, 893 (2005) (citing Roger Gordon et al., *Do We Now Collect Any Revenue from Taxing Capital Income?*, 89 J. PUB. ECON. 981 (2004)) (discussing historical examples of a wealthy person's tax planning activities).

17. *See infra* Part III.

18. *See infra* Part III.

19. *See infra* Part III.

analysis to explain the equity and efficiency problems of the mark-to-market, interest-on-tax, and retrospective taxation proposals. Part III of this Note explores Andrews' proposal in detail and explains why Andrews' consumption tax system effectively solves the realization rule problem. Part III also addresses critics' concerns of the consumption tax system.

I. A HISTORICAL PERSPECTIVE OF THE REALIZATION RULE PROBLEM AND ITS RELATION TO INCOME

Section A of Part I takes a historical look at how the realization rule became part of the definition of income. Then, Section B explores the equity and efficiency problems that the realization rule creates. Section C examines several of the remedial proposals that have emerged in response to the realization rule. Finally, Section D provides historical background for Andrews' consumption tax proposal and explains why Andrews' proposal becomes relevant today.

A. THE MEANING OF INCOME

There is no universal agreement on the meaning of income.[20] Economists generally view income differently from governmental entities, and economists and experts within government disagree among themselves.[21] The result is an income tax base that is a hybrid of economic, political, and legal concepts.[22] Economists understand income as the periodic sum of consumption and changes in savings and investments, which follows the Haig-Simons conception of income.[23] While the United States Constitution gives Congress the power to "[t]o lay and collect taxes," it does not define income.[24] The Sixteenth Amendment of the Constitution provides that "Congress shall have the

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20. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION 50–51 (1938); Eisner v. Macomber, 252 U.S. 189 (1920).

21. Marjorie M. Kornhauser, *The Story of* Macomber*: The Continuing Legacy of Realization*, *in* TAX STORIES, 93, 95 (Paul L. Caron ed., 2003).

22. Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 930–32 (1967).

23. *See* SIMONS, *supra* note 20, at 50.

24. U.S. CONST. art. I, § 8, cl. 1.

power to lay and collect taxes on incomes, form whatever sources derived."[25] The Tax Code echoes the Sixteenth Amendment, defining income as "all income from whatever source derived" and provides a non-exclusive list of 15 sources of income.[26] Section 61 of the Internal Revenue Code further defines gross income.[27]

In *Eisner v. Macomber,*[28] the Supreme Court limited taxable income to income realized and explained that income is neither a gain accruing to capital, nor a growth or increment of value in the investment.[29] Rather, the Court concluded that income could only consist of funds received or drawn by the taxpayers for his use, benefit, and disposal.[30] The *Macomber* Court not only redefined taxable income but it also made the realization rule a constitutional requirement.[31]

After *Macomber*, the Supreme Court tried to loosen the realization requirement by defining which events constitute realization.[32] The most significant departure from *Macomber* was the decision in *Helvering v. Bruun*.[33] In *Bruun*, the Court held that "separation from capital" was not an all-inclusive definition of realization.[34] Ten days later, the Court went on to explain in *Helvering v. Horst*[35] that realization was a rule "founded on administrative convenience" and meant only to delay taxation.[36] The Court, however, never fully overruled *Macomber*'s institution of realization as a constitutional requirement.[37]

Despite the Court's unwillingness to obviate the realization rule as a constitutional requirement, Congress has enacted several statutes that abandon this rule. Section 1256 of the Code treats certain contracts on a mark-to-market basis partially in order to avoid the long-standing

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25. U.S. CONST. amend. XVI.
26. I.R.C. § 61(a) (2006).
27. *Id.*
28. 252 U.S. 189 (1920).
29. *Id.* at 193.
30. *Id.*
31. *See id.*
32. *See, e.g*, United States v. Phellis, 257 U.S. 156 (1921).
33. 309 U.S. 461 (1940).
34. *Id.* at 468–69.
35. 311 U.S. 112 (1940).
36. *Id.* at 116.
37. Rodney P. Mock & Jeffrey Tolin, *Realization and its Evil Twin Deemed Realization*, 31 VA. TAX REV. 573, 592 (2012).

problem of straddles.[38] A straddle is a contract for futures or options where one position is long and the other is short, and the gain in one position is offset by loss in the other.[39] Until the adoption of § 1256, it was possible to declare the losing position in one year and the gain in the next year.[40] This would generate a deduction against other income in the first year and that loss would be carried forward to the next year.[41] Section 1256 requires that both sides of the transaction be reported on a mark-to-market basis at year-end.[42] In addition, Congress has enacted § 475, which requires dealers in securities to report their shares on a fair market basis at the last business day of the year.[43] Furthermore, lessors and lessees are required to maintain certain payments for the use of property or services on an accrual basis under § 467.[44]

B. PROBLEMS POSED BY THE REALIZATION RULE

If the federal income tax structure is designed to guarantee the same rate of tax on all income, then the realization rule violates both horizontal and vertical equity.[45] Vertical equity is violated because under the realization rule, it is wealthy taxpayers who mainly benefit from the deferral of tax.[46] Similarly, horizontal equity is compromised because the same level of income from different sources is taxed differently under the current tax system.[47]

The realization rule violates vertical equity because the wealthy benefit disproportionally from this rule. Vertical equity demands higher income taxpayers to be taxed more heavily than lower income

38. I.R.C. § 1256 (2006).

39. 57 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS:CURRENT THROUGH 2012*,* at 1 (2012).

40. *Id.*

41. *Id.*

42. HARVEY S. ROSEN, PUBLIC FINANCE 147, 334 (7th ed. 2005).

43. I.R.C. § 475 (2006).

44. I.R.C. § 467 (2006).

45. *See* Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 392 (2004) (citing Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX. REV. 39, 42 (1996) (noting that if efficiency were the only concern, different rates on labor and capital income might be preferable).

46. *See* Kennickell, *supra* note 5.

47. *See* Schenk, *supra* note 45, at 393.

taxpayers.[48] Unrealized capital gains represent a larger portion of the income of the wealthy because they can afford to hold large amounts of capital.[49] In addition, capital needs to be held for a long period of time in order for its holder to benefit from the tax deferral, again something that wealthy taxpayers are able to afford.[50] Moreover, taking full advantage of the realization rule requires careful tax planning that is typically used by the wealthy.[51] Finally, because wealthy taxpayers can borrow against their unrealized gain to support their lifestyle and later pass the gain to their heirs, they are able to avoid tax altogether.[52] To the extent that wealthy taxpayers benefit disproportionally from the tax deferral, vertical equity is violated.

Horizontal equity requires that the tax system treat similarly situated individuals the same.[53] Similarly situated individuals for tax purposes are those individuals who have the same levels of income regardless of the source.[54] Under the current tax system, however, income from different sources is treated differently.[55] Moreover, accrued gains are taxed on a stepped up basis when appreciated property is transferred to charity or held until death.[56] Inequities would result only if the tax savings are not fully capitalized into the price of the asset.[57] It is unlikely that the tax advantage of an asset is capitalized fully into its price for many reasons, including different marginal and effective rates, difficult entry barriers to the market, loss limitations, and

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48. HARVEY S. ROSEN, PUBLIC FINANCE 15, 148, 334 (7th ed. 2005).

49. *See* Schenk, *supra* note 45, at 393.

50. *Id.*

51. *Id.*

52. Edward J. McCaffery, *The Uneasy Case for Capital Taxation*, 23 SOC. PHIL. & POL'Y 166, 175 (2006), *available at* http://journals.cambridge.org/action/displayFulltext?type=1&fid=439801&jid=SOY&volumeId=23&issueId=02&aid=439800&bodyId=&membershipNumber=&societyETOCSession=#.

53. Richard J. Wood, *Supreme Court Jurisprudence of Tax Fairness*, 36 SETON HALL L. REV. 421, 422 (2006).

54. *See* Jeffrey L. Kwall, *When Should Asset Appreciation be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77, 92 (2011) (citing RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY 160 (1959)).

55. *See, e.g.*, Desco Prods. Caribbean, Inc. v. 'Virgin Islands, 511 F.2d 1157 (3d Cir. 1975) (applying Virgin Islands law); Miles v. Dep't of Treasury, 199 N.E. 372 (Ind. 1935); Welch v. Henry, 223 Wis. 319 (1937).

56. See I.R.C. § 1014(a) (2006).

57. Schenk, *supra* note 45, at 394.

taxpayers who do not change their investment behavior based on tax advantages.[58] Therefore, it seems unlikely that the tax benefits of the realization rule are fully capitalized into the price of the assets and certain sources of income are taxed at preferential effective tax rates.[59]

The realization rule in its pure form results in multiple inefficiencies.[60] Further distortions are caused by government's efforts to correct for some of the inefficiencies.[61] These inefficiencies can be roughly divided into distortions in taxpayers' behavior and inefficiencies caused by the transactional cost to both the taxpayers and the government associated with avoiding or administering the rule.[62] Moreover, the realization rule causes serious revenue effects.[63]

1. Lock-in Effect and Loss Limitations

The realization rule creates a lock-in effect that discourages many taxpayers from making divestment decisions purely based on whether it would make sense to do so.[64] This has been cited as a partial reason for the lower rates on capital gains.[65] However, while the alternative of simply borrowing against unrealized gains and paying no income tax exists, the lock-in effect will not be fully neutralized with lower rates on capital gains because the interest charges for the very rich are only a fraction of the reduced tax rate on capital gains.[66] The amnesty given to unrealized capital gains at death allows many taxpayers to borrow against their realized and unrealized assets, and never pay tax.[67] This is because the Code allows taxpayers to bequest assets to their heirs at a

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58. *Id.* at 394–96.
59. *Id.*
60. Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 25 (1993).
61. *Id.*
62. *Id.* at 24.
63. *Id.*
64. Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45, 50 (1998).
65. *See* Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 344 (1993) ("The lock-in effect describes an investor's reluctance to incur a tax on realization of gains . . . .").
66. McCaffery, *supra* note 16, at 896.
67. McCaffery, *supra* note 16, at 892–93.

step-up basis.[68] As a result, the capital gain that had accumulated until that moment is never taxed.[69] A consequence of this treatment is an exaggerated lock-in effect.[70]

2. Transactional Costs

Another source of inefficiency is the transaction costs associated with using the realization rule to one's economic advantage.[71] These costs include information costs and fees paid to lawyers or accountants to provide information about the law and various tax planning strategies.[72] The complexity of the realization rule drives information costs even higher,[73] as well asthe complexity of legislative responses that seek to limit the abuse of the realization rule.[74] Such responses include loss limitation rules to deter strategic trading or expense allocation, as well as provisions designed to recover some of the benefits of deferral.[75] Lastly, the capital gains preference adds another wrinkle of complexity.[76]

In order to limit the scope and abuses of the realization rule, Congress must constantly adopt new provisions.[77] Legislation is a continuous and costly battle because often, limiting one abuse simply shifts taxpayers' behavior to a new scheme.[78] For example, Congress adopted § 1259 to limit an investor's ability to benefit from economic gain while deferring their tax obligation;[79] however, § 1259 did not

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68. I.R.C. § 1014 (2006); Calvin H. Johnson, *Taxing the Consumption of Capital Gains*, 28 VA. TAX. REV. 477, 502 (2009).

69. Johnson, *supra* note 68, at 502.

70. *Id.*

71. Schenk, *supra* note 45, at 391.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 392.

77. *See id.* at 388 (citing I.R.C. § 1211 (2006) (limitations on capital losses); I.R.C. § 1091 (2006) (losses on wash sales); I.R.C. § 1092 (2006) (straddle rules); I.R.C. § 267 (2006) (losses on sales to related parties) I.R.C. § 163(d) (2006) (limitations on interest deductions); I.R.C. § 469 (2006) (passive loss rules)).

78. Schenk, *supra* note 45, at 392.

79. *Id.* at 388.

foreclose all opportunities to defer gain.[80] As a result, taxpayers have replaced a short-against-the-box transaction strategy—a short sale by a individual with a long position in the same securities—with one where the investor retains 25% of the risk.[81] Overall, the realization rule causes taxpayers and the government to incur substantial transaction costs.[82] Most of these transaction costs do not raise revenue.[83] It is unlikely that any tax reform will entirely eliminate transactional costs but such costs should be a main consideration in evaluating reform proposals.[84]

3. Revenue Effect

Tax deferral under the realization rule, the many ways taxpayers are able to decrease their tax bill, and the possibility of complete tax avoidance under the buy/borrow/die tax planning strategy, significantly affect government's revenue.[85] By deferring tax payments under the realize rule, the value of the tax paid will be worth less because of inflation.[86] In addition, the preferential rates for capital gains lower the government's revenue even further.[87]

II. PROPOSALS AIMING TO ADDRESS THE REALIZATION RULE PROBLEMS

Numerous proposals have emerged in an attempt to remedy problems that arise under the realization rule. One such proposal is a mark-to-market system where gains and losses are taken into account each year whether realized or not.[88] Under this regime, on the last day of the year, each unsold asset is treated as if it had been sold that day at

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80. *Id.*
81. *Id.*
82. *Id.* at 392.
83. *Id.*
84. *Id.*
85. *See supra* notes 3–4 and accompanying text.
86. Schizer, *supra* note 11, at 1563.
87. *See* I.R.C. § 1(h) (2006).
88. Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 541 (2004).

a price equal to its fair market value, and then reacquired at the same price.[89] Other proposals offer to preserve the realization rule but suggest ways to eliminate some of the negative consequences of the realization rule.[90]

The interest-on-tax deferral proposals preserve the realization requirement by assuming that the proper time to tax is upon a realization event.[91] This proposal views the deferred tax as a loan from the government where interest should be charged.[92] In this way, the interest-on-tax deferral proposals attempt to eliminate the deferral benefits of the realization rule under the current system and restore horizontal and vertical equity.[93] Similar to the interest-on-tax deferral approach, retrospective proposals also preserve the realization requirement while stripping the deferral benefits under the current system.[94] Retrospective proposals split the ex post return of an asset into a return to waiting and return to risk, allocate the returns over the holding period, and impose interest on the deferred taxes at the risk-free rate.[95]

Part II provides a detailed tax policy analysis of the main proposals for reforming the realization rule. Section A analyses a mark-to-market system, while Section B evaluates proposals that preserve the realization rule but attempt to strip deferral tax benefits. Specifically, Section B looks at interest-on-tax deferral proposals and retrospective taxation proposals. Part C discusses retrospective taxation. Part D introduces Andrews' proposal for a consumption tax system.

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89. *Id.*

90. *Id.*

91. Cynthia Blum, *New Role of the Treasury: Charging Interest on Tax Deferral Loans*, 25 HARV. J. ON LEGIS. 1 (1988); Roger Brinner, *Inflation, Deferral and the Neutral Taxation of Capital Gains*, 26 NAT'L TAX J. 565, 570–71 (1973).

92. Schenk, *supra* note 88, at 541.

93. *Id.*

94. *See* Land, *supra* note 64, at 83, 107; Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167, 167 (1991); David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 Tax L. Rev. 731, 738 (1995).

95. Schenk, *supra* note 88, at 541.

A. A MARK-TO-MARKET SYSTEM

A mark-to-market system presents a perfect world where capital gains are taxed on a periodic basis in a manner consistent with the taxation of other income, such as wages.[96] While this approach will solve many of the problems with the realization rule,[97] a new subset of efficiency and equity concerns emerges.[98] This explains why a mark-to-market system has not been adopted.[99]

A mark-to-market system presents serious liquidity concerns.[100] A system that taxes increases in net worth without regards to liquidity will distort taxpayers' behavior much more than one that taxes at sale when cash is available.[101] Under a mark-to-market system, tax is due at year-end regardless of whether the gain is realized and the taxpayer is able to pay the tax.[102] This will cause forced liquidations, which is especially problematic for real estate, closely held businesses, and other non-divisible assets.[103] Some commentators believe that liquidity is not a significant concern and is not a sufficient justification for the realization rule.[104] These commentators point out that Congress currently imposes taxes in situations where liquidity is a concern as in swaps of properties.[105] Taxpayers are also subject to tax when they are compensated with property regardless whether they decide to sell the property.[106] Also, accrual based taxpayers have tax obligations without receipt, and any liquidity concerns are simply considered the cost of doing business.[107]

Nevertheless, these situations are deviations from the norm. Currently, taxpayers are generally put on notice when they have to pay

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96. Fred B. Brown, *"Complete" Accrual Taxation*, 33 SAN DIEGO L. REV. 1559, 1562 (1996).
97. *Id.* at 1565–66.
98. Schenk, *supra* note 88, at 541.
99. Schenk, *supra* note 45, at 374.
100. Land, *supra* note 64, at 65.
101. *Id.* at 55.
102. *Id.* at 59.
103. *Id.* at 110.
104. Schenk, *supra* note 45, at 360.
105. *Id.* at 361.
106. *Id.*
107. *Id.*

tax, which helps them factor in the cost of such tax in their decision to engage in particular transaction.[108] A mark-to-market system would not always give taxpayers any forewarning or options to avoid the tax.[109] This can be particularly problematic in situations where assets are not easily sold.[110] Even more problematic is a situation where the taxpayer's only asset is his home or family farm.[111] While liquidity problems alone do not justify the realization rule, the liquidity concerns in a pure mark-to-market system will require multiple exemptions to be carved out in order to minimize the disruptiveness of such system.[112]

A second frequently cited problem to a mark-to-market system is valuation.[113] An accretion tax would require that all assets are valued at the end of the year.[114] Some believe that the resulting administrative burden is almost prohibitive.[115] Others see the valuation concern as not so easily assessed.[116] Those who do not see valuation as a significant problem cite to studies showing that the annual inventory of publicly traded securities would not be so burdensome.[117] These advocates also point to the transfer system, real estate annual valuations, and estate taxes as examples of valuations that are relatively stable and not as problematic.[118] Although such valuations are not always accurate, proponents of a mark-to-market system say that an approximate valuation might be sufficiently acceptable and therefore valuation should not be a significant reason to reject the mark-to-market system.[119]

108. Land, *supra* note 64, at 55.
109. *Id.*
110. *Id.*
111. Schenk, *supra* note 45, at 363.
112. *Id.* at 365.
113. DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 73 (2d ed. 1984).
114. Brown, *supra* note 96, at 1562.
115. Thomas L. Evans, *The Evolution of Federal Income Tax Accounting-A Growing Trend Towards Mark-to-Market?*, 67 TAXES 824, 825 (1989).
116. *See* Schenk, *supra* note 45, at 366.
117. Thomas L. Evans, *The Realization Doctrine After* Cottage Savings, 70 TAXES 897, 898 (1992) ("This argument is clearly overblown for some types of property, such as publicly traded securities. Nevertheless, it has the ring of validity for many types of property." (footnote omitted)).
118. *See* Schenk, *supra* note 45, at 366.
119. *Id.*

Critics of the mark-to-market system also note that estate taxes and property taxes under the current system are different than the scale of valuation that will be required under a mark-to-market system.[120] While estate taxes are imposed on limited wealthy taxpayers, a mark-to-market system will apply to a far larger segment of the population. Even those who accept an approximation of estate taxes for the wealthy might be unwilling to compromise to inaccurate calculations for those less well-off.[121] Property taxes are also easier to calculate because they typically apply only to real estate within a given community and track only relative property values, and these values are unlikely to change dramatically year to year.[122]

Valuation is even more complex for unique items such as jewelry, closely held businesses, artwork, etc.[123] At least one critic has recognized that since everything can be valued, the real issue is how much such annual valuations would cost.[124] While the taxpayers will have to bear the majority of such cost, the government will also have to absorb some of the cost of monitoring.[125] The taxpayers have little incentive to get the valuation right, and, therefore, the government will have to spend significant resources to monitor the correct valuation of assets.[126]

Society's deep-rooted intuition is that paper-gains are "insufficiently authentic to be taxed."[127] That perception is grounded in the idea that returns based on market risk are transient and taxpayers should not be subject to payment while that market risk continues to exist.[128] Critics argue that a mark-to-market system assumes that assets have value based on their potential to be sold when, in reality, their value is only hypothetical without an actual sale.[129] Some critics believe

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120. Land, *supra* note 64, at 56.
121. *Id.*
122. *Id.*
123. Schenk, *supra* note 45, at 367.
124. *Id.*
125. *Id.* at 367–68.
126. *Id.* at 368.
127. Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 893 (1997).
128. Schenk, *supra* note 45, at 377.
129. Land, *supra* note 64, at 56–57.

that no valuation model can assign true value to an asset because value is not an intrinsic property of an asset.[130] The income tax system appears to be socially acceptable because it is based on ability to pay.[131] Ability to pay is related both to net worth and liquidity.[132]

B. INTEREST-ON-TAX DEFERRAL PROPOSALS

"These proposals take the realization requirement as a given but assume that the proper time to tax (if it were possible) is when the income accrues."[133] Currently, the tax liability is treated as an interest-free loan from the government.[134] The interest-on-tax deferral proposals suggest that the government ought to charge a fee for these interest-free loans.[135] As such, "the investor allocates the gain or loss over the holding period of the investment, calculates tax for each year, and imputes the interest on the under- or overpayment of taxes;"[136] however, the proposals are problematic in terms of the correct valuation of the interest and even liquidity.[137]

The main valuation problem is similar to the problem that is present under the mark-to-market system.[138] The correct amount of the "loan" and interest cannot be calculated without determining what the taxpayers would have owed at the end of each year.[139] Because such calculations would be prohibitively complex, most proposals involve simplified interest calculation using the assumption that the gain grew ratably or at some compound rate.[140] Both methods of calculation are likely to either under-tax or over-tax the taxpayer.[141] Consider a constant rate model, which would result in a larger loan later in the period because of the effects of compounding.[142] The outcome is an

130. *Id.*
131. Land, *supra* note 64, at 55.
132. *Id.*
133. Schenk, *supra* note 88, at 537.
134. *Id.*
135. *Id.*
136. *Id.*
137. *See id.* at 538–39.
138. Land, *supra* note 64, at 56.
139. Schenk, *supra* note 88, at 538.
140. *Id.*
141. *Id.*
142. *Id.*

overstatement of the loan in the early period, and thus, an increased amount of interest.[143] In cases where most of the gain accrued late in the holding period, there will be a large interest charge without a matching deferral.[144] Thus, the tax will be overstated.[145] Conversely, if the gain accrued immediately after acquisition, the taxpayer will be under-taxed.[146] The potential over-taxation and under-taxation will likely cause distortions as taxpayers whose assets surged in value immediately after acquisition will try to hold on to assets in order to take advantage of the lower tax for deferral and those whose assets suddenly spiked in value will look to sell those assets.[147]

Another valuation problem is that the use of the sale price might not be an accurate measure of the correct amount of tax loan.[148] This will result in under-taxation.[149] Another administrative problem related to valuation is fixing the interest rates.[150] It is unclear whether the taxpayer's or the government's borrowing rate should be used.[151] Using the taxpayer's rate will be problematic because of the immense information gathering that would be required and the inequities that will result from taxpayers with poor credit ratings having to pay the highest interest charges.[152] However, using the government's borrowing rate is also challenging because a rate that is different from the taxpayer's borrowing rate will affect the taxpayer's borrowing decisions, particularly for taxpayers with bad credit.[153] Another problem with this approach is that the interest rate will have to remain constant which will cause further distortions and inaccuracies related to unequal conditions at the time of acquisition and time of sale.[154]

Interest-on-tax proposals are appealing because they seem to restore vertical and horizontal equity without causing the efficiency

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143. *Id.*
144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.* at 539.
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.* at 540.

problems of the accretion system.[155] However, because accurate calculation of the tax and interest will be extremely complex, simplified accounting will result in over and under calculation of the tax.[156] This will affect horizontal equity, as similar levels of income will be taxed differently depending on the length of the loan and the period in which the asset increased in value.[157]

C. Retrospective Taxation

Retrospective proposals also preserve the realization requirement while shedding the deferral benefits under the current system.[158] Alan Auerbach first developed such approach, later followed by David Bradford and Stephen Land.[159] The Auerbach and Bradford proposals are conceptually different from Land's proposal.[160] Auerbach and Bradford suggest a division of the ex post return into a "return to waiting" and "return to risk," followed by an allocation of the returns over the holding period, and charging interest at the risk-free rate on the deferred taxes.[161] Land's proposal is different in that it does not look at the deferred tax as a loan from the government but as an "equity investment by the government."[162]

Because the retrospective proposals correct the effects of the realization requirement, they promote greater horizontal and vertical equity. The retrospective proposals aim to draw no distinction between those investors who defer realization and those taxed on their income annually by eliminating the effect of the deferrals.[163] This approach promotes horizontal equity.[164] Moreover, since the realization requirement mainly favors the wealthy, stripping the deferral benefits of the realization rule, advances vertical equity.[165]

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155. *See id.* at 540–41.
156. *Id.*
157. *See id.*
158. *See* Land, *supra* note 64, at 47; Auerbach, *supra* note 93, at 167; Bradford, *supra* note 94, at 738.
159. *Id.*
160. Schenk, *supra* note 88, at 541.
161. *Id.*
162. Land, *supra* note 64, at 83.
163. *Id.* at 109.
164. *Id.*
165. *Id.*

A main advantage of the Auerbach/Bradford proposals is that they eliminate any incentives to defer the realization of gains, because "taxpayers would be in the same position regardless of when disposition takes place."[166] Like the interest-to-tax deferral proposals, the Auerbach/Bradford proposals remove liquidity issues by preserving the realization requirement and eliminate the timing option by levying an interest charge.[167] Valuation issues are resolved because only the sales price is relevant.[168] In addition, arbitrage problems, which arise "when equivalent cash flows are packaged in different ways," are eliminated by disaggregating all investments into returns to waiting and returns to risk.[169]

Critics argue that there is an opportunity to manipulate the amount of taxes paid by using entity-shifting means,[170] even though the avoidance cost under the current system is believed to be much larger.[171] Schenk claims that the true issue with the proposal will come from its complexity, and the difficulty in understanding the calculations and elections that will be required.[172] Taxpayers are likely to be confused "by the possibility of being taxed on a hypothetical gain recognition date that could occur even before the asset was acquired," and further by the potential mismatch between the "gain" reported and the profit the investor would believe had occurred.[173]

Under Land's proposal, the tax due at realization would equal the pretax yield reduced by the tax rate.[174] Land uses as an example a taxpayer, T, who invests $1,000 at a pretax interest rate of 10%. If not taxed, after 10 years the investment would grow to $2,718.[175] Assuming a tax rate of 35%, the after-tax yield for a 10-year investment would be 6.5%, or $1,916. In other words, the government should receive $802

166. Schenk, *supra* note 88, at 542.
167. *Id.*
168. *Id*.
169. *Id*.
170. *See* Michael S. Knoll, *Tax Planning, Effective Marginal Tax Rates and the Structure of the Income Tax*, 54 TAX L. REV. 555, 571–75 (2001).
171. Schenk, *supra* note 88, at 543.
172. *Id.* at 543–44.
173. *Id.* at 544.
174. Land, *supra* note 64, at 73.
175. *Id*.

($2,718-$1,916). [176] Under the current system, however, the government collects $601 because the tax rate is applied on the nominal gain of $1,718, while the extra $201 is the tax deferral benefit. The main benefit of Land's method is that it resolves many of the valuation problems of the interest-on-tax proposals.[177] Under Land's retrospective method, the tax is not dependent on the holding period and thus the interest charged does not depend on the holding period.[178] In addition, the timing of the appreciation is irrelevant, which solves the under/over taxation problems of the simplified accounting under the interest-on-tax proposals.[179] Moreover, Land's method taxes capital uniformly with no opportunity for substitution.[180] The proposal also does not present any liquidity problems and resolves the lock-in problem and strategic trading.[181]

Land argues that the taxpayer will have an incentive to get the valuation right because an accurate valuation is in the taxpayer's best interest.[182] Therefore, according to Land, the government can benefit from its reliance on the taxpayer's calculations.[183] Critics argue that this will be true only if tax and interest rates remain the same.[184] If the rates change, reliance on taxpayers' calculations will no longer be possible.[185] Moreover, even if rates do not change frequently, the valuation expense to the taxpayers will be significant. Land argues that the calculations only appear complex, but in reality the proposal has the potential to eliminate much of the complexity that already exists under current law.[186] Even so, Land acknowledges that simple models would not work well in complex situations, such as when an asset has multiple pay offs.[187] Critics believe that valuations under Land's approach will be more complex and required more often than under an accrual model.[188]

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176. *Id.*
177. *Id.*
178. Schenk, *supra* note 88, at 544.
179. *Id.* at 545.
180. *Id.*
181. *See id.*
182. Land, *supra* note 64, at 89–90.
183. *Id.* at 100–01.
184. Schenk, *supra* note 88, at 545.
185. *Id.*
186. Land, *supra* note 64, at 111.
187. *Id.* at 87.
188. Schenk, *supra* note 88, at 546.

It is unclear whether the valuation expense under Land's proposal is going to be lower than the cost under a mark-to-market system.[189]

Land acknowledges that another problem with his method will be the way it treats losses.[190] In situations where a single asset is disposed at a loss but the portfolio shows a gain, the investor will owe tax.[191] Finally, the main problem will still be the complexity of the proposal. Land's method involves difficult formulas, the results will be sometimes counter-intuitive, and frequent valuations will be required.[192] The cost to the taxpayer will be significant and individuals with "any kind of investment (stick, home, IRA) would be subject to the rule."[193] This will discourage investments in capital income, which makesit likely that the administrative costs from adopting the proposal outweigh the increased revenue.[194]

D. ANDREW'S PROPOSAL FOR REFORM

William D. Andrews' article, published in 1974, challenges the idea that the income tax burdens savings in an effective way.[195] Andrews saw the problems with the realization requirement early, and called it the "Achilles heel" of the income tax system.[196] Andrews believed that the rule made the tax law too uncertain and complex.[197] He recognized that the rule needed to be fixed and believed that a consumption tax offered an easier and more just solution.[198] According to Andrews, the consumption tax system allowed for a tax deferral on savings that resulted from realized income, while taxing the eventual consumption of

189. *Id.*
190. Land, *supra* note 64, at 92.
191. *Id.*
192. Schenk, *supra* note 88, at 547.
193. *Id.*
194. *Id.*
195. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1118 (1974).
196. Schizer, *supra* note 11, at 1551 (citing William D. Andrews, *The Achilles' Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S, at 278, 280 (Charls E. Walker & Mark A. Bloomfield eds., 1983)).
197. *Id.*
198. Andrews, *supra* note 195, at 1118.

these savings at full, ordinary income rates.[199] Andrews' solution was a post-paid consumption tax system, which would resolve many of the inequities and inefficiencies related to the realization rule under the current income tax system.[200] This section examines Andrews' proposal, and addresses critics' concerns.

Under Andrews' model, ordinary investments would be deducted in the same year they were invested and proceeds from their sale will be taxed if not reinvested at the same rate as ordinary income.[201] This treatment will be very similar to the treatment under the current system and the realization rule.[202] The difference will come from all ordinary income being taxed at the same time as realized capital gains, when consumed and not when earned.[203] Andrews recognizes that the treatment of assets held for both investment purpose and personal enjoyment, such as artworks, jewelry, and personally occupied real estate, will require for a decision to be made as to whether a deduction will be allowed for such assets.[204] For example, in an ideal consumption tax system, a valuable painting, which is purchased for investment purposes but is also hung on the wall for the owner's enjoyment, should be taxed annually because the owner consumes the enjoyment of looking at the painting.[205] At the same time, the painting was purchased for investment purpose as well as personal enjoyment and therefore its purchase price will be deducted from taxable income for the year.[206]

Even more common would be the case with owner's occupied residence. If a family buys a second property for investment purposes but also uses that property for summer vacations, then that property would be a hybrid between an investment asset and property used for personal consumption.[207] Andrews acknowledges that the decision of how to treat such assets would not be easy but he also points to the treatment of hybrid assets under a true-accretion type tax, which would necessitate the annual calculation of imputed income from the

199. *Id.*
200. *Id.*
201. *Id.* at 1151.
202. *Id.*
203. *Id.*
204. *Id.* at 1160.
205. *Id.*
206. *Id.*
207. *Id.*

enjoyment of such property.[208] Andrews notes that the problem would exist only when hybrid assets are sold at a loss because if such assets were sold at a gain, the tax imposed on the gain would be "taxable in any event."[209]

III. GOING TO BACK TO BASICS: FIXING THE REALIZATION RULE WITH A CONSUMPTION TAX

Andrews' "most sophisticated argument" for a consumption tax system is the model's pre-tax neutrality with respect to taxpayers' preference for saving or spending.[210] Andrews contends that the consumption tax does not discriminate between individuals whose present or future taste for certain goods and services is different than the preferences of other individuals.[211] Andrews' argument is one of horizontal equity, an argument that society in 1974 was not prepared to understand.[212] Andrews' consumption tax system eliminates all of the distortions caused by the realization rule under the current system and the valuation and liquidity concerns under a mark-to-market system.[213] Moreover, the added benefit of the system's simplicity is another reason why a consumption tax system is the most efficient way to solve the realization rule problem.[214]

Tax on consumption is source-neutral and thus it does not distort investment decisions. In other words, because investments from all sources are taxed at the same rate and at the same time, tax consequences will not influence investors' investment choices.[215] In comparison, under the realization rule, tax is paid upon the triggering of a realization event, which occurs at different times for different investments, and thus, distorts investment decisions ex ante.[216] In addition, a consumption tax solves distortions ex post, and the lock-in

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208. *Id.*
209. *Id.*
210. *Id.* at 1167–68.
211. *Id.*
212. McCaffery, *supra* note 16, at 842.
213 See Andrews, supra note 195, at 1152–53.
214. *See id.* at 1152.
215. *See id.* at 1153.
216. Shaviro, *supra* note 60, at 25.

effect of the realization rule is eliminated.[217] That is because divestments are taxed only if consumed.[218] If the proceeds are reinvested, there is no tax.[219]

Furthermore, a consumption tax system solves many of the valuation problems under the current system.[220] The treatment of unrealized capital gains under the current income tax system is partially justified because of the cost of appraisals under a mark-to-market system.[221] A consumption tax eliminates this costly alternative because it does not require the appraisal of unrealized gains.[222] In addition, a consumption tax eliminates the need for special tax rates for capital gains,[223] which is sometimes justified with the lock-in effects of the realization rule.[224] A consumption tax system treats unrealized gains and realized reinvested gains the same, and there is no need for preferential rates.[225] Moreover, the valuation problem that results from the difficulty to separate risk-free return and market risk would disappear.[226] Under a consumption tax model, no tax would be paid in uninflated dollars, as it would have been under mark-to-market system. Also, old costs would no longer be subtracted from current, inflated sales prices that currently result in miscalculations to profits.[227]

Liquidity issues are also solved because tax is payable only when there is current consumption and the cash is available.[228] Also, the hardship under the current system of recognizing and paying tax in one year on a gain accrued over many years is eliminated because only proceeds devoted to current consumption is taxed.[229] Furthermore, the buy/borrow/die loophole[230] is closed with a consumption tax system.[231]

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217. *See* Andrews, *supra* note 195, at 1153.
218. *Id.*
219. *Id.*
220. *See id.* at 1152.
221. Evans, *supra* note 117, at 825.
222. *See* Andrews, *supra* note 195, at 1152.
223. *Id.*
224. *See* Cunningham & Schenk, *supra* note 65, at 320.
225. *See* Andrews, *supra* note 195, at 1152–53.
226. *Id.* at 1150.
227. *Id.* at 1153.
228. *Id.*
229. *Id.* at 1152–53.
230. McCaffery, *supra* note 16, at 893.
231. *Id.*

Taxpayers can no longer borrow against their unrealized gains and wait to pass accumulated gains to their heirs at a step-up basis.[232] Lastly, the administrative and compliance cost of a whole area of the law concerning the effect on individual investors in corporate reorganizations is obsolete with a consumption tax system.[233] Because the exchange of securities is treated as a reinvestment, investors can take advantage of a deduction and no tax is due until divestment.[234] Similarly, no tax is imposed on compensation paid in stock or restricted property.[235] Again, the tax awaits divestment and consumption.

The current income tax system is not a perfect one, and is a hybrid of income and consumption tax.[236] The hybrid aspect of the system leads to horizontal inequities because equal income from different sources is not taxed equally.[237] The consumption tax system eliminates horizontal inequity because it taxes all consumption equally.[238] A consumption tax system is fairer than an income tax system because people tend to consume at a steadier rate than they tend to earn.[239] In addition, the problem of borrowing against unrealized gains, tax-free, to finance one's lifestyle will disappear under a consumption tax.[240]

Critics may also argue that horizontal equity would be compromised because certain investment assets have a dual investment and consumption purpose, and the consumption component remains untaxed.[241] Andrews recognizes that certain assets cannot easily be classified as investments or consumer goods, such as jewelry, artwork, and owner-occupied houses.[242] Andrews argues that this problem would also exist under a true accretion-type tax where the decision of whether to tax the imputed value from the enjoyment of such property will have

232. *Id.*
233. Andrews, *supra* note 195, at 1152.
234. *Id.* at 1153.
235. *Id.*
236. *Id.* at 1117.
237. *See* McCaffery, *supra* note 52, at 180.
238. *Id.*
239. *Id.*
240. *See* EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER 32–34 (2002).
241. Andrews, *supra* note 195, at 1159–60.
242. *See id.* at 1157–60.

to be made;[243] however, an accretion tax system would simply estimate and tax the market increase in value of the assets without regard for whether the owner has derived any enjoyment from owning the assets.[244] A better argument would be that tax on imputed consumption is similar to tax on imputed income,[245] such as receiving free medical services from a family member. Andrews explains that it would be acceptable to deduct the purchase of assets for imputed consumption as ordinary investments because this would be the equivalent of a failure to impute income under a true accretion-type tax.[246] In addition, Andrews proposes an alternative where "a deduction would be allowed initially for large purchases, but the deducted amount would be returned to income over some specified period or at some specified rate."[247] In sum, while the treatment of unrealized gains for hybrid assets might be more complex than the treatment of unrealized gains for ordinary investments, horizontal equity is either not sufficiently impaired to outweigh the benefits of a consumption tax system, or if it is, then a possible solution exists.

The main argument against the taxation of unrealized gains under a consumption tax model is that vertical equity is violated because the wealthy do not necessarily consume in the same proportion to their resources as do the poor.[248] Critics argue that unrealized gains represent wealth, and the mere possession of wealth has benefits that raise one's social status to a point where present consumption is not representative of one's standard of living.[249] Thus, opponents are concerned that one's level of consumption cannot be the correct measure of equality.[250]

In order to address this criticism, supporters of the consumption tax model, such as Edward J. McCaffery, separate the use of unrealized

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243. *Id.* at 1160.

244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.*

248 Daniel L. Simmons, *The Tax Reform Act of 1986: An Overview,* 1987 BYU L. REV. 151, 174 (1987).

249. *See* Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX LAW REV. 263, 359–61 (2000) ("If holding wealth yields prestige, influence, and psychic benefits, they say, then Y enjoys a better ratio of future to present consumption than exists in a no-tax world, whereas X does not, because Y holds more wealth and garners more of these benefits than X.").

250. *See id.*

gains that are not consumed into two categories: present use and potential use of unconsumed capital.[251] In terms of present use, McCaffery addresses the possibility that unconsumed capital today represents power today.[252] Wealth may also influence an individual's behavior such as the ability to take risks or undertake entrepreneurial endeavors. These examples are reminiscent of Rawls' notion of equality of opportunity.[253] Responses suggest that the tax system may not be the appropriate channel through which to ensure equality of opportunity and that government regulation might be more suitable to guarantee such rights.[254]

Another possibility is that unconsumed capital today hides potential consumption tomorrow.[255] Some responses against that view maintain that "[a] taxpayer cannot use 'her' capital without running through the gauntlet of the tax system."[256] In other words, a consumption tax will eventually get to a wealthy taxpayer's unrealized gains even if it takes several generations to spend all of that taxpayer's wealth. That is because under a consumption tax system there will be no need to transfer wealth between generations on a step-up basis as only the consumption of that wealth would trigger taxation.[257] Hence, even if a wealthy taxpayer chooses not to spend any of his wealth or only a small portion of it during his lifetime, under a consumption tax system, his heirs will eventually pay a tax on the consumption of their inheritance.[258] In contrast, under the current tax model, that taxpayer's wealth might never be taxed because as noted earlier, a wealthy taxpayer can simply borrow against his wealth and consume tax-free.[259] Upon his death, the value of his shares will be transferred to his heirs on a step-up basis and the tax revenue of his unrealized gains will be lost forever.[260]

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251. McCaffery, *supra* note 52, at 182.
252. *Id.*
253. *See* JOHN RAWLS, A THEORY OF JUSTICE 73, 245 (Harvard Univ. Press 1971).
254. McCaffery, *supra* note 52, at 182 ("Problems with how capital is used are best met by regulation . . . .").
255. *Id.* at 182.
256. *Id.*
257. Miller, *supra* note 7.
258. *Id.*
259. *Id.*
260. *See* I.R.C. § 1014 (2006).

The most difficult problem to overcome under a consumption tax system would be its adoption. The debate between an income tax system or consumption tax has remained largely academic.[261] In the political arena, the benefits of a consumption tax have been largely lost in partisanship.[262] With the ratification of the Sixteenth Amendment in 1913, the United States firmly committed to an income tax system motivated by the desire to get as much out of the yield to capital.[263] At that time, a wide range of consumption tax alternatives were proposed but policymakers rejected all of them partly on the grounds that consumption tax represents a larger percentage of disposable income for the poor and middle class than it does for the wealthy.[264] Andrews renewed the income versus consumption tax debate in 1974, making his famous argument that a consumption tax promotes horizontal equity between spenders and savers by not taxing the yield to capital.[265] Alvin Warren responded to Andrews' article by turning the question of fairness to vertical equity and looking at the outcomes ex post to evaluate the fairness of the tax.[266] Warren argued that since, in the end, savers had more than spenders, it was appropriate to tax them more.[267] Warren's argument resonated with the public opinion of the time.[268]

Later, Andrews' post-paid consumption tax proposal became a full-scale legislative proposal when the Nunn-Domenici USA Tax made its way to the House floor in 1995.[269] Congress rejected the proposal.[270] What the public and lawmakers had ignored then was how the realization rule affected vertical equity under an income tax.[271] If

261. McCaffery, *supra* note 16, at 845 ("Crudely, most tax politics have come down to a battle of liberals versus conservatives . . . .").

262. *See id.*

263. *Id.* at 833 (citing Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes,"* 33 ARIZ. ST. L.J. 1057, 1093–1131 (2001)).

264. *Id.*

265. Andrews, *supra* note 195, at 1118.

266. *See* Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 933–36 (1975).

267. *See id.* at 935.

268. McCaffery, *supra* note 16, at 842.

269. USA Tax Act of 1995, S. 722, 104th Cong. (1995).

270. Records indicate that the bill progressed to the Finance Committee, and no further. *See* GOVTRACK.US, http://www.govtrack.us/congress/bills/104/s722 (last visited Jan. 30, 2013).

271. *See* McCaffery, *supra* note 16, at 842.

unrealized gains are never taxed even when consumed and if unrealized gains are the upper class' main source of income, then the income tax system can hardly claim to preserve vertical equity.[272] Andrews' model, on the other hand, would tax the consumption of the wealthy regardless of whether that consumption was a result of realized gains or of a loan secured by unrealized appreciation.[273]

Some of the public skepticism towards consumption tax stems from fear that rates will go up under a consumption tax system.[274] Critics of consumption tax systems often assume that rates under a consumption tax have to increase to meet the demand for revenue.[275] This assumption would not necessarily be true because, under a consistent post-paid consumption tax, the base will likely increase for two reasons. First, because the realization rule will no longer create valuation problems, the preferential rate for capital gains can be repealed.[276] Second, a consumption tax will capture consumption from debt in the base.[277] These two provisions will be able to compensate for the larger exemption of savings under a consumption tax.

Others incorrectly believe that the adoption of a consumption tax will be a radical change;[278] however, while the concept of a consumption tax system would be new to society, the actual implementation of the model would not present a huge change. The reason is that we already have a system that is a hybrid between income and consumption.[279] Additionally, the actual implementation would only involve an unlimited deduction for savings and inclusion of debt as a taxable input,[280] because of the Haig-Simons definition of income in which consumption equals income minus savings.[281]

Recently, tax reform has received considerable attention from policy makers and is frequently discussed by companies and individual

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272. *See id.*
273. *See* Andrews, *supra* note 195, at 1118.
274. *See* McCaffery, *supra* note 16, at 934.
275. *Id.* at 935.
276. *See* McCaffery, *supra* note 52, at 184.
277. Andrews, *supra* note 195, at 1139.
278. McCaffery, *supra* note 16, at 934.
279. *Id.* at 933–34.
280. *See id.* at 936.
281. Andrews, *supra* note 195, at 1114 n.14.

taxpayers.[282] The realization rule is cited as one of the system's most serious problems that must be addressed through tax reform.[283] All proposals that offer solutions to the realization rule problem under an income tax system create new complications.[284] Because Andrews' tax proposal solves the difficulties of the realization rule with minimal need for further adjustments to the system, it is timely and draws renewed interest.

CONCLUSION

Andrews' proposal of a consumption tax system has often been cited for its ability to solve the realization rule problems in a simple and effective way.[285] Indeed, Andrews' approach emerges after a wave of other proposals because of its ability to remedy the equity and efficiency problems of the realization rule without creating a new set of difficulties.[286] A consumption tax eliminates the lock-in effect of the realization rule, the valuation and liquidity concerns of the accretion system, preferential tax rates for capital gains, and inflation concerns.[287] The result is a simple tax on consumption from all sources, which promotes horizontal and vertical equity.[288] Although political resistance may be a serious barrier to the adoption of a consumption tax, Andrews' proposal remains a superior solution to the realization rule problem.

282. Pamela F. Olson, *Tax Reform Approaches A Decision Point*, 365 PLI/TAX 43, 45 (2012).

283. Schizer, *supra* note 11, at 1551–52; Kleinbard & Evans, *supra* note 11, at 789; Cunningham & Schenk, *supra* note 65.

284. *See supra* Part II.

285. *See generally* McCaffery, *supra* note 16.

286. *See* McCaffery, *supra* note 52, at 184.

287. Andrews, *supra* note 195, at 1151–53.

288. McCaffery, *supra* note 52, at 184.