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A Supplemental Expenditure Tax for Canada

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PRÉCIS

Un impôt supplémentaire sur les dépenses (*supplemental expenditure tax* [SET]) pourrait être levé à des taux progressifs en plus de l'impôt sur le revenu, et les taux de l'impôt sur le revenu pourraient être réduits en conséquence. Le SET est un impôt à la consommation progressif sur les flux de trésorerie qui a été proposé initialement par Nicholas Kaldor en 1955. Son adoption faciliterait la réforme et la simplification de l'impôt sur le revenu, en imposant par exemple les gains en capital aux mêmes taux que le revenu ordinaire, et elle permettrait de supprimer l'impôt minimum de remplacement. Cet impôt peut être conçu de manière à ce que l'on exige peu d'autres renseignements que ceux déjà recueillis aux fins de l'impôt sur le revenu.

ABSTRACT

A supplemental expenditure tax (SET) could be imposed at progressive rates in addition to the income tax, and income tax rates lowered correspondingly. The SET is a progressive cash flow consumption tax originally proposed by Nicholas Kaldor in 1955. Its enactment would facilitate income tax reform and simplification—for example, by taxing capital gains at the same rates as ordinary income—and would enable the alternative minimum tax to be repealed. It could be designed so as to facilitate compliance with little additional information required beyond what already has to be gathered for income tax purposes.

KEYWORDS: ALTERNATIVE MINIMUM TAX ■ CASH FLOW ■ CONSUMPTION TAXES ■ PROGRESSIVE TAXES ■ TAX REFORM ■ TAX SIMPLIFICATION

CONTENTS

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INTRODUCTION

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

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

The debate in the academic literature on income versus consumption taxation has focused on whether the income tax should be replaced by a consumption tax. Discussion has centred on which tax is 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 will 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 being implemented as a supplement to the income tax. Viewed thus, an SET would not be an antithesis to the income tax, but rather a

1 This paper borrows from Victor Thuronyi, "A Supplemental Expenditure Tax," in Geerten M.M. Michielse and Victor Thuronyi, eds., *Tax Design Issues Worldwide* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2015), 3-34.

complement to it. The SET would leave the income tax as the mainstay of a progressive tax system, imposed at rates that are progressive but not unduly high.

WHAT IS THE SET?

The SET discussed in this paper would be a standard personal expenditure tax based on cash flow (that is, cash receipts, with a deduction allowed for net investments). Such a tax would be vastly simpler than the current income tax. To determine their SET liability, taxpayers would use the same information as they use for the regular income tax, with a few modifications. The general basis would be cash flow. Thus, items of income would be taken into account when received. A deduction would be allowed for any investments when they were made. This would include business investments. However, some items would be left out of account in order to simplify administration and compliance. Thus, certain borrowing would be excluded (mortgage debt, primarily); a deduction would be allowed for net savings; and includable receipts would be somewhat more extensive than they are under the income tax. Personal deductions[2] would generally be the same as under the regular income tax.

Instead of replacing the income tax, the SET would be levied in addition to it. Because it would entail a large personal exemption, it would 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 could facilitate income tax reform and could therefore strengthen the income tax. For that reason, those familiar with the literature's longstanding debate over income tax versus expenditure tax should look afresh at whether the SET is desirable. It raises different issues than those raised by the standard debate.

HOW THE 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 (for example, only 50 percent of capital gains are taxed), there is a distortion of economic decisions.[3] 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, such that different types of income would be taxed, so far 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 would be a neutral way of taxing consumed income, since it would apply on an even-handed basis to various types of income. The combination of an SET and the income tax would

2 For example, child-care expenses or moving expenses.

3 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

therefore be a more robust tax than the current law provides for. Under the new provision, the income tax/SET would 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, a simplification benefit would result if the SET allowed rates to be reduced and capital gains to be taxed in the same way as other income. The alternative minimum tax (AMT) could probably also be repealed, which would further simplify the system.[4]

The current federal rate structure involves top tax brackets of 26, 29, and 33 percent, while provincial rates can be as high as 25.75 percent (as in Quebec). With an SET, one could envisage a top federal rate as low as 25 percent, plus a top provincial rate of perhaps 10 percent, with the remaining progressivity coming from the SET. In order to get the top combined federal and provincial rate down to 35 percent or so, the provinces would probably have to take the lead in reducing their top income tax rates. The SET would then supply the extra progressivity that some provinces desire. Under this kind of structure, the SET would have to start kicking in at a point where personal expenditure was $150,000 or so, perhaps even lower. From an administrative point of view, it would be desirable for the SET personal exemption to be the same for federal and provincial purposes. This would ensure that individuals would be liable for the SET, for provincial tax purposes, only if they were also liable for it for federal tax purposes. The SET might involve a single flat rate at the federal level, with provinces imposing one or two rates, depending on how progressive they wanted to be.

PROGRESSIVITY

The importance of progressivity has been articulated well by Neil Brooks.[5] He envisioned 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"[6] at a time when the attention of policy analysts had shifted to efficiency concerns. Brooks noted that this had happened despite a "staggering increase in inequality"[7] over the past 20 years, accompanied by "conspicuous consumption"[8] by the super-rich. He noted that there were different views of government's distributive role. His own view was that government's role in redistribution has to do not

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4 See Peter W. Hogg, Joanne E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*, 6th ed. (Toronto: Thomson Carswell, 2007), at 475 (where it is argued that the alternative minimum tax does not fulfill an important policy role under current law).

5 See Neil Brooks, "A Restatement of the Case for a Progressive Income Tax," in John G. Head and Richard Krever, eds., *Tax Reform in the 21st Century: A Volume in Memory of Richard A. Musgrave* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2009), 275-351.

6 Ibid., at 279.

7 Ibid.

8 Ibid.

only with relieving poverty but also with "narrowing the gap between the rich and the poor"[9]—that is, reducing the income of the rich in order "to achieve a more equal distribution of resources."[10]

Brooks rejected the view that the distribution of income in society is presumptively fair. He argued that reducing inequality has multiple benefits, given that a high degree of income inequality

- reduces income mobility;
- leads to an increase in crime;
- is detrimental to public health;
- leads to greater inequality in educational attainment;
- negatively affects the sense of well-being of low-income individuals (owing, among other things, to conspicuous consumption by the wealthy);
- is destructive of social capital;
- undermines political support for the free market; and
- may negatively affect economic growth.

Given the choice between an income tax and a consumption tax, Brooks favoured the income tax as better achieving redistributive goals. He did not, however, focus on the SET. I will argue 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 favouring the SET is a practical one. It rests on the premise that the income tax does not function well in practice and that it would be difficult to repair the income tax within its own terms. A fix for the income tax would require a reduction in rates,[11] which would cost revenue and make the tax less progressive. According to my proposal, the SET would be available to supplement the income tax through progressive rates on the wealthy, thus making up for the revenue loss and reduced progressivity that result from lower income tax rates. The SET therefore would fulfill the goals of making the tax system more progressive; it would do so not on its own merits but by allowing the income tax to function better and become a more stable part of the revenue system.

There is a kind of natural limit to how high income tax rates can go before they are put under undue pressure. This limit is in the range of 30 percent. For the purposes of simplification, it is desirable to set rates on all kinds of income at the same

9 Ibid., at 288.

10 Ibid., at 290.

11 A key reason for this is that income tax reform would call for taxing capital gains the same as ordinary income. But if this were done, realized capital gains would be subject to tax at very high rates, which is distortionary.

rate schedule. Some types of income are particularly difficult to tax at rates much above 30 percent. These types of income 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, even if we take into account the combined federal and provincial rates, capital gains are taxed at a rate below 30 percent, given that 50 percent 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 percent. An SET would thus make possible a tax system more progressive than the one we have at the moment. Indeed, it would allow whatever degree of progressivity that politicians would be willing to agree to. The combination of an SET and the income tax would therefore be more robust in the achievement of vertical equity than the income tax alone is, and such a combination would more closely accord with the potent redistributive vehicle that Neil Brooks favours.

The SET would also help 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 they are taxing earned income. With the SET, this approach would no longer be needed. All income could be taxed at moderate rates that top out at about 30 percent. Additional progressivity could be provided by the SET. Importantly, each dollar of income or consumption, no matter what its nature, would be taxed at the same rate, thus satisfying the criterion of horizontal equity.

As a side benefit, the taxation of all income under the same rate schedule would allow the rules of the income tax to be simplified, thereby reducing compliance costs. (For example, the rules governing the distinction between income and capital gains could be relaxed.) The combination of SET and income tax would make for greater economic efficiency than the income tax provides on its own. The greater efficiency of the SET-cum-income tax would make it a better vehicle for redistribution, because it would have a lighter effect on the economy and therefore would be easier to adopt, from a political perspective. (It cannot be said that high tax rates would discourage small businesses, since any amounts reinvested in the business would not be 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 could add tax expenditures to the SET, but these could be limited. In some cases, tax expenditures under the income tax would already cover the situation. In the case of the credit for charitable contributions, for example, given that this credit already exists, the enactment of the SET would not raise any additional issues. Some income tax expenditures—for example, various savings incentives—are designed to reduce the tax on capital income. Because the SET would not tax the normal return to capital, it would remove the need for savings incentives. From a fairness standpoint, the SET would be preferable to a prepaid type of consumption tax, because above-normal returns to capital would be taxed. Finally, some provisions under the SET might be somewhat ambiguous concerning the status of certain expenses as tax expenditures. Problems may arise under the SET that do not arise under the income tax, and they may need to be addressed. For example, the question whether the expenses of a political campaign are part of the SET base may arise. The SET might include a rule allowing a deduction for such expenses, perhaps with various limits and conditions. Would this be a tax expenditure, or would it simply reflect a judgment on the part of Parliament that these expenditures are not properly taxable? Either way, there are likely to be a few rules of this kind under the SET. I don't see this as particularly problematic. In evaluating the likely complexity of the new tax, one can anticipate that some number of such special rules might be required. My view is that such rules would be relatively small in number, for the reasons stated above, and that the added complexity arising from such rules would not be substantial.

One of the most important functions for any tax is to raise revenues. In this regard, the SET would provide 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 could be adjusted from time to time through a change of the SET rates and exemption amounts.

THE SET AND TAX DIVERSIFICATION

Although a lot of writing about tax is theoretical, tax design is largely a practical discipline; practical considerations often predominate over theoretical considerations. One manifestation of this practical emphasis is tax diversification. A diversity of revenue sources is often preferable to one tax or a minimal number of taxes. This principle may seem counterintuitive, given that a multiplicity of taxes involves increased compliance costs. Certainly compliance costs should be borne in mind and should temper the tendency to adopt multiple tax instruments. That said, several diverse taxes are usually harder to avoid than a single tax. Moreover, every tax will be imperfect because it is impossible to design a perfect tax. The remedy is to keep the rates of each tax moderate in order to avoid the imposing of a high tax in a situation where such imposition is unfair. Given the imperfections of an income tax, combining this tax with an SET and keeping the rates of both taxes moderate would 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, one might be concerned that defining the tax base would be difficult and confusing. I hope to show below that it would be 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 would be to set a fairly high threshold for the tax, so that the great majority of taxpayers would not have to deal with it. As discussed above, the threshold might be set in the range of $100,000 to $150,000 so that it would fit in with the existing federal and provincial rate schedules.

In General

The SET would be a cash flow tax (that is, cash receipts, with a deduction allowed for net investments). Such a tax would be substantially simpler than the current income tax, although it would involve some design issues and new elements, as outlined below.[12] In a broad sense, the SET would be very similar to the income tax, except that includable receipts would be defined more broadly than under the income tax and the SET would not tax income until the income was consumed (generally, investment would be deductible).

To determine their SET liability, taxpayers would use the same information as they use for the regular income tax, with a few modifications. The general approach would be a cash flow approach. Thus, items of income would be taken into account when received. A deduction would be allowed for any investments when they were made. This would include both financial and business investments. Borrowing would generally be included in taxable receipts; a deduction would be allowed for net savings; and receipts would be somewhat more broadly included 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 of the SET, would depend on the whole tax policy picture. The SET rates and exemption could be determined at the end of the process of designing a tax reform bill, in order 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 (probably between $100,000 and $150,000), 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.

Specific Design Elements

Jurisdictional Basis

Like 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 inclusion would not require particularly complex calculations, since all that would be needed is the amount of cash distributions—an amount that would be relevant for regular income tax purposes as well.

Income

Income would be defined much as it is under the regular income tax law. Thus, income would include wages, interest, dividends, royalties, and the like. A major

12 Except as otherwise noted, I follow the design recommendations for the expenditure tax set out in Michael J. Graetz, "Implementing a Progressive Consumption Tax" (1979) 92:8 *Harvard Law Review* 1575-1661.

difference between the SET and the income tax is that, with the former, the proceeds of sales would be fully taxed when received—that is, not only the gain but also the entire sales proceeds would be includable in taxable receipts. These would be accounted for on a cash basis; thus, for example, instalment sales would be taxed as cash was actually received, not at the time the sale took place.

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

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 in the same way for the SET as for the regular income tax.

A deduction would be allowed for life insurance premiums, whether for term insurance or insurance that had an investment component. In other words, all life insurance would be treated like savings. The reason for this treatment would be 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 they were received.[13]

Treatment of Debts

Under the SET, as a general rule, all borrowing proceeds would be included as taxable receipts, and a deduction would be allowed for interest and principal paid on loans. If the borrowing proceeds were used for investment, an offsetting deduction would be allowed.

The only exception to the general rule would be for home mortgages, auto loans, and loans for other consumer durable items that were purchased with debt secured by the item. In these cases, the taxpayer would be taxed on amounts used to pay off the loan, because no deduction would be allowed for principal or interest payments made. Under this approach, consumption expenditures would be taken into account for tax purposes approximately at the same time that the taxpayer enjoys the benefits 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 used to acquire consumer durables would be taxed (since the loan proceeds were not taxed). Note, however, that there would not likely be much SET liability from the taxation of loan forgiveness, given the high threshold. Because of the threshold,

13 Ibid., at 1611-13.

most people in a position to have their consumer debt forgiven would not be subject to the SET in the first place. If the amount of loan forgiven were large, provision could be made in the law for spreading the taxable amount over several years, in order 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 was forgiven.

Treatment of Cash

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

The suggested treatment of cash would allow taxpayers to engage in a certain amount of self-help averaging. A taxpayer who wanted to increase the SET base for a year could do so by liquidating an investment and receiving cash. By contrast, a transfer of cash into an investment account would reduce the tax base for that year. Chequing accounts could be treated the same as cash, so there would be no need to report balances in these accounts, or additions to or withdrawals from them. In addition to this legitimate averaging opportunity that would arise from liquidating investments, there would be an opportunity to evade tax by failing to declare cash receipts and then transferring the cash into an investment account. The result of such evasion would be a reduction of the tax base, beyond what could occur under the income tax through a failure to declare cash income. Manoeuvres of this kind should raise a red flag for audit, but it highlights the fact that audit capacity would need to be there in order for the SET to succeed. Investments held in a brokerage account would present no evasion opportunity, because sales would be reported to the Canada Revenue Agency. (There would be no additional reporting requirement, because these transactions would already have been reported.)

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[14] would be left out of debt account (in other words, the borrowing proceeds would not be taxable and repayments would not be 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 of this expenditure into one year would tend to place the taxpayer into a higher tax bracket than usual.) The remedy would be to allow the taxpayer to amortize the expenditure over some lengthy period, say 20 to 30 years (interest should be charged on the outstanding

14 Including a second home, as well as collectibles and the like, infra note 19.

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, such that this amount would be included in the SET base. This would put the taxpayer on a footing similar to that of someone who financed with a mortgage and 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 in which there is an unused exemption amount under the SET.

Other Consumer Durables

If a taxpayer purchased a consumer durable, the transaction would 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 the use of the durable for the year in question, not the entire value of the durable. From a legal point of view, however, the entire purchase price, absent a special rule, would be part of taxable expenditure for the year, because the SET would treat the entire consumption as occurring in the year of purchase.[15] As with housing, the case of consumer durables purchased with debt could be dealt with by ignoring the debt-financed part of the transaction. The debt could be excluded from receipts, with no deduction allowed for loan repayments. As a result, loan repayments could be taxed as consumption as they were made. This is the same rule as applies to debt-financed owner-occupied housing. As with housing, one could also amortize the cost of substantial consumer durables (for example, those that cost over $10,000) that were purchased with cash over a period of years.

Averaging

An argument can be made for averaging under an SET. In a number of situations, the taxpayer might incur substantial expenses for reasons largely beyond the taxpayer's control. These could be items such as medical expenses, legal fees, or tuition. If these expenses caused taxable expenditure to be higher than normal, the tax consequence might 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 and administrative burdens for both taxpayers and the tax administration when it comes to 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 relatively large as a portion of taxable expenditure. The simplest approach would be to include no averaging rule.

Carryover of Exemption

The specific form of SET that I am proposing raises an averaging problem that is somewhat different from the averaging problem that exists under a broader consumed-income tax. The large annual threshold (probably on the order of $100,000 to

15 The same approach is taken by the value-added tax/goods and services tax.

$150,000) means that taxpayers with relatively low amounts of consumption in a given year would "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 were not subject to the SET for the year in question, and to carry over the unused exemption. Although this would involve a record-keeping burden, the burden would not be 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 (for example, by purchasing consumer durables rather than investments). 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 and by limiting the period of time for the carryover (otherwise, returns that were many years old might have to be audited in the tax year when the carryover was used, at which point much of the applicable information might no longer be available). It would probably also make sense to allow an unused exemption to be transferred to a spouse, similar to the way in which medical expenses can in effect be transferred between spouses. Such an allowance would mean that if one spouse were earning below the exemption level and the other spouse were earning above that level, the lower-earning spouse could transfer the unused exemption to the higher-earning spouse, who might then not have to pay any SET or would have a higher exemption. Transfer between spouses would raise fewer administrative issues than carryover from one year to another, because the unused amount would be used up in the same year, and it would not be necessary to go back to prior years.

International Aspects

Rules would be needed to avoid the double taxation of residents who earned amounts from foreign sources and paid foreign tax. This could be done either by allowing a credit against SET for foreign-income tax paid, or exempting from the SET base amounts of consumption that were financed by foreign-source income. For the purposes of the foreign tax credit limitation (assuming that the foreign tax credit remains in its current form), the SET should be considered as part of the income tax. Under this approach, the foreign tax credit does not pose any difficulties for the SET. Admittedly, the result would end up being rough and ready, particularly where a substantial amount of taxable expenditure was financed out of income of previous years. The formula for the foreign tax credit limitation does not take into account whether that previous income was domestic or foreign-source, or what tax rates it bore. Likewise, under the SET, if the taxpayer were to incur foreign income tax but save a substantial portion of the current year's income, with the result that the current year's domestic tax was low, the formula would reduce 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 non-residents, the SET would simply not apply, since the jurisdictional scope of the tax would extend only to residents. Non-residents would continue to be taxed under the income tax on their domestic-source income.

An individual who would be subject to the SET at a high marginal rate might have a tax incentive to retire abroad, if he or she were 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, savings that the individual intended to consume during retirement). It might be appropriate to provide rules requiring expatriating individuals to continue to pay SET for a period of years, particularly if the amounts involved would be 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.[16]

Family Unit: Gifts and Bequests

I assume that gifts and bequests would not be taxed to the donor. In other words, they would 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—would create 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 prevent this opportunity, it would make sense to include in the SET base of the parent any consumption by minor children. In most cases, there would 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 attained majority. For this situation, one would probably need an anti-avoidance rule providing that a purported gift would be disregarded to the extent that the gift was used to provide a consumption benefit to the donor. This rule would not, of course, catch everyone; this weakness in the SET raises a good argument for not relying on an expenditure tax exclusively, and it indicates why it would be a good strategy to combine the SET with the income tax. Even if the donor could avoid the SET by making gifts, manoeuvres of this kind would not avoid income tax.

Assuming that a deduction were allowed for gifts, rules would 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 category 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 deductible gifts need to be restricted, since one would not want to allow deductions for gifts to a politician, or gifts to a person who provided services to the taxpayer.

Housing and Other Personal-Use Property

In the long term, the principal residence, if purchased after the effective date, would be entirely tax-paid. To the extent that the principal residence was purchased with cash, the cost would be included in the SET base in the year of expenditure (or

16 See subsection 128.1(4).

would be spread over several years; for special rules that might be provided in this regard, see the foregoing discussion of averaging). To the extent that the purchase was financed with debt, no SET deduction would be allowed for repayments of principal or interest. Upon sale, the entire proceeds should be exempted (see the discussion below, under the heading "Transition," for the treatment of housing purchased before the effective date). The same treatment should apply for sales of other personal-use property.

Rules would be needed to deal with property that was 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. The simplest rule would be to exempt from tax the proceeds on the disposition of such property. Any tax on the gain would be excessive according to consumption tax principles (except to the extent that the gain is attributable to sweat equity).

This approach would require treating as personal-expenditure property any property that is in fact used for personal purposes, as well as property that is held for investment or used in a business if the property 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 (a spouse, or children 18 and under) would be treated in the same way as personal-expenditure property. Proceeds from rental of the property should be exempted. Thus, for example, if a vacation home were purchased partly with cash and partly with debt, the debt would be excluded (as consumption debt), and the cash payment for the home would be included in the SET base. Suppose that rental income were used to pay interest on the debt, property taxes, repairs, and so forth. All of these amounts would simply be ignored for SET 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[17]) yield exemption treatment for this kind of asset. (The same principle could be applied to artwork, a yacht, race horse, or other property that is treated as personal-expenditure property: any income from renting the property could be ignored.)

Anti-Abuse

One fairly obviously necessary anti-abuse rule would 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 might 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

17 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.)

it himself, the expenditure would have been part of the SET base.[18] 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 was 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 (for example, if someone rented a car from a company engaged in automobile leasing). Although the suggested anti-abuse rule would be harsh, this harshness 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 would not be necessary to actually apply the rule very often.

TRANSITION

If the existing income tax were completely replaced by an expenditure tax, there would be a need for transition relief. The classic case would be 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. Under the income tax, the taxpayer could draw down these assets without additional tax. Under an expenditure tax, however, this taxpayer would face paying tax again. This situation would call for giving the taxpayer relief for consumption that was financed out of tax-paid assets.

In the case of the SET, however, the transition situation would be somewhat different. The SET would be designed to be an additional tax—that is, imposed in addition to the regular income tax (hence its name: the *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 was consumed. This seems fair. The income tax would continue. Taxpayers holding wealth at the time of the SET's introduction would benefit from any reduction of income tax rates that took place at the same time that the SET was introduced. The taxpayer in the example above would not pay any more income tax on assets that were liquidated to finance consumption. The SET payable would therefore not duplicate income tax already paid. The imposition of a one-time tax burden on existing capital would, in other words, be part of the politically accepted strategy.

Although general transition relief should therefore not be needed, a few specific transition rules would be required to avoid unfairness in particular cases. One such rule would apply to consumer durables, particularly housing. Someone buying a house after the effective date with borrowed funds would pose no particular problem. Given that the loan would be kept out of account, the result would be that interest

18 See above, under the heading "Other Consumer Durables."

and principal on the loan would be included in the tax base as the loan was repaid. This would provide an advantage to those who already owned 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 had saved up but not yet purchased a house as of the effective date. If no transition rule were provided, these prospective buyers 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 disadvantage, an exemption could be provided (subject to an appropriate limitation) for the purchase of a principal residence within a specified period (for example, one year) after the effective date, in the case of someone who did 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 would 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 that someone sells a principal residence that qualifies for the gain exclusion after the effective date. This could apply for SET purposes as well.

In addition, a transition rule should be considered for those who, before the effective date, purchased an unusually large house. Such individuals would be advantaged as compared with those who bought housing with income earned after the effective date, since the latter would be taxed on these amounts. For these individuals, there would be an undue preference if no account were taken of the existing asset as of the effective date. Accordingly, in the case of homes worth more than a specified amount, it would make sense to include in the SET base an estimated rental value.[19] I recognize that this would involve some valuation issues and that 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 the 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 chequing account or other bank balances are treated the same as cash (that is, not taken into account) for SET purposes generally.

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19 Compare Nicholas Kaldor, "Alternative Theories of Distribution," (1955) 23:2 *Review of Economic Studies* 83-100, 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.

Although they are not without their difficulties, the transition rules described above 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.[20] 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 the elimination of the 50 percent deduction for capital gains, so that realized capital gains would be taxed on the same basis as other income. The reduced income tax rates would reduce the distortions of the income tax. The resulting system could be made more progressive than the current law, by appropriately setting the rates and exemption level for the SET.

20 See Mitchell L. Engler and Michael S. Knoll, "Simplifying the Transition to a (Progressive) Consumption Tax" (2003) 56:1 *SMU Law Review* 53-82, at 54.