

## Five Federal Lessons From California's Near-VAT Experience

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Federal tax policymakers can learn some important lessons for the future federal debate on VATs from last year's near-VAT experience in California. The California Commission on the 21st Century Economy's proposal for a subtraction-method VAT provides important practical lessons on the challenges of designing and adopting a VAT at the state or federal level in the United States. This article discusses five key lessons from the California experience.

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As discussions of a federal VAT start again in Washington, it would be helpful to consider some lessons from U.S. states' experience with VATs, and in particular California's 2009 near-VAT experience.

This article will address some of the key questions raised in California. Similar questions will be raised in any serious federal VAT discussion. The questions include:

- How would you know a VAT if you paid one?
- Why should a company pay a VAT if it is losing money?
- Is a broad-based VAT politically sustainable over time?
- Which business taxpayers are winners or losers under a VAT?
- Does today's dire fiscal outlooks overcome the traditional objections to a federal VAT?

The California Commission on the 21st Century Economy, appointed by the governor and the State Legislature to recommend fundamental, long-run

changes to modernize the state's tax system, issued its final report last September. The report included recommendations for significant reductions and restructuring of California's personal income tax, the elimination of most of the state sales tax, and the complete elimination of the corporate income tax. The tax reductions would be paid for by a new, entity-level business tax, the business net receipts tax (BNRT).<sup>1</sup>

While new to California, value added taxation is not a new concept in other states. The BNRT is a variation of a VAT that was first adopted in Michigan in 1953 and continued in a different form, the single business tax, until 2008. Another version of a VAT, the business enterprise tax, has been used in New Hampshire since 1993. In concept, these state taxes and the proposed BNRT are similar to the VATs used in more than 140 countries around the world, although they are quite different in operation.

The California commission's analysis of the BNRT and the public discussion of the proposal provide important practical lessons on the challenges of designing and adopting a VAT at the state or federal level in the United States.<sup>2</sup> This article discusses five key lessons from the state experience.

**Lesson #1: Value added taxation comes in many designs and with different labels.** The challenging first step in adopting a VAT is understanding what it is, and what it is not. In simple terms, a VAT is a consumption tax that operates like an indirect retail sales tax. A VAT is designed to tax final consumption of goods and services by households, but is paid by businesses over the course of the production and distribution of the product or service.

A critical operational difference between a VAT and a retail sales tax is that a VAT is collected from all firms in the economy, not just retailers. A VAT would be paid by producers of raw materials all the way through to the retailer at the end of the chain of production and distribution. Total collections under a comprehensive VAT would equal, in theory, the amount of taxes collected from a retail sales tax imposed only on purchases by final consumers. In addition to taxing all industries, a VAT is imposed on all business entities (C corporations, S corporations, partnerships, and sole proprietorships).

<sup>1</sup>For a description of the full package of recommendations and the details of the BNRT, see California Commission on the 21st Century Economy, "Report of the Commission on the 21st Century Economy," Sept. 2009.

<sup>2</sup>For a high-level overview of the VAT concept and policy issues related to the adoption of a federal VAT, see Robert Carroll and Alan D. Viard, "Value Added Tax: Basic Concepts and Unresolved Issues," *Tax Notes*, Mar. 1, 2010, p. 1117, *Doc 2010-2925*, or *2010 TNT 42-8*.

State VATs, in Michigan and New Hampshire, and the BNRT proposed in California, differ from state retail sales taxes and European-style VATs by being calculated from a firm's books and records, rather than at the individual transaction level. The tax is calculated on the net of aggregate business receipts less aggregate purchases from other businesses, rather than being a tax (or refund) on individual transactions.

The BNRT, for example, defined the tax base as gross business receipts minus the purchase of goods and services from other firms.<sup>3</sup> The BNRT provided a full subtraction for all purchases from other firms. This distinguishes the BNRT from the gross receipts tax in Ohio and modified gross receipts tax base in Texas (margin tax).

The way a VAT is administered, or what it is called, does not determine what type of tax it is in operation. Some critiques of the BNRT proposal asserted that it was not a VAT because it was not constructed as a credit-invoice, European-style VAT. In fact, the BNRT was designed as a tax on the value added of all taxable firms. There are many different ways of imposing a VAT at the state (or federal) level, including the additive approach (Michigan's SBT and New Hampshire's business enterprise tax), the subtraction approach (the BNRT proposal), or the credit-invoice approach (typical country-level VAT or goods and services tax). In the United States, prior federal VAT proposals have used labels such as business activity tax, growth and investment tax, business transfer tax, or business cash flow tax.

The definition of the tax base determines what type of tax is being imposed on business, not the label attached to the tax or the way it is administered. This basic fact was lost in the initial debate on the BNRT proposal.<sup>4</sup>

**Lesson #2: VAT is not an income tax since it is paid by all companies, even unprofitable ones.** While economists may describe the BNRT (and the VAT more generally) as equivalent to an indirect retail sales tax, business taxpayers' perspective (especially for nonretailers) is often quite different. Businesses viewed the entity-level BNRT as being similar to the current corporate income

tax, not as a multistage alternative for collecting sales taxes from final consumers. U.S. business taxpayers will analyze a VAT from their corporate or individual income tax system perspective. When taxpayers ran the numbers to determine the impact of a VAT on their own tax liabilities, they used income and expense information from their current income tax returns and they compared the BNRTs to their income tax liabilities. That the proposed BNRT in California replaced the corporate income tax (as did the SBT in Michigan) encouraged this taxpayer perspective.

One way you know, however, that the BNRT is not an income tax is that taxpayers with little or no income tax liability may have a substantial VAT liability. This is the case because the VAT base is equivalent to payments to capital (including interest and profits) and payments to labor. A labor-intensive business with significant interest expense that is losing money still has value added. Under Michigan's additive form of a VAT, labor compensation accounted for approximately 70 percent of the aggregate tax base across all industries. You also know that a subtraction VAT is not an income tax because there is no subtraction of interest paid or compensation in determining the base because they are components of value added.

The initial response of many taxpayers will be that they should not be paying taxes on their business operations if they are not making any profits. While an economist would argue that the VAT is a tax on final consumption or the income of all labor and all capital, not just the income of equity capital (profits), taxpayers will have a hard time accepting these interpretations given their income tax frame of reference. The fact that economists may conclude that a national VAT is likely, in the long run, to be passed forward in higher prices to consumers may not overcome this fundamental objection.<sup>5</sup>

To successfully advance the VAT concept, proponents will have to convince skeptical business taxpayers that it is fair for them to pay VAT even if they have no profits. Another way to think about this is that business taxpayers will have to accept the view that the VAT is similar to local property taxes paid on business property or to retail sales taxes paid on business purchases. These non-income-based taxes are owed regardless of the taxpayer's current level of profits.

Politically, this is a hard sell, as demonstrated by the negative reaction of many businesses to the BNRT proposal, and Michigan's 50-year experience trying to defend the VAT against intense, ongoing pressure to add profit-sensitive income tax adjustments to the SBT. Those experienced with the SBT have pointed out that the tax base inexorably shifted over time from a relatively pure

<sup>3</sup>Michigan experimented with both a subtraction method VAT (business activity tax) and an addition VAT (SBT). Under the addition approach, a firm calculates the tax base as the sum of all the payments to labor (wages and salaries and fringe benefits) and to capital (rents, royalties, interest, and profits). This sum is value added by the firm and, in theory, equals gross receipts minus purchases from other firms, which is the subtraction approach. Under the BNRT proposal, multistate taxpayers would apportion the national VAT base to California using a destination sales factor.

<sup>4</sup>It is true that a state-level VAT, because of constitutional limits on state taxation of multistate firms, cannot be constructed with the full border adjustments provided in country-level VATs. However, as states have shown, a business tax base can be constructed that uses value added, not profits, as the tax base concept. For a detailed description of how the Michigan SBT operated, see Robert J. Cline, "Should States Adopt a Value-Added Tax?" in Steven D. Gold, ed., *The Unfinished Agenda for State Tax Reform*, National Conference of State Legislatures, Nov. 1988, pp. 235-254.

<sup>5</sup>Although economists believe that a broad-based consumption tax would reduce the real income of consumers through higher prices or lower real wages, businesses should be concerned about additional costs of a consumption tax, including compliance costs, nonrecoverable tax on purchases from other businesses, partial coverage of the tax base or taxable business entities, and cash flow considerations.

VAT to a hybrid value added and income tax system. Given this history, it is not surprising that the new Michigan business tax that replaced the SBT in 2008 is a package of separate taxes on income and modified value added.

**Lesson #3: It will be difficult to maintain a broad value added base.** The California BNRT debate shows the difficulty in adopting and sustaining a broad VAT base, without carveouts that reduce revenue and create economic distortions.

The BNRT proposal defined value added as the difference between a taxpayer's total nonfinancial revenue and all of its purchases from other firms. Late in the commission's deliberations, the question was raised whether payments to health insurers would be allowed as a subtraction in determining the VAT base. Some members of the commission argued forcefully that these payments are purchases from other firms and should be subtracted in determining the BNRT base.

Fringe benefits, including healthcare premiums, purchased by an employer are a form of compensation paid to employees. As such, they would be treated under a subtraction VAT like wages and salaries with no subtraction from the base. This is clear if you think of a VAT base as including all payments to capital and labor (the additive approach) in which compensation includes wages and salaries and all fringe benefits.

The commission could not reach agreement on the definition of employee compensation for the BNRT and punted the issue to the Legislature, noting that:

Wages and salaries have been excluded as deductions from gross receipts, together with health benefits, pension contributions, other employee benefits and payroll taxes. Such treatment may warrant examination especially with respect to health benefits if such coverage is mandated by future changes in federal law.<sup>6</sup>

This is a clear example of the challenge in explaining what a VAT is and how to think about its construction. A pure VAT would not allow subtractions for alternative forms of compensation. The tax base is designed to tax value added by labor and capital, and that includes all forms of payments to labor. Without a clear understanding of the concept of a VAT base, members of the commission had a hard time thinking about what should or should not be subtracted in defining the BNRT base.

When adopted in 1975, the Michigan SBT included all forms of compensation in the tax base. The broad definition of compensation was maintained for two decades before unemployment insurance, workers' compensation, and Social Security taxes were excluded. It was another 10 years before the Legislature agreed to phase in a 50 percent deduction for health and welfare plan contributions. While the Michigan experience suggests that the subtraction of healthcare payments from the BNRT may have been inevitable, the fact that the door was opened before the California Legislature began de-

bating the proposal should warn VAT advocates of the difficulties of explaining and defending the concept in the legislative arena.

Once a VAT is adopted, the challenges in defending the VAT base from steady erosion over time will be just as great, if not greater, if the VAT is viewed as an indirect sales tax. As is clear from the state experience with the sales tax, one can expect continuous legislative changes over time that provide full exemption or reduced tax rates on a growing list of goods and services.

The experience with the credit-invoice form of national VATs also demonstrates that a VAT base will fall far short of a comprehensive consumption tax base. According to recent estimates, the percentage of potential consumption that is taxed under the VATs in OECD countries averages only 58 percent.<sup>7</sup>

**Lesson #4: A VAT would cause a major redistribution of business tax liabilities.** While there has been extensive discussion about the distributional effects of a VAT on households, it is likely that an entity-level VAT would involve debate about the distribution of statutory business tax liabilities by industry and form of doing business. At least in the short run, many businesses would not assume that all of a VAT could be passed forward to their customers in higher prices.

The above discussion has emphasized that an entity-level VAT (administered as either an addition or subtraction type) would be evaluated by business taxpayers under their corporate income tax perspective. It is also likely that another state VAT or a new federal VAT would be considered partly or fully to substitute for the corporate income tax. In this situation, business taxpayers will first focus on the change in their tax liabilities if a VAT is adopted.

Michigan's experience with the SBT, as well as estimates of the distribution of the BNRT base by industry prepared by Ernst & Young for the commission, provide insights as to how the distribution of business taxes would change if the corporate income tax is replaced with a VAT. The key insights are:

- A VAT would redistribute business taxes from C corporations to passthrough entities. A VAT would apply an entity-level tax to all forms of doing business. As a result, a revenue-neutral switch from a corporate income to a VAT base would impose new taxes on passthrough businesses and lower taxes on C corporations. This redistribution would be characterized as a shift in taxes from large businesses to small businesses, although it is a function of the type of business, not size.
- Among C corporations, profitable capital-intensive industries, such as manufacturing, would generally pay lower taxes, while labor-intensive industries, such as professional service firms, would pay higher

<sup>7</sup>OECD, "Consumption Tax Trends 2008: VAT/GST and Excise Rates, Trends and Administration Issues." This is an unweighted average of the VAT revenue ratios presented in Table 3.14, p. 69. They measure the ratio of actual VAT collections to the revenue that would be raised at a standard rate on total household consumption.

<sup>6</sup>California Commission on the 21st Century Economy, *supra* note 1, at p. 45.

taxes. This occurs because capital-intensive industries tend to have higher ratios of profits to value added.

- The combination of shifting taxes to passthrough entities and labor-intensive industries would result in a significant increase in the share of business entity taxes imposed on service industries compared with manufacturing industries. Because of this result, proponents of state-level VATs have argued that the VAT is an effective, indirect way of extending consumption taxes to services, something that has been difficult to do using the retail sales tax. Proponents of a national VAT also view it as an indirect way to tax the final consumption of goods and services.

The important lesson here for both business taxpayers and legislators is that business taxpayers will focus on the industry-by-industry distribution of the VAT payments, as well as the payments by different types of businesses. This information is critical in evaluating a VAT proposal. One of the criticisms raised by opponents of the BNRT is that the commission did not provide industry distributional information when the BNRT was debated.<sup>8</sup> While economists argue that in the long run a VAT would be shifted forward to consumers through higher prices or backward primarily to labor through lower wages, the initial change in the distribution of the legal liabilities on businesses would be part of the focus of the political debate.

**Lesson #5: Proponents of a new tax have the burden of proof.** While tax policy economists tout the economic efficiency of a broad-based VAT relative to alternative tax designs, the BNRT debate shows that there are many different reasons for opposing a VAT.

Redistribution of the California tax burden was a major reason for opposition to the BNRT. A VAT without specific low-income relief would make up a larger share of low-income families' income, because of their lower saving rate and different consumption patterns. The California tax reform proposal increased the focus on the potential redistribution across income groups by significantly lowering the top personal income tax rates.

The perspective of both supporters and opponents on a VAT will likely depend on how its revenue will be used. For example, support for a federal VAT as an add-on tax to reduce future deficits may be quite different from support to use the tax to replace the corporate income tax or a portion of the individual income tax or payroll taxes. In California, the BNRT rate was proposed at 4 percent to be revenue neutral. Most businesses were concerned that even with repeal of the corporate income tax and reduction in sales taxes, the BNRT would be a significant tax increase for them, and that they could not pass all of the tax forward to their customers.

<sup>8</sup>The California Legislative Analyst's Office (LAO) did provide limited distributional information to legislators in testimony presented to the State Assembly Revenue and Taxation Committee on the BNRT proposal on January 13, 2010. Using 2007 tax return data, the LAO estimated that only 55 percent of the BNRT would be paid by C or S corporations.

Unlike a federal VAT, which could tax imports and exclude exports to achieve a consumption tax on domestic households, the California BNRT could not fully tax imports in California or fully exempt exports from California. Opponents argued that this would place California businesses at a potential competitive disadvantage in the national and global marketplace. At the federal level, more complete border adjustments under a destination VAT would overcome this problem, but result in significant tax refunds to exporters. This refund mechanism has generated compliance problems in countries with VATs.

Finally, the BNRT was considered a new and untried state tax. Despite the long experience of Michigan and New Hampshire, and other countries, with VATs, legislators and many policy analysts had significant concerns about the proposal. Although people are familiar with the transaction-based, credit-invoice method VATs and GSTs in other countries, many of the U.S. proposals for a VAT are for a subtraction method tax calculated at the aggregate entity level, similar to the corporate income tax. A VAT variant, the Bradford X tax proposed as part of the 2005 President's Advisory Panel on Federal Tax Reform which allows a deduction for labor compensation, is even closer to a corporate income tax.

A tax whose effects are confusing is less likely to gain widespread public support. If businesses think the burden of a VAT will reduce their profits, while consumers think they will pay the VAT in higher prices, there will be few supporters of the new tax as a viable way to raise additional federal taxes. Confusion about the economic effects of an existing tax, such as who really bears the burden of the corporate income tax, is a different matter. Proponents of a new tax have the burden of proof.

### Conclusion

Federal tax policymakers do not have to take trips to other countries to learn about VATs. A trip to Michigan, New Hampshire, or California could provide important insights to the coming debate of value added taxation. The recent near-VAT experience with the California Commission on the 21st Century Economy's tax reform proposal can provide some important lessons for the federal VAT debate.

A VAT can come in many different designs and with different names. Confusion about what the new tax actually is would make it more difficult to adopt. A VAT is not an income tax, so proponents need to prepare unprofitable corporations and passthrough businesses for remitting additional taxes to the government. The confusion about the tax base, and any resemblance to the corporate income tax, will make it less likely to achieve a broad, nondistortional, and sustainable tax base. The distributional consequences (in terms of who ultimately bears the tax burden) of a VAT will be important, and an entity-level VAT will cause debate about the industry distribution of tax liabilities.

The California debate over the BNRT focused on a replacement consumption tax to reduce or eliminate other taxes. At the federal level, a VAT may be considered as an add-on to reduce the deficit or finance additional spending, in addition to consideration as a complete or partial replacement of existing taxes. The California BNRT had a 4 percent tax rate, which was high by U.S.

state standards, but low compared with VAT rates in other countries and at the federal level. The California debate did not focus on the full range of transition issues that will be important in any federal consumption tax debate.

Finally, there are many reasons different groups will find to oppose a federal VAT. As the respected public finance economist Henry Aaron said almost three decades ago in commenting on a federal VAT: "The value added tax belongs to a class of issues sufficiently interesting and attractive never quite to die, but not sufficiently appealing ever to be adopted."<sup>9</sup> The proponents of a U.S. VAT, whether as a replacement tax or an add-on tax, will have the burden of proof to convince the public, business taxpayers and Congress that the net benefits of a national VAT are now sufficient to make it politically appealing.

<sup>9</sup>Henry Aaron, "Consumption Taxes: Revenue, Structural and Equity Effects," *Tax Notes*, May 17, 1982, p. 523, at p. 527.

## **Vainisi: Seventh Circuit Reverses Tax Court in QSub Bank Decision**

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The Seventh Circuit held that a deduction for interest on some tax-exempt obligations is not automatically reduced for qualified subchapter S subsidiary banks, reversing a Tax Court decision. This article discusses the deduction at issue and concludes that, in the authors' opinion, the Seventh Circuit reached the correct decision by literally interpreting the code, even though the result might not be sound tax policy.

On March 17, 2010, the Seventh Circuit Court of Appeals issued its decision in *Vainisi v. Commissioner*,<sup>1</sup> reversing a decision by the Tax Court<sup>2</sup> regarding the application of section 291(a)(3) to a qualified subchapter S subsidiary (QSub) bank. In its opinion, the Seventh Circuit concluded that section 291(a)(3) does not apply to reduce the deduction that a QSub bank is permitted to take for interest allocable to specified tax-exempt obligations if the deduction arises more than three years after a conversion to S corporation status.

As discussed in previous articles,<sup>3</sup> the Tax Court's decision relied on a questionable distinction between S

<sup>1</sup>No. 09-3314 (7th Cir. 2010), *Doc 2010-5763*, 2010 TNT 52-14.

<sup>2</sup>*Vainisi et al. v. Commissioner*, 132 T.C. No. 1 (Jan. 15, 2009), *Doc 2009-968*, 2009 TNT 10-11.

<sup>3</sup>See Deanna Walton Harris, Paul F. Kugler, and Richard H. Manfreda, "IRS Succeeds With an Unexpected Argument Regarding a QSub Bank," *Tax Notes*, Mar. 23, 2009, p. 1505, *Doc 2009-5460*, or 2009 TNT 54-17. See also Carol Kulish Harvey, "The Application of Section 291 to Subchapter S Banks — A Look at the *Vainisi* Decision," 22(6) *J. Taxation & Regulation of Financial Institutions* 47 (2009).