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Introduction (Issue on Incremental and Fundamental Tax Reform)

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INTRODUCTION

*Christopher H. Hanna**

IN April 2001, the staff of the U.S. Congressional Joint Committee on Taxation (“Joint Committee”) released a comprehensive three-volume study entitled the *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*.¹ Congress mandated the study as part of the IRS Restructuring and Reform Act of 1998 with the purpose of the study being a review of the overall state of the Federal tax system with recommendations to simplify taxpayer and administrative burdens.² The study received tremendous praise upon its release and serves as a blueprint for many members of Congress who have introduced tax simplifications bills since April 2001.³

In conducting its study, the Joint Committee invited approximately thirty-eight law professors and twenty-five tax policy advisors to assist in the study. The law professors and tax policy advisors met several times with the Joint Committee over the course of a year making numerous

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1. STAFF OF J. COMM. ON TAX’N, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, JCS-3-01 (Comm. Print 2001).

2. Internal Revenue Service Restructuring & Reform Act, Pub. L. No. 105-206, 112 Stat. 685, § 4002(a) (1998) (codified as amended at 26 U.S.C. § 8022 (2002)). Section 8022(3)(B) reads:

[It shall be the duty of the Joint Committee] [s]ubject to amounts specifically appropriated to carry out this subparagraph, to report, at least once each Congress, to the Committee on Finance and the Committee on Ways and Means on the overall state of the Federal tax system, together with recommendations with respect to possible simplification proposals and other matters relating to the administration of the Federal tax system as it may deem advisable.

3. See, e.g., From the Editor, *Hey, How About a Little Appreciation Here?*, 91 TAX NOTES 853 (2001) (JCT study is “one of the most significant contributions to tax literature and tax policy in the last 20 years. Period!”); Martin A. Sullivan, *Will Congress Follow JCT Simplification Roadmap?*, 91 TAX NOTES 859, 860 (2001) (“[T]he shortcomings of the JCT report are minor compared to its enormous utility for furthering the cause of tax simplification.”); N.Y. State Bar Ass’n, *Simplification of the Internal Revenue Code*, 95 TAX NOTES 575, 576 (2002) (JCT “devoted more than 1,000 thoughtful pages to the subject [of simplification] in a study published in April 2001.”); Letter from Pamela J. Pecarich, Chair, Tax Executive Committee of the American Institute of Certified Public Accountants, to The Honorable William Thomas, Chair of the Ways and Means Committee (Feb. 7, 2002), 2002 TAX NOTES TODAY 27-15 (2002) (“[T]he [JCT] study [is] of the highest quality that provides an excellent understanding of both the sources of tax law complexity and its effect on the present system.”).

recommendations and suggestions for simplification. A number of these recommendations made their way into the study; however, a number of recommendations were considered to be beyond simplification and more in the nature of reform of the tax system, which was not the purpose of the study.

Several months after the Joint Committee released its simplification study, the *SMU Law Review* decided to put together a tax symposium issue in which a number of the academics who participated in the study were asked to contribute articles in various areas of the tax laws making recommendations for incremental and fundamental tax reform. These academics would not be limited by the sole goal of simplification. In addition, a number of leading academics who did not participate in the Joint Committee study as well as a number of leading practitioners were invited to contribute articles discussing tax reform in specific areas of the tax laws. The result is an impressive tax symposium issue, comprising fifteen articles and six comments covering fundamental tax reform—such as transitioning from the present income tax system to a consumption tax system—as well as more modest incremental proposals in areas such as corporate tax, partnership tax, international tax, deferred compensation, and tax-exempt organizations.

Fundamental Tax Reform

The first section of the symposium issue focuses on fundamental tax reform. In the first article, Professor Calvin Johnson argues that the implicit tax on tax-exempt municipal bonds is a thermometer that is now giving warning that the current tax system is not in good shape.⁴ He argues that the United States needs to stop using the tax system as a vehicle for delivering subsidies. In fact, the United States needs to give considerable attention to repairing the tax base through a tax overhaul at least as major as the Tax Reform Act of 1986. Tax-exempt municipal bonds give an interest rate that is lower than that on comparable taxable bonds by the amount of what is called the “implicit tax.” In theory, high tax bracket investors should be willing to accept an implicit tax, just short of their statutory tax rate. The implicit tax is now very low, Johnson argues, hovering not far above zero. Johnson argues that the implicit tax is so low today because investors have too many easy alternative ways to avoid tax and are not willing to accept very low interest rates from tax-exempt municipal bonds. The low implicit tax indicates that tax is an inefficient vehicle for delivering tax subsidies and that the tax system is not reaching its best sources.

Professors Mitchell Engler and Michael Knoll discuss transitioning from an income tax system to a consumption tax system.⁵ They write that

4. Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13 (2003).

5. Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53 (2003).

the existing personal income tax system is seriously flawed and that the benefits of shifting to a consumption tax system, which has fewer opportunities for tax avoidance and evasion, are obvious. As a result, Professors Engler and Knoll demonstrate how a conventional cash-flow consumption tax eliminates many of the tax avoidance and evasion problems of the current income tax system. They further discuss how retention of the tax on wages would greatly simplify the transition to a consumption tax, noting that this would alleviate the difficult transition issues that arise in any discussion of moving from an income tax system to a consumption tax system.

Professor Joseph Bankman comments on the Engler-Knoll proposal on transitioning from an income tax system to a consumption tax system.⁶ He writes that full transition relief is unfair because it “overcompensates holders of capital, exacerbates unequal distribution of wealth, and reduces welfare.”⁷ While acknowledging that the Engler-Knoll proposal is ingenious, Professor Bankman believes that a cash-flow tax with limited transition relief and lower rates is more likely to be enacted than the Engler-Knoll proposal.

Professor Deborah Geier describes the historical shift from consumption taxation at the federal level to income taxation with enactment of the Sixteenth Amendment (the intent of which was chiefly to tax the capital income of the wealthy) and the incremental shifts since then back toward consumption taxation (which frees capital from tax) through expansion of both the payroll taxes as well as the consumption tax features of our current hybrid income/consumption tax that target the middle class.⁸ She then addresses the issue of whether we ought to expand consumption tax treatment to the very wealthy by reviewing two recently published books on fundamental tax reform, Edward J. McCaffery’s *Fair Not Flat* and Michael J. Graetz’s *The Decline (and Fall?) of the Income Tax*.

Professor Geier’s main concern with McCaffery’s proposal to replace the income tax (as well as the estate and gift tax) with a cash-flow consumption tax with graduated rates is the effect his proposal could have on the tax paid by the top one-percent of wealth owners, which now own nearly forty percent of private wealth in this country. She believes that a significant shift in the tax burden away from the top one-percent would likely occur under McCaffery’s proposal—in return for speculative economic benefits for the country, in the view of many economists—which could do no more than accelerate the wealth concentration in the top one percent that has already reached record levels in recent years. Graetz proposes a two-tier tax system in which all individuals pay a VAT and those individuals earning above \$75,000 to \$100,000 also pay an income

6. Joseph Bankman, *The Engler-Knoll Consumption Tax Proposal: What Transition Rule Does Fairness (or Politics) Require?*, 56 SMU L. REV. 83 (2003).

7. *Id.* at 97.

8. Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99 (2003).

tax. Professor Geier believes that Graetz's proposal, which would keep 100 million taxpayers from having to file an income tax return, is extremely important, but she would attempt to accomplish what Graetz is proposing within a single tax system rather than a two-tier system.

Professor Jeff Strnad notes that two distinguished and significant literatures affecting tax reform have developed over time.⁹ The first involves the choice of a tax base, such as a comparison of an accretion tax to a consumption tax. The second involves the impact of taxes on short-run fluctuations and long-term growth. Professor Strnad attempts to "deepen the cross-fertilization" between the choice of a tax base and the impact of taxes (both in the short-run and the long-term).¹⁰ He discusses the macroeconomic implications of four different tax bases: an accretion tax, a realization-based tax, a cash-flow tax, and various hybrid tax systems. Professor Strnad then summarizes his discussion concluding that further research is necessary using more explicit and sophisticated modeling.

Professor David Weisbach contributes an article in which he examines the implementation of a two-tier consumption tax, which is a variation of a proposal made by David Bradford under the name x-tax.¹¹ A two-tier consumption tax is a tax on consumption by imposing a progressive wage tax on individuals coupled with a cash-flow or VAT-like tax on businesses (and granting the businesses a wage deduction). Professor Weisbach believes that a two-tier consumption tax has many desirable features and is worth serious attention but acknowledges that designing a workable system is a challenge. Professor Weisbach focuses on three primary issues in his article: problems that may arise under GATT because the two-tier consumption tax must be origin-based under GATT, which may lead to significant avoidance problems; utilizing a credit-invoice VAT rather than a subtraction-method VAT; and transition issues that will need to be addressed in implementing a two-tier consumption tax.

Corporate Tax

Michael Schler writes a detailed article focusing on the spin-off rules contained in section 355.¹² He believes that the rules are "in many respects illogical, complex, and uncertain."¹³ Schler gives several reasons for this: (1) the spin-off rules were developed during a time when mostly closely-held corporations with simple corporate structures were doing spin-offs as opposed to publicly-traded corporations with complex structures doing spin-offs, which is common today; (2) most of the spin-off rules were designed for the pre-1986 period, which was prior to the repeal of the *General Utilities* doctrine; and (3) with *General Utilities* repeal in

9. Jeff Strnad, *Some Macroeconomic Interactions with Tax Base Choice*, 56 SMU L. REV. 171 (2003).

10. *Id.* at 172.

11. David A. Weisbach, *Does the X-Tax Mark the Spot?*, 56 SMU L. REV. 201 (2003).

12. Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules*, 56 SMU L. REV. 239 (2003).

13. *Id.* at 240.

1986, tremendous pressure is placed on the spin-off rules because they are the principal method for appreciated assets to leave a corporate group without triggering gain. Schler suggests a number of revisions to the spin-off rules that will make the rules simpler and more consistent with their purpose. He cautions that his proposals must be taken as an integrated package and that selective adoption of his proposals may not lead to simplicity and may not accomplish the purpose of the spin-off rules.

Professor George Yin comments on Mr. Schler's article.¹⁴ Professor Yin immediately notes that Schler has, for the most part, avoided a discussion of a major discontinuity in subchapter C involving the different tax treatment of stock acquisitions and asset acquisitions. As a result, Professor Yin evaluates Schler's proposals in the context of the skewered framework of current corporate tax law. Professor Yin believes that it is possible to achieve significant simplification of section 355 and stay within its purpose of not taxing business-driven divisions of corporate enterprises. Professor Yin cautions, however, that true reform of section 355 may have to wait until resolution of the more fundamental problems of subchapter C.

Professors Terrence Chorvat and Michael Knoll write that the corporate alternative minimum tax ("AMT") should be repealed.¹⁵ They note that recent events involving Enron, WorldCom, Global Crossing, and Qwest have demonstrated that Congress' justification for enacting the corporate AMT in 1986 has been undercut because book income, like taxable income, can also be subject to wholesale manipulation. Professors Chorvat and Knoll argue that the corporate AMT raises minimal revenue, distorts investment incentives, and imposes substantial compliance costs. In addition, they argue that the corporate AMT does not increase efficiency or equity and does not prevent corporate tax shelters. In lieu of the corporate AMT, Professors Chorvat and Knoll propose reducing tax preferences and requiring greater public disclosure of the tax information of public companies.

Professor Reuven Avi-Yonah responds to Professors Chorvat and Knoll by noting that the arguments for repealing the corporate AMT are not particularly persuasive.¹⁶ Rather, Professor Avi-Yonah believes that, at best, Professors Chorvat and Knoll "make a case for reforming the corporate AMT, not for repealing it."¹⁷ Professor Avi-Yonah states the case for retaining the corporate AMT and then reviews the arguments for repeal. Finally, he discusses how the corporate AMT can be improved and simplified primarily by basing it more on a corporation's book income.

14. George K. Yin, *Taxing Corporate Divisions*, 56 SMU L. REV. 289 (2003).

15. Terrence R. Chorvat & Michael S. Knoll, *The Case for Repealing the Corporate Alternative Minimum Tax*, 56 SMU L. REV. 305 (2003).

16. Reuven S. Avi-Yonah, *The Case for Retaining the Corporate AMT*, 56 SMU L. REV. 333 (2003).

17. *Id.* at 333.

Partnership Tax

Professor Mark Gergen writes that the capital accounts system that was developed in the late 1970s and early 1980s has solved many of the problems that have arisen in subchapter K since 1954.¹⁸ The capital accounts system was created primarily to handle special allocations; however, Professor Gergen notes that special allocations have been one of the weaker points of the system. Professor Gergen is concerned that new types of problems are beginning to arise in subchapter K for which the capital accounts system is not well equipped to handle. For example, he cites partnership options and discounts involved in family limited partnerships as putting pressure on what has already been a weak point in the capital accounts system. Similar to special allocations (and guaranteed payments), options and discounts “break the relationship between capital accounts and partnership economics.”¹⁹ Professor Gergen believes that only time will tell whether the capital accounts system will survive the new problems arising in subchapter K.

Professor Lawrence Lokken comments on Professor Gergen’s article and does not share Professor Gergen’s fear that the issues raised by options and discounts threaten to end the intellectual revolution in partnership taxation.²⁰ Rather, Professor Lokken believes that new thinking will probably provide acceptable answers for all of these new problems. He believes, however, that the new answers will bring us no closer to answering the more imponderable question: “has the partnership taxation revolution ever begun, and should it ever begin, for the daily practice of partnership taxation for the ordinary partnership?”²¹

International Tax

In my article, I propose four changes to the inbound U.S. international tax rules.²² These changes should be read in conjunction with the changes proposed by the Joint Committee in its simplification study. First, I recommend increasing the dollar threshold for nonresidential alien individuals performing services in the United States from \$3,000 to \$25,000 to reflect the fact that the threshold amount has not changed since its enactment in 1936. Second, a nonresident alien or foreign corporation owning U.S. real property should be treated as having income from the U.S. real property as income effectively connected to a U.S. trade or business unless the activity is not a trade or business and the nonresident alien or foreign corporation elects to have the income subject to the thirty-percent gross basis withholding tax. Third, a nonresident alien

18. Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343 (2003).

19. *Id.* at 364.

20. Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365 (2003).

21. *Id.* at 376.

22. Christopher H. Hanna, *Some Modest Simplification Proposals for Inbound Transactions*, 56 SMU L. REV. 377 (2003).

should be treated as a nonresident for purposes of the sourcing rules for personal property even if the nonresidential alien has a tax home in the United States. Fourth, a provision treating foreign source income from the sale of inventory as effectively connected income should be repealed.

Professor Robert Peroni writes that reform is needed with respect to the foreign tax credit limitation in U.S. international tax law.²³ He proposes four changes affecting the foreign tax credit limitation and outbound rules in general. First, Professor Peroni writes that the foreign tax credit limitation should be calculated on a country-by-country basis, with two categories per country: a passive basket and a residual basket. Second, he recommends revision of the source rules so that, for example, income that is not taxed by a foreign country should not be treated as foreign source income for purposes of the foreign tax credit limitation. Third, he proposes that income earned through a foreign corporation be taxed currently to each U.S. ten-percent shareholder of the foreign corporation by imposing a pass-through regime with respect to these shareholders. Fourth, Professor Peroni argues that the special provisions in the alternative minimum tax that apply to a U.S. taxpayer's foreign tax credits (i.e., the ninety-percent limitation on foreign tax credits for AMT purposes) should be eliminated.

Financial Instruments

Professor Jeff Strnad contributes an article on the taxation of convertible debt.²⁴ He notes that convertible debt plays an important funding role in U.S. capital markets. Professor Strnad believes that the most important explanation for the widespread use of convertible debt is its usefulness in signaling firm prospects. For example, in the conversion game, "managers signal private information to investors through their decision to call or not to call convertible issues."²⁵ In the issuance game, managers signal through their decision as to what security will be issued to fund new investment. A tax proposal to delay deductions for original issue discount ("OID") on convertible debt until the OID is paid could have a major impact on both the conversion game and the issuance game. Professor Strnad cautions that policymakers should avoid tax provisions that substantially affect convertible debt or that focus on the conversion feature of convertible debt unless there are important reasons for doing so. Stated more generally, tax policy should assist (and certainly not hinder) the corporate finance functions served by convertible debt.

Edward Kleinbard comments on Professor Strnad's discussion on the taxation of convertible debt.²⁶ Kleinbard writes that Professor Strnad's thesis seems to be that in analyzing a tax regime for a financial instru-

23. Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391 (2003).

24. Jeff Strnad, *Taxing Convertible Debt*, 56 SMU L. REV. 399 (2003).

25. *Id.* at 446.

26. Edward D. Kleinbard, *Taxing Convertible Debt: A Layman's Perspective*, 56 SMU L. REV. 453 (2003).

ment, the focus should be on whether the tax regime advances or hinders the corporate finance objectives of that particular financial instrument. Kleinbard has two primary concerns with the Strnad thesis. First, "current tax law already permeates corporate finance decision making."²⁷ Second, the tax system is fundamentally at odds with any non-tax economic corporate model so as to "overwhelm any efficiency gains from, for example, enhancing the signaling effects of convertible bonds."²⁸ Kleinbard ultimately concludes, with a touch of sadness, that the gap between tax policy academics and the marketplace seems to be growing wider.

FASITs

Professor Clarissa Potter writes that the financial asset securitization investment trust ("FASIT") regime Congress enacted in 1996 has failed miserably as almost no asset-backed securities have been issued under the FASIT regime.²⁹ Professor Potter notes that Congress has one of three choices with respect to the FASIT regime. First, it can leave the FASIT regime in place, essentially condemned to deadwood status. One of the dangers of this approach is that taxpayers may use the provisions in unanticipated ways. Second, Congress could simply repeal the FASIT regime, which is the approach recommended by the Tax Section of the New York State Bar Association. Third, Congress could make substantial changes to the FASIT regime so that more taxpayers will utilize it. As a policy matter, Professor Potter is "weakly in favor of making legislative changes to better accommodate securitization transactions."³⁰ But she notes that if revenue cannot be devoted to making substantial changes to the FASIT regime, then the entire regime should be repealed.

Estate and Gift Tax

Professor Joseph Dodge contributes an article with the principal focus of comparing a reformed version of the present transfer tax system with an inheritance tax, an accessions tax, and an income-inclusion system.³¹ Professor Dodge sets forth two theses: the first is that the basic features of the existing transfer taxes (large exemptions and an unlimited marital deduction) should not simply be carried over to any of the alternative systems, and the second is that a generation-skipping transfer tax (or its equivalent) is not a necessary feature of any system, and is not justifiable on equity grounds or as a means of rendering the system into a proxy wealth tax. Professor Dodge examines such basic structural features as

27. *Id.* at 466.

28. *Id.*

29. Clarissa C. Potter, *A Wrench or a Sledgehammer? Fixing FASITs*, 56 SMU L. REV. 501 (2003).

30. *Id.* at 505.

31. Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 SMU L. REV. 551 (2003).

the appropriate rate and exemption structures, the marital deduction or exemption, exclusions for inter vivos gifts, timing issues, and valuation issues. Professor Dodge reaches a number of conclusions including: (1) “an *unlimited* marital exclusion is contrary to the purpose of an accessions tax;”³² (2) “an accessions tax and an income-inclusion offer considerable simplification advantages over an estate tax or an inheritance tax;”³³ (3) an exclusion for consumption-type (as opposed to wealth) transfers is justified under any system; (4) “an income-inclusion system is doctrinally the simplest;”³⁴ and (5) “the accessions tax and income-inclusion approaches are sufficiently close as to suggest the possibility of a hybrid system that would combine the most appealing features of each.”³⁵

Professor Henry Lischer discusses the implications of retaining the gift tax while repealing the estate tax and the generation-skipping transfer tax.³⁶ He notes that Congress retained the gift tax due to allegations that the absence of a gift tax would encourage income-shifting transactions that would lead to significant federal income tax revenue losses. Professor Lischer reviews various “income-shifting techniques that have been proffered as viable if there were no gift tax”³⁷ and possible methods of combating inappropriate income shifting by means of income tax mechanisms rather than relying on the gift tax.

Deferred Compensation

Professor Norman Stein contributes an article suggesting a number of changes to the Internal Revenue Code and ERISA that would “increase the probability that employer-sponsored retirement plans will enhance the retirement security of working people sufficiently to justify our national tax-expenditure commitment to such plans.”³⁸ Although he believes that the United States lacks a coherent retirement policy and he also believes in a mandatory universal pension system of the sort proposed by President Carter, Professor Stein accepts (without endorsing) the continuation of the employer-sponsored pension system. Professor Stein proposes twenty-six changes to the Internal Revenue Code and ERISA, which can be broken down into two categories: “(1) improving coverage and benefit levels for lower- and middle-income employees; and (2) increasing the efficiency of the tax incentives for qualified plans.”³⁹

32. *Id.* at 554 (emphasis added).

33. *Id.*

34. *Id.*

35. *Id.*

36. Henry J. Lischer, Jr., *Incomplete Transfer Tax Repeal: Should the Gift Tax Survive?*, 56 SMU L. REV. 601 (2003).

37. *Id.*

38. Norman P. Stein, *An Alphabet Soup Agenda for Reform of the Internal Revenue Code and ERISA Provisions Applicable to Qualified Deferred Compensation Plans*, 56 SMU L. REV. 627 (2003).

39. *Id.*

Tax-Exempt Organizations

Professor Frances Hill proposes a new approach to tax exemption to address what she describes as charitable inefficiency arising from the diversion of resources from exempt activities to commercial and political activities within exempt organizations.⁴⁰ Her article suggests that a new “nondiversion constraint” be developed to address charitable inefficiency. Using insights from theories of the firm, Professor Hill suggests that an exempt organization should be treated as an aggregate of activities, only some of which are exempt, rather than as an entity, which permits charitable inefficiency. Current law focuses on distributions outside the organization, but has no criteria for looking at diversions inside the organization. The unrelated business income tax applies only if the business activity is profitable and does not address diversions to unprofitable business activities. Professor Hill suggests that exempt organizations be analyzed in terms of patterns of sources and uses of revenue, so that exemption and the charitable contribution deduction can be targeted to exempt purposes, thereby satisfying the norm of charitable efficiency. This new nondiversion constraint provides the operational basis for both transparency and accountability for exempt organizations.

In closing this introduction, it is interesting to note that incremental and fundamental tax reform is a topic that is gaining a lot of attention at the United States Treasury Department.⁴¹ The twenty-one tax scholars who participated in this symposium issue have made a significant contribution to the tax law literature. Hopefully, Treasury, in its tax reform study, will consider some or all of the proposals and recommendations made by the authors in this symposium issue. In addition, any future study of incremental and fundamental tax reform should begin by considering many of the thoughtful ideas advanced by these authors.

40. Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 SMU L. REV. 675 (2003).

41. See, e.g., John D. McKinnon, *Treasury Weighs Overhaul of Complete U.S. Tax Code*, WALL ST. J., Oct. 30, 2002, at A2; Alan Murray, *New Bid to Replace Tax System is Mired in Murky Options*, WALL ST. J., Nov. 19, 2002, at A4.