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A Supplemental Expenditure Tax for Canada

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Introductory

This paper explores whether a Supplemental Expenditure Tax (SET) might be appropriate for Canada.[1] My conclusion is that the SET, if properly implemented, would support the following policy goals:

- It would facilitate the tax system becoming more progressive.
- It would provide for appropriate revenue diversification.
- It would constitute a broad-based tax based on ability to pay, and would facilitate the reform of the income tax (especially taxation of capital gains as ordinary income).

The debate in the academic literature on income vs. consumption taxation has focused on whether the income tax should be replaced by a consumption tax. Discussion centered on which tax was better. Further reflection on the mechanics and politics of replacing an income tax with a consumption tax suggests that this is a false choice. It is quite unlikely that the income tax would ever be replaced by a consumption tax. This is partly because the transition arrangements for such a replacement would be quite difficult to fashion and would be controversial, particularly those having to do with the corporate income tax. A more fruitful approach is to think of a consumption tax as being implemented as a supplement to the income tax. A supplemental expenditure tax (SET) then ends up not being an antithesis to the income tax, but rather a complement. The SET would allow the income tax to remain as a mainstay of a progressive tax system, imposed at progressive rates, but rates that are not unduly high.

What is the SET?

The SET discussed in this paper is a standard personal expenditure tax based on cashflow (i.e. cash receipts, with a deduction allowed for net investments). Such a tax would be vastly simpler than the current income tax.Taxpayers would determine their SET liability using the same information as for the regular income tax, with a few modifications. The general approach is cash flow. Thus, items of income are taken into account when received. A deduction is allowed for any investments when made. This includes business investments. However, some items are left out of account to simplify administration and compliance. Thus, certain borrowing would be excluded (primarily mortgage debt), a deduction would be allowed for net savings, and includable receipts would be somewhat broader than under the income tax. Personal deductions would generally be the same as under the regular income tax.

[1] This paper borrows from Victor Thuronyi, A Supplemental Expenditure Tax, in Tax Design Issues Worldwide (G. Michielse and V. Thuronyi eds. (Kluwer 2015).

Instead of replacing the income tax, the SET would be levied in addition to the income tax. It would entail a large personal exemption, and thereby be paid only by a relatively small segment of taxpayers.   The various arguments about whether the income tax should be replaced by an expenditure tax do not necessarily apply to the SET. The SET should be regarded as a tool that can facilitate income tax reform, and that can therefore strengthen the income tax. For that reason, those familiar with the long-standing income-versus-expenditure-tax debate in the literature should look afresh at the question of whether the SET is desirable. It presents different issues.

How SET can help the income tax

The income tax suffers from a number of problems. Because different forms of income are taxed under different rules, there is a distortion of economic decisions (for example, only 50% of capital gains are taxed[2]). Income tax is only loosely tied to ability to pay.

The SET offers a possibility of rescuing the income tax. Bolstered by the SET, the income tax could be maintained at lower tax rates, and in a reformed configuration, whereby different types of income are taxed as much as possible under the same rules. Low rates are important to this result, because distortions inherent in the income tax increase as the tax rate increases. The SET itself is a neutral way of taxing consumed income, since the tax applies on an even-handed basis to various types of income. The combination of SET and income tax therefore would be a more robust one than current law. It would allow the income tax / SET to be imposed at whatever combined rates were considered appropriate from the point of view of progressivity and revenue needs.

Although adding the SET to the income tax would not be a simplification, if the SET allowed rates to be reduced, and capital gains to be taxed the same as other income, there would be a simplification benefit. The AMT could probably also be repealed, thereby also simplifying the system.[3]

Progressivity

The importance of progressivity has been articulated well by Neil Brooks.[4] He saw the income tax as contributing to distributive justice and sharing the burden of the state fairly. He argued "for a return to the priority of justice and progressivity" at a time when attention of policy analysts had shifted to efficiency concerns. Brooks noted that this happened despite a "staggering increase in inequality" over the past 20 years, accompanied by "conspicuous consumption" by the super-rich. Brooks noted that there were different views of government's distributive role. His own was that government's redistribution role has to do not just with

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[2] See Income Tax Act, sec. 38.

[3] See Peter Hogg et al., Principles of Canadian Income Tax Law 475 (2007)(arguing that the AMT does not fulfill an important policy role under current law).

[4] See Neil Brooks, A Resume of the Case for a Progressive Income Tax, in [essays in honor of Richard Musgrave]

relieving poverty, but also "narrowing the gap between the rich and the poor", i.e. "reduce the income of the rich in order to achieve a more equal distribution of resources".

Brooks rejected the view that the distribution of income in society is presumptively fair. He argued that there were multiple benefits from reducing inequality, given that –

- increased income inequality reduces income mobility;
- increased inequality leads to an increase in crime.
- increased inequality is detrimental to public health;
- increased inequality leads to greater inequality in educational attainment;
- individuals' sense of well-being is influenced by the degree of inequality (due among other things to conspicuous consumption by the wealthy);
- income inequality is destructive of social capital;
- inequality undermines political support for the free market;
- a less equal society may also enjoy lower economic growth.

Given the choice between an income tax and a consumption tax, Brooks favored the income tax as better carrying out redistributive goals. He did not, however, focus on the SET. The argument I will develop is that the SET is an effective way to achieve the values that Brooks has been championing.

How the SET can enhance progressivity and fairness

The argument favoring the SET is a practical one. It depends on the premise that the income tax does not function well in practice and that it would be difficult to fix the income tax within its own terms. A fix for the income tax would require a reduction in rates, which would cost revenue and make the tax less progressive. On the other hand, the SET is available to compensate for these. It can be applied at progressive rates on the wealthy, thus making up for the revenue loss and reduced progressivity resulting from lower income tax rates. The SET therefore fulfills the goals of making the tax system more progressive not on its own merits, but because it is an instrument that allows the income tax to function better and hence become a more stable part of the revenue system.

There is kind of a natural limit to how high the rates of income tax can go before they are put under undue pressure. This is in the range of 30%. From the point of view of simplification, it is desirable to set rates on all kinds of income at the same rate schedule. There are types of income that are particularly difficult to tax at rates much above 30%. These include many forms of capital income (due to the mobility of capital), corporate income (due to the ability of corporations to shift income to tax havens) and capital gains (because taxpayers tend not to realize gains if rates are higher). In Canada, capital gains are taxed at a lower rate than this, even taking into account the combined Federal and provincial rates, given that 50% of capital gains are excluded. By contrast, an SET could be adopted without difficulty at top rates of 20-30 percent if needed, thereby leading to a top tax rate in excess of 50%. The SET therefore allows a tax system that is more progressive than the one we have at the moment. The SET therefore would allow the realization of whatever degree of progressivity politicians are willing to agree to. The combination of SET and income tax is therefore more robust in terms of achieving

vertical equity than the income tax alone, and would be a more potent redistributive vehicle of the kind that Brooks favors.

The SET also helps achieve horizontal equity. In terms of the income tax, horizontal equity calls for any dollar of income to be taxed at the same rate, no matter what its source or nature. Because of concerns about the mobility of capital, many income tax regimes throughout the world today have given up on horizontal equity and are taxing capital income at lower rates than earned income. With the SET, this approach is no longer needed. All income can be taxed at moderate rates that top out at about 30 percent. Additional progressivity can be provided by the SET. Importantly, each dollar of income or consumption is taxed at the same rate, no matter what its nature, thus satisfying the criterion of horizontal equity.

As a side benefit, the taxation of all income under the same rate schedule allows the rules of the income tax to be simplified, thereby reducing compliance costs. (For example, rules policing the income-capital gains distinction can be relaxed.) The SET-income tax combination makes for greater economic efficiency than the income tax on its own. The greater efficiency of the SET cum income tax makes it a better vehicle for redistribution, because it has a lighter effect on the economy and accordingly is easier to adopt as a political matter. (High tax rates cannot be said to discourage small businesses, since any amounts reinvested in the business are not subject to current tax under the SET.)

As a new tax, the SET could be enacted without the many tax expenditures that are attached to the income tax. Of course, legislatures can add tax expenditures to the SET, but the hope would be that (in line with the desire to raise as much revenue as possible while keeping tax rates moderate) the SET would be relatively free of tax expenditures. We can expect some tax expenditures to remain in the SET, in particular those that fulfill an important function related to raising revenue and that cannot be implemented as well as direct spending or regulatory programs. For example, the SET would presumably allow a credit for charitable contributions. If income tax rates were reduced, and an SET were introduced, the current credit rates for charitable donations could be left unaffected. Although this would be a tax expenditure, there is a justification for including it, given the government's interest in promoting charitable contributions.

One of the most important roles for any tax is its ability to raise revenues. From this point of view, the SET provides an appropriate complement to the income tax, allowing the combined taxes to raise substantially more revenue than the income tax alone. The amount of revenue raised can be adjusted from time to time by changing the SET rates and exemption amounts.

The SET and tax diversification

Although a lot of writing about tax is theoretical, I think of tax as a largely practical discipline, when it comes to how taxes should actually be designed. Practical considerations often dominate theoretical considerations. One manifestation of this is tax diversification. It will often be a good idea to use a diversity of revenue sources instead of one or a minimal number of taxes. This may seem counter-intuitive, because a multiplicity of taxes involves increased compliance costs. Certainly compliance costs should be borne in mind, and the tendency to adopt multiple

tax instruments tempered. Several diverse taxes are usually harder to avoid than a single tax. Moreover, every tax will be imperfect because design of a perfect tax is impossible. The remedy is to keep the rates of each tax moderate, so as to avoid the unfairness of imposing a high tax in an unfair situation. Given the imperfections of an income tax, combining it with an SET, and keeping the rates of both taxes moderate, tends to make for a fairer system and a system that makes it harder to avoid or evade tax.

Can an SET be well defined?

Because an SET would be new, there would be concerns that defining the tax base might be difficult and confusing. I hope to show below that it is feasible to define the SET base in a fairly simple way, and that this tax would not impose an undue compliance burden. The key to success in this respect is to set a fairly high threshold so that the great majority of taxpayers do not have to deal with this tax.

[A] In General

The SET would be a cash-flow tax (i.e., cash receipts, with a deduction allowed for net investments). Such a tax would be substantially simpler than the current income tax, although it does involve some design issues and new elements as outlined below.[5]

In a broad sense, the SET is very similar to the income tax, except that includable receipts are defined more broadly than under the income tax and the SET does not tax income until the income is consumed (generally, investment is deductible).

Taxpayers would determine their SET liability using the same information as for the regular income tax, with a few modifications. The general approach is cash-flow. Thus, items of income are taken into account when received. A deduction is allowed for any investments when made. This includes business investments. Borrowing would generally be included in taxable receipts, a deduction would be allowed for net savings, and includable receipts would be somewhat broader than under the income tax.

Even though the tax base is personal expenditure, the base would be legally defined as income less specified deductions.

Appropriate levels for the SET exemption, or for the rates, will depend on the whole tax policy picture. The SET rates and exemption can be determined at the end of the process of designing a tax reform bill so as to attain the desired distributional and revenue results. In very general terms, however, I would envisage setting the SET exemption at a rather high level, so that only a small percentage of taxpayers would pay this tax

The SET would be a return-based tax that would be implemented with an additional schedule on an income tax return and would be administered as part of the income tax.

[B] Specific Design Elements

[1] Jurisdictional Basis

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5. Except as otherwise noted, I follow the design recommendations for the expenditure tax in Michael Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575 (1979).

As with the income tax, the SET would apply to individuals who are residents. It would not apply to corporations or partnerships. Distributions from those entities would, however, be included in the SET tax base of the distributees. This would not require particularly complex calculations, since all that is needed is the amount of cash distributions, an amount that is relevant for regular income tax purposes as well.

[2] Income

Income would be defined much as under the regular income tax. Thus, income would include wages, interest, dividends, royalties, and the like. A major difference from the income tax is that the proceeds of sales are fully taxed when received, i.e., it is not just the gain that is includable in taxable receipts but the entire sales proceeds. These are accounted for on a cash basis, so, for example, installment sales would be taxed as cash is actually received, not at the time the sale takes place.

Fringe benefits present much the same issues under an expenditure tax as under the income tax. Accordingly, one could expect the same solutions, i.e., if a particular item is taxed as a fringe benefit under the income tax, it would be taxed in the same way under the SET. An example would be use of an employer-provided automobile.

[3] Deductions

In general, special deductions would be the same as for the income tax. For example, the deduction for support payments under section 60 (and the corresponding inclusion in income) would apply for the SET the same as for the regular income tax.

A deduction would be allowed for life insurance premiums, whether for term insurance or insurance that has an investment component. In other words, all life insurance would be treated like savings. The reason is to avoid having to make distinctions among different kinds of life insurance policies. (All life insurance has a certain degree of investment value.) Correspondingly, life insurance payouts would be taxable to the beneficiary of the policy when received.[6]

[4] Treatment of Debts

As a general rule, all borrowing proceeds are included as taxable receipts and a deduction is allowed for interest and principal paid on loans. If the borrowing proceeds are used for investment, an offsetting deduction is allowed.

The only exception to the general rule is for home mortgages, auto loans, and loans for other consumer durable items, purchased with debt secured by the item. In these cases, the taxpayer will be taxed on amounts used to pay off the loan, because no deduction would be allowed for principal or interest payments made. This approach times taxation closer to actual consumption of the consumer durable.

Forgiveness of loans the proceeds of which were included in taxable receipts would not be taxed. In contrast, forgiveness of mortgage debt, auto loans, and loans to acquire consumer durables would be taxed (since the loan proceeds were not taxed). Note, however, that there is unlikely to be much SET liability by reason of taxation of loan forgiveness, given the high threshold. Most people in a position to have their consumer debt forgiven will not be subject to the SET in the first place because of the threshold. If the amount of loan forgiven is large, then provision could be made in the law for spreading the taxable amount over several years, in order

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6.*See*Graetz, *supra* n. 3, at 1611-13.

to allow taxpayers to make use of the threshold. Otherwise, a taxpayer generally below the threshold might get bumped up into being taxable in the year when a large mortgage loan is forgiven.

[5] Treatment of Cash

In principle, cash could be tracked, but the simpler approach is not to do so. This means, for example, that when an investment asset is liquidated and cash proceeds are obtained, the cash is included in the SET base at the time of receipt as personal expenditure. The particular time that the taxpayer uses the cash to pay for consumption items is irrelevant.

The suggested treatment of cash will allow taxpayers to engage in a certain amount of self-help averaging. If a taxpayer wants to increase the SET base for a year, this can be done by liquidating an investment and receiving cash. By contrast, a transfer of cash into a checking account or other investment account will reduce the tax base for that year. In addition to this legitimate averaging opportunity, there is an opportunity to evade tax by failing to declare cash receipts and then transferring the cash into a bank account. The result would be a reduction of the tax base, beyond what could be accomplished under the income tax by failing to declare the cash income. Manoeuvres like this should raise a red flag for audit, but highlight that audit capacity does need to be there in order for the tax to succeed.

[6] Housing

To understand the treatment of owner-occupied housing under the SET, consider first the typical case of a home that is mortgage-financed. A purchase money mortgage used to buy a residence[7] would be left out of debt account (in other words, the borrowing proceeds are not taxable and repayments are not deductible). In the case of someone buying a home with cash or putting up a substantial down payment, it would be unfair to treat the entire amount as expenditure for SET purposes in the year that the house is purchased. (Bunching all this expenditure into one year would tend to place the taxpayer into a higher tax bracket than usual.) The remedy is to allow the taxpayer to amortize the expenditure over some lengthy period, say twenty to thirty years (interest should be charged on the outstanding balance; in effect, the taxpayer would be put on the same footing as if a mortgage had been used.). The taxpayer should be allowed to notionally pay off all or part of the outstanding balance at any time, thereby including this amount in the SET base. This would put the taxpayer on a similar footing to someone who financed with a mortgage, who could achieve this tax result by paying off all or part of the mortgage. It would be advantageous for a taxpayer to do this in any year where there is an unused exemption amount under the SET.

[7] Other Consumer Durables

If a taxpayer purchases a consumer durable, the transaction does not lead to a substantial amount of consumption for the year in an economic sense, given that annual consumption should include only the value of use of the durable for the year in question, not the entire value of the durable. However, from a legal point of view, absent a special rule, the entire purchase price is part of taxable expenditure for the year, because the SET treats the entire consumption as occurring in the year of purchase.[8] As with housing, the case of consumer durables purchased with debt can be dealt with by ignoring the debt-financed part of the transaction. The debt could

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7. Including a second home, as well as collectibles and the like described in [12]below.

8. The same approach is taken by the VAT/GST.

be excluded from receipts, with no deduction allowed for loan repayments. The result will be that loan repayments will be taxed as consumption as they are made. This is the same rule as applies for debt-financed owner-occupied housing. As with housing, one could also amortize the cost of substantial (such as those costing over $10,000) consumer durables purchased with cash over a period of years.

[8] Averaging

An argument can be made for averaging under an SET. In a number of situations the taxpayer may incur substantial expenses for reasons largely beyond the taxpayer's control. These may be items such as medical expenses, legal fees, or tuition. If these expenses cause taxable expenditure to be higher than normal, the tax consequence may be considered unfair. An averaging rule could address this concern. Such a rule would, however, introduce complexity to the system. The complexity would involve both definitional issues as well as administrative burdens for both taxpayers and the tax administration in keeping track of carryovers from one year to the next. The added complexity of an averaging rule could be minimized by limiting the rule to expenditures that are quite large as a portion of taxable expenditure. The simplest approach would be to include no averaging rule.

[9] Carryover of Exemption

The specific form of SET proposed raises an averaging problem that is somewhat different from that under a broader consumed-income tax. The large annual threshold means that taxpayers with relatively low amounts of consumption in a given year "waste" that year's exemption. This could be dealt with by allowing taxpayers to file the information on expenditure with their return even if they are not subject to the SET for the year in question, and carry over the unused exemption. Although this would involve a recordkeeping burden, it is not major, particularly for taxpayers with relatively simple financial affairs. If this option were not allowed, taxpayers would have the incentive to accelerate consumption into low-expenditure years (e.g., by purchasing consumer durables rather than investments), and this distortion would not make sense as a matter of policy. Administration of the rule might be simplified by limiting the amount that could be carried over, as well as limiting the period of time for the carryover (otherwise, returns that are many years old might have to be audited in the tax year when the carryover is used, at which point much of the applicable information might no longer be available).

[10] International Aspects

Rules would be needed to avoid double taxation in the case of residents who earn amounts from foreign sources and pay foreign tax. This can be done either by allowing a credit against SET for foreign income tax-paid, or exempting from the SET base amounts of consumption that are financed by foreign-source income. Assuming the foreign tax credit in its current form, for purposes of the foreign tax credit, the SET should be considered as part of the income tax for purposes of the foreign tax credit limitation. Under this approach, the foreign tax credit does not pose any difficulties for the SET. Admittedly, the result ends up being rough and ready, particularly where there is a substantial amount of taxable expenditure financed out of income of previous years. The foreign tax credit limitation formula does not take into account whether that previous income was domestic or foreign-source, and what tax rates it bore. Likewise, if the taxpayer incurs foreign income tax but saves a substantial portion of the current year's income, with the result that the current year's domestic tax is low, the formula reduces the foreign tax credit available. To calculate the foreign tax credit more precisely in a way that

coordinated the different approaches of foreign and domestic tax law would, however, introduce needless complexity.

In respect of nonresidents, the SET would simply not apply, since the jurisdictional scope of the tax extends only to residents. Nonresidents would continue to be taxed under the income tax on their domestic-source income.

An individual subject to SET at a high marginal rate might have a tax incentive to retire abroad, if intending to continue at a high consumption level (or if the individual engaged in a high level of savings during the individual's earning years, which the individual intends to consume during retirement). It may be appropriate to provide rules requiring expatriating individuals to continue to pay SET for a period of years, particularly where the amounts involved are substantial. The policy issues are similar to those for an exit tax under the income tax, and one would expect the SET rules to track the exit tax rules for the income tax.[9]

[11] Family Unit; Gifts and Bequests

I assume that gifts and bequests will not be taxed to the donor. In other words, they will not be treated as part of the donor's consumption. The donor would accordingly receive a deduction for a cash gift. This – combined with a generous exemption – creates an obvious tax avoidance opportunity. A wealthy individual could transfer assets to his or her children, who could use them to purchase consumption goods and services. To cut off this opportunity, it would make sense to include in the SET base of the parent any consumption by minor children. In most cases, there will not be anything to report, because most children typically do not liquidate financial assets in order to pay for their consumption. The proposed rule would not apply once the child attains majority. For this situation, an anti-avoidance rule would probably be needed providing that a purported gift will be disregarded to the extent that the gift is used to provide a consumption benefit to the donor. This rule will of course not catch everyone; this weakness in the expenditure tax represents a good argument why we don't want to rely on an expenditure tax exclusively, and why it is a good strategy to combine the SET with the income tax. Even if the donor could avoid SET by making gifts, manoeuvres of this kind would not avoid income tax.

Assuming that a deduction is allowed for gifts, rules will be needed to police the boundaries of this deduction. For example, gifts to corporations and other entities that do not qualify for the charitable deduction under the income tax should not be deductible. Importantly, this would include political contributions. The resulting inclusion of political contributions in the donor's tax base is a strength of the SET. The only deductible gifts should be those made to individuals. Even these need to be restricted, since one would not want to allow deductions for gifts to a politician, or gifts to a person who provides services to the taxpayer.

[12] Housing and Other Personal Use Property

In the longer term, the principal residence, if purchased after the effective date, will be entirely tax-paid. To the extent purchased with cash, the cost will be included in the SET base in the year of expenditure (or would be spread over several years; see above discussion of averaging for special rules that might be provided). To the extent financed with debt, no SET deduction would be allowed for repayments of principal or interest. Upon sale, the entire proceeds should be exempted (*see* discussion of transition in §1.04below for treatment of

[9] See Income Tax Act section 128(4).

housing purchased before the effective date). The same treatment should apply for sales of other personal-use property.

Rules will be needed to deal with property that is purchased with a mixed personal use and investment purpose. This kind of property consists of either immovable property or movable property such as antiques, collectibles, and art. A simple but tough rule would be to treat all such property as consumption expenditure. On disposition, the simplest rule would be to exempt the proceeds from tax. Any tax on the gain is excessive as a matter of consumption tax principles (except to the extent attributable to sweat equity).

This approach will require treating as personal expenditure property any property that is in fact used for personal purposes, as well as property held for investment or used in a business if it constitutes fine art, a collectible, or an antique. Immovable property (such as a vacation home) that is available for use by the taxpayer or members of the immediate family (spouse or children 18 and under) would be treated in the same way as personal expenditure property. Proceeds from rental should be exempted. So, for example, if a vacation home is purchased partly with cash and partly with debt, the debt would be excluded (as consumption debt) and the cash payment for the home included in the SET base. Suppose that rental income is used to pay interest on the debt, property taxes, repairs, and so forth. All of these amounts would simply be ignored for SET tax purposes. There would be no need for the taxpayer to keep track of the number of rental days or the amount of rental income received. In other words, there would be a (possibly modified[10]) yield exemption treatment for this kind of asset. (The same principle can be applied to artwork, a yacht, race horse, or other similar property which is treated as personal expenditure property: any income from renting the property can be ignored.)

[13] Anti-abuse

One fairly obvious anti-abuse rule would be to provide that a purported gift to a third party will be disregarded to the extent that the gift is used to provide a consumption benefit to the donor.

Another abuse situation would consist of the purchase of a yacht, car, airplane, real property, or similar item by a corporation, trust, or other entity. The corporation might be owned at least in part by the potential user of the property, who might then lease it from the corporation. If the user of the property had bought it himself, the expenditure would have been part of the SET base.[11] In principle, it would be possible to police the amount of rental charged, but this is unlikely to be effective because of potential disputes about the fair value of the rental, particularly in situations where the property is also rented to others for part of the time. A possible anti-abuse rule would impute to the user the purchase of personal-use property by a corporation or other entity (including an individual acting as an accommodation party). The purchase amount could be included in the expenditure tax base of the user in the year of purchase. An exception would be made for bona fide rentals by publicly held companies (e.g., if someone rents a car from a company engaged in automobile leasing). While the suggested anti-abuse rule would be harsh, this would be justified because there would be little bona fide non-tax reason for entering into such an arrangement. The existence of a tough anti-abuse rule of this kind should stamp out these kinds of transactions, with the result that it will not be necessary to actually apply the rule very often.

10.Modified if inflation-adjusted gains on disposition are taxed. (One reason for doing this is to capture any sweat equity by the taxpayer that results in increased value of the property.)

11.*See* section §1.03[B][7] above.

§1.04 Transition

If the existing income tax were completely replaced by an expenditure tax, then there would be a need for transition relief. The classic case is that of the taxpayer who has saved up during a working life and is just about to retire when the expenditure tax is introduced. Suppose that the taxpayer's savings are in high-basis assets. If the income tax continued, the taxpayer could draw down these assets without additional tax. However, under an expenditure tax, this taxpayer would face paying tax again. This situation would call for giving the taxpayer relief for consumption financed out of tax-paid assets.

In the case of the SET, however, the transition situation is somewhat different. The SET is designed to be an additional tax, imposed in addition to the regular income tax (hence it is called a *supplemental* expenditure tax). Its incidence could be intended to fall partly on existing wealth, and partly on wealth accumulated after the effective date, to the extent that either is consumed. This seems fair. The income tax continues. Taxpayers holding wealth at the time of introduction of the SET will benefit from any reduction of income tax rates that take place at the same time that the SET is introduced. The taxpayer in the above example would not pay any more income tax on assets that are liquidated to finance consumption. The SET payable would therefore not be in duplication of income tax already paid. Imposing a one-time tax burden on existing capital would, in other words, be part of the politically accepted strategy.

While general transition relief should therefore not be needed, a few specific transition rules will be required to avoid unfairness in particular cases.

One such rule involves consumer durables, particularly housing. In the case of someone buying a house after the effective date with borrowed funds, there would be no particular problem. Given that the loan would be kept out of account, the result is that interest and principal on the loan would be included in the tax base as the loan is repaid. This would provide an advantage to those who already own housing, but the advantage would be limited: no deduction for interest on existing housing would be available for SET purposes. The unfairness would apply to those who have saved up but not yet purchased a house as of the effective date. If no transition rule were provided, they would be seriously disadvantaged in comparison with someone who had purchased a house with cash just before the effective date of the SET. To address this, an exemption could be provided (subject to an appropriate limitation) for the purchase of a principal residence within a specified period (e.g., one year) after the effective date in the case of someone who does not own such a residence. (The exemption would apply only to amounts paid in cash. Any amounts in excess of the exemption limit would be eligible for averaging via amortization of the purchase price as explained above.)

A special rule will also be needed for disposals of the principal residence after the effective date, in the case of a residence purchased before the effective date. Assume that under current law, gain on the disposition of the principal residence is excluded. Suppose someone sells a principal residence qualifying for the gain exclusion after the effective date. This could apply for SET purposes as well. Any excess of the sales proceeds over the amount of gain that is excluded under the regular income tax should be included in taxable receipts for SET purposes.

Consideration should also be given to a transition rule for those who, before the effective date, purchased an unusually large house. Such individuals would be advantaged as compared with those who buy housing with income earned after the effective date, since the latter would be taxed on these amounts. If no account is taken of the existing asset as of the effective date, there will be an undue preference for these individuals. Accordingly it would make sense to include in the SET base an estimated rental value in the case of homes worth more than a specified

amount.[12] I recognize that this would involve some valuation issues, and it would be possible to get along without this rule, but some such rule would seem to be appropriate as a matter of fairness.

Apart from amounts invested in a principal residence (subject to a possible limitation as discussed above), the SET would constitute a levy on existing capital. The burden of this tax would, however, depend on the taxpayer's consumption choices: it would become due only for consumption at a luxury level. As long as the taxpayer (or the taxpayer's heirs) spent at or below a frugal level represented by the SET exemption, no tax would be due.

Initial cash balances as of the effective date would be taxed (with an appropriate de minimis exclusion). Cash balances for this purpose would include whatever type of checking account and other bank balances that are treated the same as cash (i.e., not taken into account) for SET purposes generally.

Although not without difficulty, the above transition rules are far more modest than the transition rules that would likely be required if the existing income tax were completely replaced by a consumed-income tax. The difficulty of transition is often cited as one of the principal problems of a cash-flow tax.[13] The SET would largely avoid these problems.

Conclusion

Adding an SET to the Canadian income tax would allow top income tax rates to be reduced. It would allow elimination of the 50% deduction for capital gains, so that realized capital gains are taxed on the same basis as other income. The reduced income tax rates would reduce the distortions of the income tax. The resulting system can be made more progressive than current law, by appropriately setting the rates and exemption level for the SET.

12. Compare Kaldor (1955) who proposed including in the expenditure tax base the annual rental charge on housing. The approach suggested here differs from Kaldor's in that it applies only to pre-effective-date housing, and applies with a threshold, so that only more expensive houses are affected. The value of a second home should also be included in the calculation.

13.*See*Engler and Knoll, Simplifying the Transition to a (Progressive) Consumption Tax, 56 S.M.U.L. Rev. 53, 54 (2003).