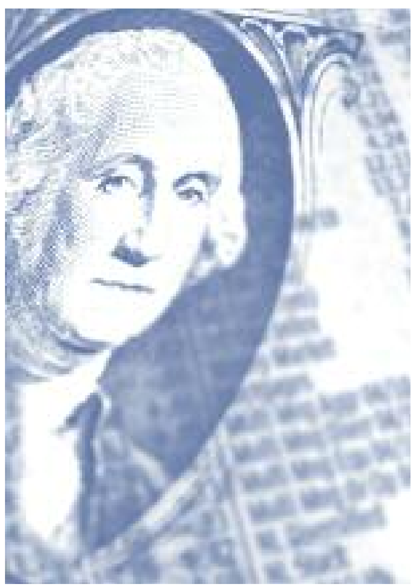
AICPA

Understanding Tax Reform: A Guide to 21st Century Alternatives



September 2005

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Preface

The American Institute of Certified Public Accountants[a] is the national professional association of CPAs with approximately 350,000 members, including CPAs in business and industry, public practice, government, and education; student affiliates; and international associations.

The AICPA has a long history of assisting lawmakers with tax policy matters, and advocating sound tax policy is a goal articulated in the Tax Section's Mission Statement.[b] In December 1995, the AICPA issued *Flat Taxes and Consumption Taxes: A Guide to the Debate*.[c] Well-received by tax experts, this study is regarded as a comprehensive and balanced analysis of consumption tax alternatives. Although the tax reform debate may be different in 2005, many issues have not changed. Revisiting the 1995 study can offer some historical perspective on the current tax reform debate.

The 1995 study described four major types of consumption taxes, and reviewed the major economic policy issues surrounding consumption taxation. Also examined were (1) issues likely to be of concern to businesses under any new consumption tax; (2) problems that consumption taxation can pose for housing, financial institutions, charitable organizations, and state and local governments; and (3) implications for financial statements. The study also described the two leading proposals then under consideration, and estimated the impact of these proposals on businesses and individuals.

In January 2005, President George W. Bush created the President's Advisory Panel on Federal Tax Reform charged with recommending options to make the Internal Revenue Code simpler, fairer, and more pro-growth.

In response, the AICPA has undertaken this updated report to discuss recent developments and serve as a resource in the tax reform debate. This report is designed to provide policymakers, AICPA members, and interested individuals with a clear understanding of the issues and alternatives involved in federal tax reform. While details of the tax reform debate have changed, many of the reasons supporting a call for reform and the nature of reform proposals remain fairly consistent with those discussed in 1995. One area of change is greater consideration today of hybrid reform approaches that encompass both an income and consumption tax, or significant elements of each.

Tax reform will have a far-reaching effect on all Americans. We strongly urge policymakers and the public to understand the tax reform options and their impacts. The AICPA does not take a position on what is the "best possible solution" for reforming the federal income tax system. The goal of this report is to foster informed discussion by providing unbiased facts and analysis. Through such discussion, creative and fair solutions will be found.

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[a] See www.aicpa.org.

[b] The Tax Section serves the public interest by assisting AICPA members to be the pre-eminent professional providers of tax services, and by advocating sound tax policy and effective tax administration.

[c] Available at http://www.aicpa.org/taxreform/.

Acknowledgments

The AICPA Tax Division acknowledges the efforts of the Tax Reform Task Force and the Tax Legislation and Policy Committee in the development of this study, Martin A. Sullivan,* for his role as economic consultant and technical adviser, and Judyth A. Swingen,** for the considerable time and attention to detail she dedicated to this report, particularly her contributions to the footnotes and the thorough bibliography of tax reform proposals.

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Executive Summary

In December 1995, the American Institute of Certified Public Accountants issued *Flat Taxes and Consumption Taxes: A Guide to the Debate*. The Study was well received by tax experts and regarded as a comprehensive and balanced analysis of consumption tax alternatives. Now in 2005, tax reform is in the forefront again. Central to the current debate is President George W. Bush announcing his intent to make tax reform a key priority in his second term.

While the tax reform debate is different in 2005, many of the reasons that support a call for reform have not changed and the nature of reform proposals remains fairly consistent. One area where the debate has changed is greater consideration today of hybrid reform approaches – that is, a system with both an income and a consumption tax or significant elements of each.

In response, the AICPA has undertaken this 2005 report to serve as a resource to those engaged or interested in the current tax reform debate. The AICPA's objective is to provide policymakers, its members and other interested individuals with a clear understanding of the issues and alternatives involved in federal tax reform, and to foster informed discussion by providing unbiased information and analysis.

Accordingly, this report describes the nature of the issues leading to a tax report debate, suggests a balanced approach for analyzing tax reform proposals, and summarizes key issues to be addressed whether taxing income or consumption. Descriptive material on consumption tax alternatives is derived from the 1995 report, with additional coverage of recent developments. The 1995 study contains more detailed information on consumption tax issues and is available at http://www.aicpa.org/taxreform. The 2005 report is also posted at this address.

The United States is on the brink of significant events that will impact federal tax revenues: (1) the "baby boomers" will start to retire, placing additional burdens on already strained entitlement programs; (2) the 2001 and 2003 tax cuts will expire, generating additional government revenues without corresponding examination of appropriate and fair tax burdens; and (3) the alternative minimum tax will grow exponentially, subjecting millions of taxpayers to unintended, higher levels of taxation. Further, the debate over the appropriate levels of federal deficits and national debt – and thus, the appropriate levels of federal revenues and spending – is far from settled. Finally, President Bush has made reviewing and reforming the federal income tax system a priority and identified three important tax principles to be considered: simplification, fairness and economic growth. These events and concerns provide the impetus to undertaking federal tax reform at this time.

Three general approaches to tax reform have emerged in the current debate. The first approach reforms the current system rather than replaces it. Under this approach, current law would be adjusted as necessary to achieve the goals of reform. This report refers to this incremental approach as "bottom-up" reform, which would reach many tax reform goals by modifying the current income tax system.

The report outlines efforts to improve the current system without changing its fundamental character as an income tax, including wide-ranging simplification efforts, increasing fairness, reducing revenue lost from tax evasion (known as the "tax gap"), and broadening the tax base. "Bottom-up" proposals address economic growth by creating incentives for capital formation, accelerating depreciation, eliminating double taxation of corporate profits, and increasing tax-preferred savings options. Other areas of taxation, such as reform of the Social Security tax and the estate and gift tax, have been mentioned for consideration in conjunction with income tax reform. Although this report does not include this type of expansive reform, the AICPA has issued *Understanding Social Security Reform: The Issues and Alternatives*,[a] and jointly with the ABA and other interested organizations, the *Report on Reform of Federal Wealth Transfer Taxes*.[b]

The second approach would replace the entire current tax system (or major parts of it) with a new system of taxation. The most dramatic manifestations of this approach would significantly reduce tax filing by most individuals. This substitution approach is often referred to as "fundamental tax reform." A consumption tax system is the most frequently proposed substitute.

The report examines the five major consumption tax alternatives: a retail sales tax, a credit-invoice value-added tax (VAT), a subtraction-method VAT, "the flat tax" (a single-rate consumption tax), and a personal consumption tax. Despite considerable differences in appearance – a credit-invoice VAT looks like a sales tax; a subtraction-method VAT looks like a corporate income tax; and a personal consumption tax looks like the current individual income tax – all consumption taxes have similar economic impacts.

Income and consumption taxes differ in their effects on: (1) saving, investment, and overall economic growth; (2) distribution of the tax burden among income classes; (3) treatment of imports and exports; and (4) administration and compliance burdens. In general, income taxes are considered more progressive, while consumption taxes are considered simpler and more conducive to economic growth. However, these general observations may not hold true for specific proposals.

The third approach consists of hybrid proposals that would include features of both an income tax and a consumption tax. The current income tax is better characterized as a hybrid income-consumption tax than as a "pure" income tax because many forms of investment are subject to reduced tax rates (capital gains, dividends), a zero tax rate (state and municipal bond interest), or deferred tax recognition (retirement plans, certain important features of life insurance contracts). Recognizing this fact may be essential to understanding the next round of tax reform if there is movement toward consumption taxation.

Transition concerns arise from any major tax reform. Special rules to facilitate a transition from an income tax to a consumption tax would surely be needed to prevent retroactive tax increases on existing investments. In their absence many investments may be subject to unintended tax penalties.

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[a] AICPA, *Understanding Social Security Reform: The Issues and Alternatives*, March 2005, 2nd Edition. Available at www.aicpa.org/members/socsec.htm.

[b] Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes*, 2004. Available at http://www.abanet.org/tax/pubpolicy/2004/04fwtt.pdf.

GOALS FOR EVALUATING TAX REFORM PROPOSALS

As policymakers engage in the current federal tax reform debate, a framework for evaluating the tax system and alternatives must be followed. In this report and in the AICPA's initial comments to the President's Advisory Panel on Federal Tax Reform,[c] we provide principles of analysis that we believe should be used to evaluate competing proposals for reform based on the AICPA's *Tax Policy Concept Statement #1: Guiding Principles for Good Tax Policy*.[d]

The AICPA recommends employing the following, widely recognized indicators of good tax policy to analyze proposed changes. These ten guiding principles are equally important, and should be considered both separately and together when evaluating the current system and reform proposals.

1. ***Simplicity.*** The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

2. ***Fairness.*** Similarly situated taxpayers should be taxed similarly.

3. ***Economic Growth and Efficiency.*** The tax system should not impede or reduce the productive capacity of the economy.

4. ***Neutrality.*** The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

5. ***Transparency.*** Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

6. ***Minimizing Noncompliance.*** A tax should be structured to minimize noncompliance.

7. ***Cost-Effective Collection.*** The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

8. ***Impact on Government Revenues.*** The tax system should enable the government to determine how much tax revenue will likely be collected and when.

9. ***Certainty.*** The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.

10. ***Payment Convenience.*** A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

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[c] Available at http://tax.aicpa.org/Resources/Tax+Advocacy+for+Members/IRS+Regulation+and+Administration/AICPA+Offers+Preliminary+Comments+to+Presidents+Advisory+Panel+on+Federal+Tax+Reform.htm.

[d] Available at http://tax.aicpa.org/NR/rdonlyres/AC230E51-D650-4D65-B160-C7450A9381F4/0/2I_08a.pdf.

CONCLUSION

The American Institute of Certified Public Accountants does not take a position on the "best possible solution" to reforming the current federal income tax system. We do, however, encourage an in-depth debate of the issues, undertaken through an organized and logical process, with the goal of enacting "good tax policy" reforms in the near future. As the Administration and Congress consider federal tax reform, the unifying goals should be established *now* to make the effort one that is rational, thoughtful and lasting.

Chapter 1

Reasons for Significant Tax Reform

SUMMARY

- The perennial reasons for considering significant tax reform include (1) simplifying the tax system; and (2) reducing impediments to economic growth and international competitiveness.

- In addition, tax reform proposals should address (1) the importance of increasing domestic savings; (2) reducing the tax compliance gap; (3) whether tax provisions should have a more neutral affect on individual and business decision-making; and (4) the challenges of measuring income.

A. INTRODUCTION

The United States is on the brink of significant events that will impact federal tax revenues: (1) the "baby boomers" will start to retire placing greater demands on already strained entitlement programs; (2) the 2001 and 2003 tax cuts are scheduled to expire; (3) the cost of Medicare and Medicaid are rising significantly; and (4) the alternative minimum tax will grow exponentially, subjecting millions of taxpayers to unintended taxes. Further, these events will affect deficit projections, discussion about the appropriate level of federal deficits, and the debate over federal spending versus revenues. These events and concerns, detailed below, about the current tax system provide the impetus for undertaking federal tax reform now.

1. Presidential Priority

President George W. Bush made reviewing and reforming the federal tax system a priority for 2005, creating the President's Advisory Panel on Federal Tax Reform (Advisory Panel) in January 2005.[1] The Advisory Panel's charge is to gather and analyze information, and submit a report to the Secretary of the Treasury explaining options for reforming the Internal Revenue Code ("the Code"). The Advisory Panel's report is now due September 30, 2005, and its mandate ends 30 days after submitting the report.

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1 Executive Order on President's Advisory Panel on Federal Tax Reform, Jan. 7, 2005; available at http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html or http://www.taxreformpanel.gov/executive-order.shtml.

The Panel's reform options must:

- Be revenue neutral;
- Simplify the existing tax system to reduce administrative and compliance costs and burdens;
- Contain elements of progressivity in how the burdens and benefits of the tax system are shared among taxpayers;
- Recognize the importance of home ownership and charity to American society;
- Promote long-term economic growth, create jobs and strengthen U.S. competitiveness in the global market by encouraging work effort, saving and investment; and
- Include one option that is based on the current federal income tax.

2. A Perennial Concern

This is not the first time that significant tax reform at the federal level – in particular, replacing the income tax with a different type of tax system – has been considered in the recent past. Discussions of major tax reform occur about once every decade,[2] with the last major discussion occurring in the mid-1990s with hearings held by the House Ways and Means Committee and many reports prepared by the Joint Committee on Taxation and others. Several reform proposals were introduced, including the "flat tax" proposed by former Congressman Armey, a national retail sales tax, and the "USA Tax" proposed by Senator Domenici, R-N.M., and former Senator Nunn.[3]

The reasons for discussing tax reform in the 1990s are largely the same reasons that have led President Bush to make it a priority today: (1) simplifying the tax system; and (2) reducing any impediments to economic growth and international competitiveness imposed by the current system.

This report does not attempt to examine every reform proposal that has been introduced or discussed; rather it examines a representative sample of proposals covering the major thematic

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[2] For example, Treasury's 1977 *Blueprints for Basic Tax Reform* proposed designing an entirely new tax system instead of "tinkering with" the current system. In 1980, the *Tax Restructuring Act of 1980* (H.R. 7015, 96th Congress) proposed income tax changes as well as a 10 percent value-added tax; Congressional Record, April 2, 1980, p. 7481.

[3] In 1995, congressional leaders, Senator Dole and Congressman Newt Gingrich, formed the National Commission on Economic Growth and Tax Reform. Although the Commission's report did not recommend any particular plan, it laid out principles for replacing the current federal tax system. See National Commission on Economic Growth and Tax Reform (1996), *A New Tax System for the 21st Century: Unleashing America's Potential*. The final report listed six "points of principle" (economic growth, fairness to all taxpayers, simplicity, neutrality, visibility, stability) and six "points of policy" (a single tax rate, a generous personal exemption, lower taxes on families, payroll tax deductibility, ending bias against work, savings, and investment, and making the new system hard to change).

Available at http://www.singletax.us/Single%20Tax%20research%20048.pdf.

reform approaches. The reader is referred to the report's bibliography for more comprehensive list of tax reform resources.

3. Design Features versus Type of Tax

The following concerns about the current tax system lead many people to call for its reform. These issues can exist under any type of tax system, because they stem primarily from design decisions, rather than the underlying structure of the tax itself. For example, although there is little dispute that the federal income tax is complex, so are state sales and use tax systems.

An income tax does not have to be complex. Our system has become complex for many reasons, including some that have nothing to do with measuring income (for example, the child credit, energy credits, education credits and deductions).

Another concern with the current income tax is the significant tax gap between (1) the amount of taxes owed; and (2) the amount that is reported and paid voluntarily, on a timely basis. However, a tax gap is not unique to an income tax.

B. FREQUENTLY CITED REASONS FOR MAJOR FEDERAL TAX REFORM

1. The Current System Is Too Complex

Numerous examples illustrate the complexity of the federal tax system:

- Most taxpayers do not prepare their federal income tax returns themselves. In 2003, 56 percent of individuals and over 85 percent of businesses hired a tax return preparer. Over 70 percent of taxpayers claiming the earned income tax credit (EITC) used a paid preparer, as did 75 percent of taxpayers owing alternative minimum tax (AMT).[4]
- The instruction booklet for the 2004 Form 1040-EZ is 36 pages long. The 1040A instructions are 72 pages long. The IRS estimates that it takes 10 hours and 25 minutes to prepare a "short form" 1040A, not including the schedules.[5]
- A majority of individual taxpayers surveyed in a 2005 survey did not understand commonly encountered rules for calculating taxable income. For example, 16 percent knew that a homeowner must live in their residence for two out of five years to exclude capital gain from the sale. Only 27 percent knew that qualified distributions from Roth IRAs were excludable from income; and 8 percent knew that certain tax preferences were omitted when calculating the alternative minimum tax.[6]

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4 National Taxpayer Advocate, *2004 Annual Report to Congress*, *Volume I*, Publication 2104, pp. 4-5, available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

5 2004 Instructions to Form 1040A, p. 57.

6 Commerce Clearing House, *CCH Complete Tax Survey Suggests Taxpayers Confused by Tax Code Complexity*, March 16, 2005; available at http://www.cch.com/press/news/2005/20050316t.asp.

The problem of complexity has been discussed for many years. In response to *The Tax Reform Act of 1976*,[7] the Joint Committee on Taxation (JCT) staff issued a report to the congressional tax committees explaining how the tax law had become complex and suggesting simplifications.[8] In April 2001, the JCT issued an extensive, three-volume report, which reviewed the entire Code and explained sources of complexity and possible solutions.[9] However, the first major legislation enacted after the 2001 JCT report, the *Economic Growth and Tax Relief Reconciliation Act of 2001*,[10] included a number of provisions that increase complexity, such as phase-outs, varying effective dates, and temporary provisions.

The AICPA has also issued reports and testified before Congress outlining the problems arising from tax law complexity and offering solutions.[11] In fact, the issue of simplifying our tax system has been of such importance that, in recent years, the AICPA has joined with the American Bar Association (ABA) Section of Taxation and the Tax Executives Institute (TEI) to urge that Congress and the Treasury Department make this subject a top priority. In promoting simplification of the tax law,[12] we agree with the National Taxpayer Advocate that "the confounding complexity of the tax code" is the most serious problem facing taxpayers today.[13]

2. The Level of Savings in the United States Is Too Low

Household savings rates are lower for the United States than for other industrialized countries. (See **Exhibit 1.1**.) According to the Organisation for Economic Co-operation and Development (OECD), household savings is a key domestic source of investment. Household savings are computed by *adding* disposable income from wages, unincorporated businesses, investment and imputed rents paid by owner-occupiers of housing, and *subtracting* cash outlays for consumer goods and services and imputed rents owner-occupiers pay to themselves.

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7 P.L. 94-455.

8 JCT, *Issues in Simplification of the Income Tax Laws*, JCS-57-77, September 19, 1977.

9 JCT, *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, April 2001.

10 P.L. 107-16.

11 The AICPA has long been an advocate for tax law simplification. Over the last two decades, the AICPA has, weighed in on simplification by, for example: (1) issuing *The Blueprint for Tax Simplification* (1992); (2) developing the AICPA Complexity Index to measure complexity factors in assessing proposed tax law changes (1993); (3) co-sponsoring the *Invitational Conference on Tax Law Simplification* (held on Capitol Hill, December 4, 2001); (4) collaborating with the American Bar Association Section of Taxation and the Tax Executives Institute in developing a package of tax simplification recommendations (submitted to Congress on February 25, 2000); (5) testifying before Congress concerning the potential complexities of pending provisions; (6) issuing *Tax Policy Concept Statement No. 2: Guiding Principles for Tax Simplification* (2002); and (7) submitting multiple comprehensive simplification recommendations on particular legislative and regulatory proposals.

12 For example, in addition to joint simplification proposals made to Congress, the three organizations sponsored a simplification conference on Capitol Hill on December 4, 2001. In 1990 the ABA and AICPA sponsored an invitational conference on reduction of income tax complexity. See Madeo (1990).

13 National Taxpayer Advocate Report to Congress for 2004; available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

Exhibit 1.1

Household Net Saving Rates, 2003[14]

Country	Percent of Disposable Household Income
Canada	1.4
France	11.1
Germany	10.7
Italy	10.5
Japan	6.3
Netherlands	10.1
United Kingdom	5.5 (gross savings)
United States	1.4

In addition, gross national savings[15] are lower for the United States than for other industrialized countries. (See **Exhibit 1.2**.)

Exhibit 1.2

Gross National Saving, 2002[16]

Country	Percent of Nominal GDP
Canada	22.3
France	20.9
Germany	21.1
Italy	19.7
Japan	25.7
Netherlands	22.6
United Kingdom	14.9
United States	14.6

14 OECD, *Economic Situation, Analysis and Projections*, December 2004, Annex Table 23, available at http://www.oecd.org/dataoecd/5/48/2483858.xls.

15 The Congressional Budget Office defines "gross national saving" as "total saving by all sectors of the economy: personal saving, business saving (corporate after-tax profits not paid as dividends), and government saving (the budget surplus). National saving represents all income not consumed, publicly or privately, during a given period." See http://www.cbo.gov/showdoc.cfm?index=6060&sequence=13.

16 OECD, *Economic Situation, Analysis and Projections*, December 2004, Annex Table 24. Available at http://www.oecd.org/dataoecd/5/48/2483858.xls.

3. The Current System Impedes the International Competitiveness of U.S. Firms

The U.S. tax system differs from its trading partners' tax systems. For example, the United States has a worldwide tax system under which all income is taxed without regard to where it is derived. In contrast, many countries use a territorial system which only taxes income derived within the country's borders.

United States income taxes are not "border adjustable," whereas indirect taxes, such as value-added taxes (VATs), are imposed on imported goods and refunded for exports. All OECD countries, other than the United States, rely on a value-added tax *in addition to* an income tax.

In July 2003, the Senate Finance Committee held hearings on the global competitiveness of American firms, from the perspective of both U.S.-based firms and U.S.-owned foreign operations. Witnesses pointed out areas in which U.S. tax laws have not kept up with changes in how business is done, noting that tax reform is needed "to ensure that our tax system does not impede the efficient, effective, and successful operations of U.S. companies and the American workers they employ in today's global marketplace."[17] The long-standing issue of international competitiveness of the U.S. income tax system has taken on more urgency with the globalization of trade and product movement and increasing competition from foreign workers.

4. The Tax Gap Is Too Large

The IRS estimates that the 2001 tax gap (the difference between taxes owed and taxes paid on time) was between $312 and $353 billion for all types of taxes, with an approximate noncompliance rate between 15 and 17 percent. The Service estimates that 67 percent of this tax gap is due to non-filing and under-reporting by sole proprietors whose income is not subject to W-2 and 1099 reporting. Enforcement and collection efforts reduced the uncollected amount to between $257 and $298 billion.[18] According to the National Taxpayer Advocate, on average, each of 130 million individual taxpayers pays approximately $2,000 annually to "subsidize" this noncompliance.

The tax gap has grown at ever-expanding rates. The gross tax gap was estimated at $76 billion in 1981, $127 billion in 1992, and $312 billion in 2001. Thus, the gap increased 67 percent from 1981 to 1992, and 144 percent from 1992 to 2001.[19]

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17 Testimony of Pamela Olson, Assistant Secretary (Tax Policy), Department of the Treasury, Washington, D.C.; Senate Finance Committee Hearing: *An Examination of U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.-Owned Foreign Operations*, July 15, 2003; available at http://finance.senate.gov/sitepages/2003HearingF.htm/hearings2003.htm. A July 8, 2003, hearing examined U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.-Based Operations.

18 Internal Revenue Service, "Understanding the Tax Gap," FS-2005-14, March 2005; available at http://www.irs.gov/newsroom/article/0,,id=137247,00.html.

19 National Taxpayer Advocate Report to Congress for 2004, pp. 5-6, 66, 211, and 229; available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

In addition, public attitudes about cheating on tax returns have worsened.[20] In 1999, 11 percent of Americans indicated that it was okay to cheat at least a little on their tax return; that number was 13 percent in 2002 and 17 percent in 2003 – almost one in five people.[21]

5. The Tax System Is Not 'Neutral'

Tax systems should interfere as little as possible with taxpayer decisions about whether or how to undertake a transaction or activity. In contrast, the current U.S. tax system is frequently used either to encourage or discourage taxpayers from undertaking a particular activity. Many economic, social and environmental policies have been implemented through tax provisions. For example, a tax credit for purchasing energy-efficient equipment may alleviate some environmental problems, but increases the complexity of the tax law and affects taxpayer decision-making. Further, Congress does not often consider alternative approaches outside the tax system when attempting to grant benefits or encourage certain behaviors, such as subsidizing child care.

Implementing policy goals by using preferential tax treatment comes at a cost that should be weighed against alternative means for reaching the same goal. For example, does the exclusion for interest income on state and local bonds cost the federal government more than the benefit derived by the state and local governments? A direct subsidy from the federal government to the state and local governments may or may not be a "cheaper" and more direct method of achieving the goal. Similar questions should be asked on a wide variety of individual and corporate provisions but such analysis is rarely performed due to its difficulty versus the ease of adding preferences to the tax law.

Some tax preferences have evolved to the point of, arguably, losing sight of their underlying purpose. For example, the home mortgage interest deduction encourages home ownership. However, the law currently allows deduction of mortgage interest on two homes, and on debt up to $1.1 million, far greater than the average home cost in most geographic areas. Home equity loan interest may also be deducted, allowing homeowners to deduct interest on loans used for personal expenditures – something a non-homeowner may not do. A plethora of provisions aimed at helping families and individuals pay for higher education has increased complexity and confusion which diminishes the effectiveness of the incentive.

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20 Davis, Hecht and Perkins (2003), "Social Behaviors, Enforcement and Tax Compliance Dynamics," *The Accounting Review*, Vol. 78, No. 1, January, p. 39.

21 IRS Oversight Board, *FY2005/Special Report* of March 2004, pp. 19-20; available at http://www.treas.gov/irsob/documents/fy2005-budget-report.pdf.

6. Income Is Difficult to Measure

Measuring income is not a precise science. Thus, accurately determining the tax base in an income tax system is challenging. In addition, determining who is the taxpayer – an individual, a married couple or a family unit – can also be difficult.

Features of the federal income tax that are questioned in the tax policy literature include:

- Double taxation of corporate income.
- Encouraging the use of corporate debt over corporate equity by allowing a deduction for interest, but not for dividends.
- Limits on offsetting ordinary income with capital losses.
- Taxing inflationary gains.
- Preferential treatment of certain types of income, such as fringe benefits, tax-exempt bond interest, and capital gains.
- Lack of conformity with financial accounting principles, such as disregarding the matching principle.
- Depreciable lives defined in the tax law are not always related to an asset's economic life.
- Many married taxpayers are subject to higher tax rates than if they had each filed as single (the "marriage penalty").
- Geographic disparities in income and expenses cause tax provisions – particularly those with fixed dollar limitations – to have an uneven impact across the country.
- Children's investment income is taxed at the parent's higher tax rate (the "kiddie tax").
- Effective reporting mechanisms are not available for all types of income, causing some income to go unreported (one cause of the tax gap).

C. REPORT OVERVIEW

These reasons do not necessarily mandate repealing the income tax and replacing it with a different type of tax system. Instead, our focus must be on which system meets the country's fiscal and policy goals and can be designed using principles of good tax policy to prevent, alleviate or eliminate the concerns that have led to the call for tax reform. As policymakers engage in the current federal tax reform debate, a framework for evaluating the tax system and alternatives must be followed. In addition, efforts to simplify the tax system must be integral to reform.

Chapter 2 outlines AICPA-recommended principles of analysis for evaluating tax reform proposals and transition provisions.

Chapter 3 compares the two methods of undertaking tax reform – "bottom-up" and "fundamental" reform – and covers the primary features of income versus consumption taxes.

Chapter 4 considers "bottom-up" reform – achieving reform objectives by modifying the current system – one of the Advisory Panel's mandated options along a continuum of simplifying and improving the current income tax system, moving our hybrid system further toward a consumption tax, or adding a consumption tax to the current system.

Chapters 5 through 9 each discuss one of five different consumption tax approaches: a federal retail sales tax; a credit-invoice value-added tax (VAT); a subtraction-method VAT; a flat rate consumption tax option; and a personal consumption tax.

Chapter 10 raises issues that require further consideration if a major shift to consumption taxation is undertaken.

Chapter 11 contains concluding comments.

Chapter 2

Analyzing Tax Reform Proposals

SUMMARY

- Tax reform proposals should be evaluated against a set of common principles.
- Evaluating proposed reforms against these principles will enhance the likelihood that any new or reformed tax system will improve upon the system it replaces.

A. INTRODUCTION

There are a variety of ways to analyze tax proposals. In calling for a study of tax reform, President Bush cited three important considerations: simplification; fairness; and economic growth. In 2001, the AICPA proposed a framework of ten principles:[22] simplicity; fairness; economic growth and efficiency; neutrality; transparency; minimizing noncompliance; cost-effective collection; impact on government revenues; certainty; and payment convenience.

Policymakers should consider and balance these objectives when amending, reforming, choosing, or replacing a tax system, thereby ensuring the resulting system's effectiveness over the long-term.

B. TAX POLICY OBJECTIVES

1. Simplicity

Tax laws should be simple enough to enable taxpayers to understand the rules and comply with them correctly and cost-effectively. Simplicity reduces the number of errors, improves compliance, and increases respect for the system. Although a truly simple tax system may not be possible, the level of complexity should be appropriate for the taxpayer or the transaction involved.[23] The tax laws which affect multinational corporations can be more complex than those affecting the average individual, reflecting differences in the taxpayers' sophistication and the complexity of the transactions in which they engage.

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[22] *Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*. Available at http://tax.aicpa.org/NR/rdonlyres/AC230E51-D650-4D65-B160-C7450A9381F4/0/2I_08a.pdf.

[23] AICPA (1975). *Statement of Tax Policy 2: Value-Added Tax.*

Simplicity is the basis for achieving many of the remaining tax policy goals, including transparency, minimizing noncompliance, cost-effective collection, and payment convenience. The less complex a tax system is, the better taxpayers are able to anticipate the tax consequences of their economic choices.

2. Fairness

Fundamental fairness dictates that similarly situated taxpayers should be taxed similarly. However, this can be challenging to define. Some would view an income tax system with few exclusions and deductions as fair; others might view a single-rate income tax as fair.

Tax system fairness is usually evaluated by looking at both horizontal and vertical equity. Horizontal equity means that taxpayers with equal abilities to pay should pay the same amount of tax. Vertical equity means that taxpayers with a greater ability to pay should pay more tax. Defining and achieving equity is a matter for political, social and economic debate.

Because taxpayers usually are subject to a range of different types of taxes, equity is probably best measured by considering the full range of taxes imposed, rather than looking at a single tax. For example, wages subject to the payroll tax result in a higher total tax bill than the same amount of investment income.

3. Economic Growth and Efficiency

The tax system should not impede or reduce an economy's productive capacity. A tax system should encourage the taxing jurisdiction's economic goals, such as economic growth, capital formation and international competitiveness. In general, the tax system should not favor one industry or type of investment at the expense of others.

Although encouraging economic growth and efficiency may appear to conflict with the principle of neutrality (below), this is not necessarily the case. By recognizing the economic effects of choosing what to tax and at what rate, policymakers can work toward intended economic results and avoid unintended consequences.

4. Neutrality

Tax considerations should have the smallest possible effect on a taxpayer's economic decisions about whether or how to carry out a particular transaction. A neutral tax system neither encourages nor discourages taxpayers from engaging in certain activities. A completely neutral tax system is unlikely. Although the primary purpose of a tax system is to raise revenue, tax law is often purposefully used to influence taxpayer behavior. However, within the system, the system should be neutral when determining how to measure income, the appropriate tax rate, and taxpayers' ability to pay.

5. Transparency

Taxpayers should know that a tax exists and how and when it is imposed upon them and others. Transparency enables taxpayers to know the true cost of transactions and to better understand the impact of the tax system. Transparency is an important partner to tax simplification because complex provisions make it more difficult for taxpayers to assess whether and when they will be taxed.[24]

6. Minimizing Noncompliance

A tax should be structured to minimize noncompliance. The "tax gap" between the amount of tax owed and the amount collected can be minimized by increasing the ease of compliance, decreasing the incentives to avoid compliance, and using appropriate procedural rules and enforcement measures. Generally, a balance must be struck among the desired level of compliance and the costs and intrusiveness of enforcement.[25]

7. Cost-Effective Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

Consideration should be given both to the number of revenue officers needed to administer the tax and to the compliance costs for taxpayers. This principle is closely related to the principle of simplicity.

8. Impact on Government Revenues

The government should be able to determine, with reasonable certainty, the amount and timing of tax collections. Policymakers need to predictably and reliably achieve a desired level of revenue within a reasonable range. Generally, a tax system that combines a variety of tax sources will permit a more stable source of revenue. For example, rising unemployment leads to reduced income tax collections, but property taxes and sales taxes might be less affected, thereby total revenues would be less volatile than if the government relied solely on an income tax.

9. Certainty

Taxpayers need to be able to calculate their tax liabilities. Tax rules should clearly specify how to determine the amount of tax owed and when and how the tax must be paid. Uncertainty results if taxpayers have difficulty measuring the tax base, determining the applicable tax rate, or anticipating the tax consequences of a transaction. When taxpayers lack confidence that they

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24 AICPA (2003). *Tax Policy Concept Statement 3 – Guiding Principles for Tax Law Transparency*, at http://tax.aicpa.org/Resources/Tax+Advocacy+for+Members/IRS+Regulation+and+Administration/Tax+Policy+Concept+Statement+3%E2%80%94Guiding+Principles+for+Tax+Law+Transparency.htm.

25 GAO (1995). *Reducing the Tax Gap – Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June. p. 13. Available at http://archive.gao.gov/t2pbat1/154381.pdf.

know (1) what their tax obligations are; (2) whether their calculations are correct; and (3) if their returns are properly filed, compliance rates fall and collection costs rise.

10. Payment Convenience

Making tax payment convenient helps ensure compliance. The most appropriate payment mechanism would take into account the liability amount, the best tax collection point, and the frequency of collection. For example, is it better to collect the tax from the manufacturer, wholesaler, retailer, consumer, employer or employee? Should the tax be collected annually, quarterly, monthly or weekly?

C. SUMMARY AND RECOMMENDATION

Tax reform proposals should be evaluated against a set of common principles to ensure that informed comparisons of tax system components are made, thereby enhancing the likelihood that any new or reformed tax system will improve upon the system it replaces.

The AICPA offers policymakers a "Tax Reform Analysis Questionnaire" (see **Appendix A**) – derived from the principles and objectives outlined above – to compare competing tax reform proposals and provisions. We recommend evaluating both the overall structure and the implementing details of each tax reform proposal before a final choice is made.

Using this or a similar framework for analyzing tax reform options will help us create a simpler, fairer and more economically efficient tax system.

Chapter 3

Income Versus Consumption Taxes

SUMMARY

- Choosing between an income tax and a consumption tax must be distinguished from choosing between reforming the current system or replacing it.
- In general, income taxes are considered more progressive, while consumption taxes are considered simpler and more conducive to economic growth, but regressive. However, these general observations may not hold true for specific proposals.
- Income and consumption taxes differ in their effects on: (1) saving, investment, and overall economic growth; (2) distribution of the tax burden among income-classes; (3) treatment of imports and exports; and (4) administration and compliance burdens.
- Moving to consumption taxation generally has the potential to reduce complexity; however, whether significant simplification can actually be realized is less clear, especially in terms of administrative and compliance burdens.
- Although the various consumption taxes share a number of economic similarities, each imposes different compliance costs – in terms of total cost, the distribution of these costs across taxpayer groups, and administrative costs to government.
- Broadening the tax base would result in additional simplification.
- Significant transition issues arise if the income tax is replaced by a consumption tax, including the potential for double taxation for taxpayers using already taxed savings to consume currently, thereby subjecting those savings to tax once more.

A. INTRODUCTION

Two general structural approaches to tax reform have emerged in the current debate. The first approach reforms the current system rather than replaces it. Under this approach, current law would be adjusted as necessary to achieve the goals of reform. This incremental approach will be referred to here as “bottom-up” reform.

The second approach would replace the entire current tax system (or major parts of it) with a new system of taxation. The most dramatic manifestations of this approach would significantly reduce tax filing by most individuals by, for example, replacing the income tax with a national retail sales tax. This substitution approach is often referred to as "fundamental tax reform."

In addition to debating the proper *structural* approach to reform, one must also consider the *conceptual* debate about income taxation versus consumption taxation. Income tax reforms are often incremental, bottom-up reforms. Consumption taxation is often proposed as a fundamental tax reform because many proposals would replace the current tax system with an entirely new system. For clarity of discussion, it is important to avoid equating bottom-up reform with income taxes and fundamental reform with consumption taxes. This is not an "either-or" proposition. Some proposals would add significant consumption tax elements to our present tax system, moving our income-based, hybrid tax system further along the continuum toward a consumption tax. Others would follow the lead of our major trading partners and add a consumption tax to our system.

Exhibit 3.1 gives an overview of some approaches to reform that will be discussed in the following chapters, and demonstrates that choosing a structural approach to reform ("bottom-up" versus "fundamental") and choosing between an income and a consumption tax are not equivalent.

Exhibit 3.1

Overview of Tax Reform Proposals

		Structural Approach		**Conceptual Approach**	
	Tax Reform Proposal	**Bottom-Up**	**Fundamental**	**Income**	**Consumption**
1	Retail Sales Tax		X		X
2	Value-Added Tax		X		X
3	Flat Tax		X		X
4	1986 Act	X		X	
5	Simplification	X		X	
6	Exempt-Saving/Expensing	X			X
7	CBIT / I-VAT		X	X	
8	Add-on Consumption Tax	X		X +	X +

Proposals 1-3 – retail sales tax, value-added tax, and "flat tax" proposals – would replace the current income tax with a new consumption tax. These proposals began to receive widespread attention in the 1980s and were particularly prominent in the mid-1990s.

Proposals 4 and 5 – overhauling the income tax like the 1986 Act or major simplification – would entail adjustments to the current income tax that would not change the underlying character of the current system from an income tax to a consumption tax.

Proposal 6 – exempt saving/expensing – deserves special attention. Many salient features of a consumption tax can be achieved by making modest adjustments to the current income tax, although this approach has received far less attention in the past than proposals to replace the income tax with a flat tax or a retail sales tax.

Proposal 7 – a comprehensive business income tax (CBIT) – is a broad-based flat income tax imposed on all business entities. Enacting a CBIT in conjunction with an individual income-based VAT (I-VAT) at a flat rate would achieve fundamental income tax reform.[26] This option is included to illustrate the range of possibilities.

Proposal 8 is a hybrid proposal that would add a value-added tax to a greatly simplified version of the income tax system and reduce the number of income tax filers.

Before examining proposals in detail, this chapter examines the differences between income and consumption taxation and the impacts and implications of each. In general, income taxes are considered more progressive, while consumption taxes are considered simpler and more conducive to economic growth. However, these general observations may not hold true for specific proposals. For example, it is *possible* to design a consumption tax that is as progressive as an income tax.

B. HOW INCOME AND CONSUMPTION TAXES DIFFER

Despite considerable differences in appearance – a credit-invoice VAT looks like a sales tax; a subtraction-method VAT looks like a corporate income tax; and a personal consumption tax looks like the current individual income tax – all consumption taxes have similar economic impacts. Income and consumption taxes differ in their effects on: (1) saving, investment, and overall economic growth; (2) distribution of the tax burden among income classes; (3) treatment of imports and exports; and (4) administration and compliance burdens.

1. Savings and Growth

Under a consumption tax, income that is saved is not taxed, and the tax burden on income from saving and investment is eliminated. By providing greater after-tax rewards for saving than an income tax, a consumption tax that replaces an income tax (hereafter referred to as a "replacement consumption tax") has the potential to increase private saving.

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[26] The Treasury Department has considered a broad-based, flat *income* tax – called an I-VAT – that combined a CBIT-like tax on business with a broad-based individual flat rate income tax on individuals. See Tax *Reform Materials Memorandum for Secretary O'Neill* from Pamela F. Olson, November 7, 2002, available at http://thepriceofloyalty.ronsuskind.com/thebushfiles/archives/000093.html.

Many economists believe that a lack of saving is a shortcoming in the U.S. economy. Increasing saving would likely increase domestic capital formation, which could in turn boost the productivity of U.S. workers, raise real wages, and increase the rate of economic growth.[27]

2. Distribution of Tax Burden

The wealthy are more able to save than the poor, who must, by necessity, consume a larger portion of their incomes to meet living costs. Therefore, consumption taxes generally place a greater overall burden on low-income households than do income taxes. This potential to shift the tax burden to low-income households is a major objection to a consumption tax. A single-rate income tax rate structure would also shift the tax burden to lower-income households as compared to a progressive structure.

3. Imports and Exports

Consumption taxes often are implemented in a manner that subjects imports to tax while exempting exports. Economists believe that these "border tax adjustments" do not have a significant impact on international trade; however, they are important to maintaining a level international playing field. Further, consumption taxes may affect international trade, particularly if they can improve economic performance by increasing saving.[28]

4. Compliance Burden: Eliminating the Complexity Inherent in the Income Tax

Some complexity is unique to the income tax; switching to a pure consumption tax would eliminate at least this complexity, particularly when taxing businesses and income from savings and investment. For example, depreciating and amortizing capital expenditures would be replaced by expensing. Immediate deductibility would eliminate disputes over which business expenses must be capitalized and the complexities of tracking inventory costs. The corporate income and alternative minimum taxes would be eliminated. The notoriously complex rules surrounding corporate distributions, liquidations, and reorganizations would become almost entirely obsolete. The issues surrounding the differences in financial and tax accounting – referred to as "book-tax differences" – would be largely irrelevant.[29] Because most consumption taxes are imposed only on activity within a country's borders, all foreign-source income would be exempt from U.S. tax, eliminating the need for foreign-tax-credit and anti-deferral rules.[30]

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27 See AICPA (1995), Chapter 6, pp. 50-55, for a more complete discussion, at http://www.aicpa.org/taxreform/.

28 See AICPA (1995), Chapter 7, pp. 58-64, for a more complete discussion.

29 See AICPA (1995), Chapter 17, pp. 207-213, for a more complete discussion.

30 However, complex rules for determining the source of income would remain an issue.

Under a consumption tax, most income generated by personal saving would effectively be exempt from tax,[31] eliminating the complicated rules that give preferential tax treatment to pensions, IRAs, tax-exempt bonds, annuities and life insurance.[32]

C. ADDITIONAL CONSIDERATIONS

1. Potential for Simplification

Current tax law is often incomprehensible. Taxpayers, tax practitioners and government officials are all interested in tax simplification. Although moving to consumption taxation generally has the potential to reduce complexity, whether significant simplification can actually be realized is less clear, especially in terms of administrative and compliance burdens. Further, the assumption of a simpler consumption tax needs to be tested against a simpler, more broadly based income tax and the actual features of any consumption tax likely to be enacted.

Although many current complexities disappear under a consumption tax, several sources of complexity would remain after making a switch to consumption taxation. For example, the need to distinguish between business and personal consumption expenses does not disappear. Consumption taxes allow business expenses to be deducted, but “mixed use” expenditures – such as computer purchases or other items that can be converted to personal use – would continue to pose compliance problems.

Consumption taxes will introduce new administrative and compliance issues not present under the income tax. These complexities will vary, depending on the structure of the tax and the number of exemptions and special provisions. Under a credit-invoice value-added tax (VAT), recordkeeping burdens may increase as businesses must retain records of taxes paid on all invoices in order to earn tax credits. Under a subtraction-method VAT, taxpayers must revise their accounting procedures to differentiate between non-deductible internal costs and deductible external costs. A personal consumption tax would require taxpayers and tax authorities to maintain previously unrequired records of changes in their total savings balances and net indebtedness.

Complex transition rules are likely to be part of any shift to a consumption tax system, to avoid penalizing taxpayers caught between the old income tax and any new consumption tax. Businesses will need special rules for cost recovery of previously acquired, but not fully depreciated, capital. Individuals will want provisions for recovering basis on assets acquired before a new consumption tax becomes effective, thereby subjecting only gains to tax, not the entire sale proceeds of those assets. Wholesale education on how the new system works would be required for businesses, tax advisors and the general public. New tax forms, instructions, audit procedures, and regulations would need to be devised, and IRS employees – or a substitute administrative agency – would need to be trained.

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[31] Excluding savings from the consumption tax base is the equivalent of exempting investment income from income tax. See Chapters 5-9 of this report.

[32] Consumption taxes grant relief for investing in capital either by exempting investment income from tax or by allowing deductions for investments. See Chapters 5-9 of this report.

Instead of replacing the income tax, a new consumption tax may be added to the current tax system, thereby imposing a supplemental tax system that would result in new, additional types of complexity on top of existing income tax complexities (unless some of that complexity was eliminated by the reform effort).

2. Differences Among Consumption Taxes

Although the various consumption taxes share a number of economic similarities – with respect to growth, income distribution, and trade – several important differences exist. Each imposes different compliance costs – in terms of total cost, the distribution of these costs across taxpayer groups; and administrative costs to government. Some consumption taxes would face greater opposition from the states or our trading partners than others.

Consumption taxes also differ in how they would be perceived by the public – some are highly visible, separately stated, direct taxes on consumers; others are "hidden taxes" imposed on businesses.

As will be discussed in the following chapters, the flexibility to give preferential treatment to certain types of products and classes of taxpayers varies among types of consumption taxes.

3. Base Broadening

As a matter of pure tax policy, the broadest tax base is preferable, because special exceptions reduce the economic efficiency of any tax.[33] Much of the current tax law complexity arises from special tax breaks and limitations on those breaks. Consumption taxes appear simpler than income taxes because they are idealized proposals as yet untainted by legislative compromise. However, providing special exceptions is common to consumption taxes currently in use, and allows governments to implement economic and social policy through tax preferences.

Many consumption tax proposals, especially those of the "flat tax" variety, include significant base broadening, such as eliminating the exclusion for employer-provided benefits from the tax base, and eliminating deductions for home mortgage interest, charitable contributions, and state and local taxes. In general, broadening the tax base would result in additional simplification.

4. Federalism

Replacing the current federal income tax with a federal consumption tax would affect state and local governments in a variety of ways, including: (1) loss of a federal deduction for state and local income and property taxes; (2) taxing government activities; and (3) loss of tax-favored status for investing in state and local government debt. Further, adding a federal sales tax on top of state and local sales taxes may reduce consumption and lead to greater noncompliance, which in turn, will result in lower state and local tax revenues.

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[33] Narrowing the tax base reduces efficiency because: (1) exceptions cause individuals and businesses to alter their economic choices to avoid tax; (2) tax rates must increase to make-up for revenue lost from the special exceptions; and (3) a broad consumption tax base is generally easier to administer.

Adding a federal retail sales tax or a credit-invoice value-added tax (VAT) could also affect the ability of state and local governments to raise revenue through state sales tax rate increases. States would likely face resistance to raising an already higher combined federal-and-state tax rate, and be under pressure to conform to the federal sales tax rules to simplify compliance. Implementing a federal subtraction-method VAT or personal consumption tax could alleviate these problems.

Most states that collect income taxes rely heavily on the federal income tax to determine taxable income for state purposes and benefit from federal enforcement efforts. The states would find it difficult to administer their income taxes without information sharing with the IRS. Eliminating federal income taxation will increase the complexity of state income taxation, potentially leaving taxpayers to comply with multiple, disparate systems. States that conform their income tax to a new federal consumption tax, while maintaining a state sales tax, will increase the regressivity of their total tax systems by subjecting their taxpayers to two significant consumption taxes.

D. TRANSITION ISSUES FOR REPLACING THE FEDERAL INCOME TAX WITH A CONSUMPTION TAX[34]

- The change could lead to a "one time" impact on price levels, depending on decisions made by businesses to raise prices to cover the tax or absorb the costs, along with the rate of tax, the comprehensiveness of the tax base, and Federal Reserve actions.[35]
- Imposing a consumption tax could lead to double taxation that would be viewed as unfair to many individuals who are using prior savings – which have already been taxed as income – to consume, thereby subjecting those savings to a second, consumption tax.
- State tax systems become more regressive if a federal consumption tax is added onto an existing or proposed retail sales tax system.
- State income tax administration and burden increases in states that rely on federal tax statutes and guidance to determine adjusted gross income or the tax base for income tax purposes. States would need to create their own income tax rules.
- A replacement system would require new federal administration, guidance, forms, enforcement mechanisms, etc.
- Complexity is added for businesses that will now be required to collect tax on multiple tax bases.

[34] For a more detailed discussion of transition issues, see Chapter 10 of this report.

[35] See AICPA (1995), Chapter 5, pp. 48 (Table 5.2) and 57, at http://www.aicpa.org/taxreform/.

Chapter 4

'Bottom-Up' Reform of the Current System

SUMMARY

- Many goals of tax reform can be achieved by modifying the current income tax system through "bottom-up" tax reform, rather than by replacing it with a new consumption tax system.
- Significant simplification to the current income tax system can be achieved by eliminating the individual and corporate alternative minimum taxes, consolidating education and retirement savings incentives, replacing the 20-factor worker classification test, and simplifying the earned income tax credit.
- Avoiding the use of phase-outs and temporary provisions in writing tax law and closing the tax gap would result in a more efficient tax system.
- The current federal income tax system is a "hybrid system" containing consumption tax features, such as tax-preferred savings options, accelerated depreciation, and preferential tax rates for capital gains and dividend income.
- Further movement toward a consumption tax can be accommodated within the current income tax system.

A. INTRODUCTION

Dissatisfaction with the current income tax system is so great that some policymakers believe the best course would be to replace it with a new system, witness former Congressman Bill Archer's goal of "tearing the income tax out by its roots." However, others believe that such a large and unprecedented change would be neither desirable nor feasible. Many objectives of tax reform – including simplification, fairness, and improved economic performance – can also be accomplished by modifying the current system.

This report refers to modifying the current system as "bottom-up" tax reform. This chapter examines how the current system can be improved without changing its fundamental character as an income tax, including wide-ranging efforts to simplify tax law, increase fairness, reduce revenue lost from tax evasion (known as the "tax gap"), and broaden the tax base. One option would combine simplification of the current income tax with a consumption tax to reduce individual compliance burdens.

Finally, this chapter reviews proposals that would move the current hybrid income-consumption tax system closer to a pure consumption tax system. These proposals include expanding opportunities for tax-favored savings and immediate write-off of the cost of capital purchases.

B. IMPROVING THE INCOME TAX

If the income tax is entirely replaced with a new consumption tax collected by business (such as a retail sales tax or a value-added tax), there would be no need to review the details of current law for ways to make tax collection less painful for taxpayers and more effective for government. However, the current system may remain largely intact. Therefore, this report offers a review of the incremental modifications which could significantly simplify the current system and improve compliance.

C. TAX SIMPLIFICATION

1. The Need for Simplification

There is widespread recognition that U.S. tax law is complex and needs to be simplified. The National Taxpayer Advocate identified tax law complexity as the most serious problem facing taxpayers and the IRS.[36] A selection of recent studies and simplification proposals are listed in **Exhibit 4.1**. (See p. 27.) A 2001 letter to the Secretary of Treasury authored jointly by the AICPA, the American Bar Association Section of Taxation, and the Tax Executives Institute stated:

> American taxpayers have lost not only the ability to understand and comply with the law without expending considerable resources, but also respect for a tax system that increasingly makes them victims of its unintended consequences and outdated or ill-conceived policies. This cannot help but reduce compliance, increase the cost and complexity of administering the tax system, and undermine the public's general confidence in government. Simplification is not merely an ideal to be sought but never achieved; in our view, it is an economic, political, and even moral imperative.[37]

In briefing material recently provided to the President's Advisory Panel on Federal Tax Reform, the Treasury Department quantified the costs of compliance:[38]

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36 *2004 National Taxpayer Advocate Report to Congress*, pp. 4-5, available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

37 ABA/TEI/AICPA February 12, 2001, transmittal letter to Treasury Secretary Paul O'Neil, accompanying, *Tax Simplification Recommendation.*

38 U.S. Department of the Treasury. *Fact Sheet: What are the Costs of Complying with the Federal Income Tax System?* April 8, 2005, available at http://www.taxreformpanel.gov/meetings/pdf/tax_burden_factsheet_04-08-05.pdf.

- Taxpayers spend about 6 billion hours per year to comply with the tax system.
- Total compliance costs of the income tax have been estimated to be $130 billion annually. Of that total, $90 billion was incurred by individuals.
- On average, individuals annually spend about 26 hours working on their taxes and (in 2002) spent $157 per return on out-of-pocket costs for the services of tax professionals, filing fees, and software purchases.
- U.S. businesses with assets of over $5 million reported total compliance costs of nearly $25 billion per year.

2. Some Simplification Proposals

Some of the more important proposals to reduce administration and compliance costs of the current tax system are discussed below. Many additional proposals – not discussed here – have been examined at length within the studies referenced in **Exhibit 4.1**. (See p. 27.)

a. Repeal the Individual Alternative Minimum Tax

The individual alternative minimum tax (AMT) produces enormous complexity and no longer serves the purpose for which it was enacted – to address concerns that individuals with significant economic income were paying little or no federal taxes because of tax preferences. Today, the AMT has little impact on its original target, but increasingly affects an unintended group of taxpayers – the middle class – not engaged in tax-shelter or deferral strategies or claiming a wide range of tax deductions, exclusions and credits.

The number of taxpayers paying more tax due to the individual AMT is expected to increase from 3.8 million in 2005 to 20.5 million in 2006, and to 51.3 million in 2015 (assuming the 2001 and 2003 tax cuts are extended).[39] AMT significantly increases complexity, not only for the millions subject to AMT, but for additional millions who must complete AMT calculations simply to determine that they are *not* subject to AMT.

The 2003 National Taxpayer Advocate Annual Report designated the AMT as the most serious problem facing taxpayers.[40] Repealing the individual AMT would result in significant tax simplification. Unfortunately, the cost of repeal is growing rapidly; some projections indicate that within three or four years it would be less costly to the government to repeal the regular income tax than the AMT. According to Treasury, the AMT could increase the taxes paid by individuals by $34 billion in 2006, and $210 billion in 2014.

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[39] U.S. Department of the Treasury. Office of Public Affairs, *Fact Sheet: The Toll of Two Taxes: The Regular Income Tax and the AMT,* March 2, 2005, available at http://www.treas.gov/press/releases/js1293.htm.

[40] National Taxpayer Advocate (2003). Available at http://www.irs.gov/pub/irs-utl/nta_2003_annual_update_mcw_1-15-042.pdf.

b. Avoid Multiple Incentives to Achieve the Same Policy Goal

Tax incentives are meant to encourage certain types of economic and social behavior, but taxpayers will only respond if they are aware of and understand those incentives. For example, few – if any – taxpayers are both aware of all the education tax incentives and familiar with their particulars. Fewer still can do the analysis to determine which incentive is most advantageous.

Multiple provisions aimed at achieving the same policy objective should be avoided. For example, a myriad of provisions appear throughout the tax code which relate to children: the child tax credit, the child care credit, dependency exemptions, etc. A uniform definition of a child has only recently been introduced for some, but not all, of these tax provisions.

The Code also contains a complex set of incentives to encourage saving for and spending on education, including two tuition credits, Coverdell IRAs, Section 529 state tuition programs, limited interest deductions, and employer-provided assistance programs. Requirements, definitions, and income phase-outs vary from incentive to incentive. Tax benefits for higher education can be simplified by: (1) combining the two tuition credits into one; (2) eliminating or standardizing the income ranges required for eligibility; and (3) replacing all or most of the current tax benefits with one universal education deduction or credit. Applying similar unified system for child-related tax provisions – and expanding the uniform definition of a child to the entire Code – would also reduce complexity. In all cases, these provisions can only benefit intended taxpayers by being clear, simple and easy to use.

c. Avoid Temporary Provisions

Uncertainty breeds complexity. The need to extend expiring provisions (such as AMT relief for individuals, the research tax credit, and the work opportunity tax credit) adds confusion and, in many cases, undermines the policy reasons behind these incentives. The on-again-off-again nature of these provisions, coupled with retroactive tax law changes necessitating filing amended returns, makes long-term planning difficult and significantly increases complexity.

Since 2001, problems generated by temporary provisions have become especially acute because the fate of nearly all major tax changes included in the 2001 and 2003 tax acts is uncertain. Cuts in the individual income tax and repeal of the estate tax enacted in 2001 are currently scheduled to expire at the end of 2010.

Future tax changes should be enacted with a presumption of permanency, except in rare situations where there is an overriding and explicit policy reason for making provisions temporary, such as when a new provision requires evaluation after a trial period.

d. Repeal the Corporate Alternative Minimum Tax

Although not as pervasive as the individual AMT, the corporate AMT creates similar difficulties. By requiring corporations to keep at least two sets of books for tax purposes, the corporate AMT imposes burdens on businesses, especially those with significant depreciable assets. The corporate AMT often results in taxing struggling or cyclical companies at a time when they can least afford an additional tax burden.

Any specific concerns about tax avoidance or evasion remaining after repealing the corporate AMT can be addressed directly, rather than by preserving a system requiring many corporate taxpayers to compute their tax liability twice and keep an additional set of tax records.

e. Replace the 20-Factor Worker Classification Test

Currently, a 20-factor common-law test is used to determine whether a worker is an employee or independent contractor. The factors are subjective, and little guidance exists on how to interpret and weigh them. Many factors do not apply to all situations, nor do they provide a meaningful indication of whether the worker is an employee or independent contractor. Further, different rules govern worker status for income and employment tax purposes.

Because worker status determines income reporting and employer withholding and payroll tax obligations, this is an area rife with abuse. This complex and highly uncertain determination should be eliminated and replaced with a more objective test that applies to income and employment taxes. Alternatively, the differences between how employees and independent contractors are treated for tax purposes could be reduced. For example, withholding requirements could be expanded to payments to independent contractors, the deductibility of employees' work-related business expenses could be relaxed, and the Form 1099 reporting requirements could be expanded.

f. Eliminate or Rationalize Phase-Outs

The Code includes many exclusions, exemptions, deductions, or credits aimed at benefiting low- and middle-income taxpayers. Already complex, these benefits are further complicated by phasing out benefits for individuals or families whose incomes exceed certain levels.

Unfortunately, there is no consistency across these phase-outs in how income is measured, the income range over which the phase-out applies, or the method of applying the phase-outs. Phase-outs become hidden tax increases that: (1) create irrational marginal income tax rates; (2) make tax returns longer and more complicated; (3) increase errors; (4) are difficult to understand; and (5) impair taxpayer ability to know whether the intended benefits will ultimately be available. Affected taxpayers are understandably angry when they discover that they have lost – either wholly or partially – itemized deductions, personal exemptions, or credits.

Simplicity would be achieved by: (1) eliminating phase-outs altogether; (2) substituting "cliffs" for phase-out ranges; or (3) providing consistency in income measures, phase-out ranges, and the method of phasing out the benefits.

g. Simplify the Earned Income Tax Credit

According to the latest estimates from the Joint Committee on Taxation, in 2004 the earned income tax credit (EITC) provided $20.8 billion in tax benefits to 38 million families.[41] More than 85 percent of these credits benefited families earning less than $30,000 annually. Since its inception in 1975, the EITC has lifted millions of families above the poverty level, and it is now the largest mean-tested, anti-poverty program in the United States.

The program has experienced a high rate of noncompliance. The IRS estimates that EITC over-claim rates for 1999 were between 27 and 32 percent of dollars claimed, or $8.5 to $9.9 billion.[42] On the other hand, eligible taxpayers are not claiming all the benefits to which they are entitled. For example, the Taxpayer Advocate's 2004 report indicated that after audit reconsideration, 43 percent of taxpayers received additional EITC benefits that had been initially disallowed.[43]

The EITC's complexity, coupled with a lack of financial sophistication of many eligible families, presents a major challenge for the IRS. However, Congress substantially reduced the complexity of the EITC by adopting a uniform definition of a qualifying child in the *Working Families Tax Relief Act of 2004*.[44] In addition, as a result of significant steps the IRS has taken to address many of EITC compliance problems, the Taxpayer Advocate has removed the EITC from its "most serious" list. Even so, any federal tax reform effort must take into account the difficulties of administering this enormous program and further reducing its complexity.

h. Simplify and Consolidate Retirement Saving Incentives

More than a dozen tax-advantaged retirement planning vehicles are available, and each is subject to different rules governing eligibility, contribution limits, tax treatment of contributions and distributions, withdrawals, the availability of loans, and portability. Although some consolidation of the rules governing these options has been introduced in recent years, further substantial simplification of the confusing array of retirement savings options should be undertaken.

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41 JCT (2005, January). *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2009*, JCS-1-05, p. 33, available at http://www.house.gov/jct/s-1-05.pdf.

42 General Accountability Office, *Earned Income Tax Credit: Implementation of Three New Tests Proceeded Smoothly, but Tests and Evaluation Plans Were Not Fully Documented*. GAO-05-92, December 30, 2004. 1999 rates are the most recent data available. Available at http://www.gao.gov/new.items/d0592.pdf.

43 National Taxpayer Advocate, *2004 Annual Report to Congress Volume II – Earned Income Tax Credit (EITC) Audit Reconsideration Study*, Publication 21048 (Rev. 12-2004), available at http://singletax.us/Single%20Tax%20research%20048.pdf.

44 H.R. 1308, Pub. L. No. 108-311.

Exhibit 4.1

Overview of Selected Simplification Proposals

PROPOSAL:	AICPA/ABA/ TEI 2001	NTA 2004 Report	JCT 2001	JCT 2005	TREASURY 2003
Repeal the Individual AMT	X	X	X		
Simplify Education Incentives	X	X	X	X	
Avoid Temporary Provisions	X				
Repeal the Corporate AMT	X		X		
Simplify Worker Classification Rules	X		X		
Eliminate or Consolidate Phase-Out Ranges	X		X		
Earned Income Tax Credit	X	X	X		X
Retirement Savings Incentives		X	X		
Return-Free Filing			X		X

Sources:

AICPA/ABA/TEI 2001: See, American Bar Association Section of Taxation, the Tax Executives Institute, and the American Institute of Certified Public Accountants Tax Division. *Tax Simplification Recommendations*, February 2001, available at http://www.abanet.org/tax/pubpolicy/2001/01simple.

NTA 2004: Internal Revenue Service, National Taxpayer Advocate. *2004 Annual Report to Congress*, available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

JCT 2001: Joint Committee on Taxation. *The Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Federal Tax System,* Volume II: Recommendations of the Staff of The Joint Committee on Taxation to Simplify the Federal Tax System (JCS-3-01), April 2001, available at http://www.house.gov/jct/pubs01.html.

JCT 2005: Joint Committee on Taxation. *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-2-05), January 27, 2005, available at http://www.house.gov/jct/s-2-05.pdf.

TREASURY 2003: U.S. Department of the Treasury. *Report to Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite*, December 2003, available at http://www.ustreas.gov/offices/tax-policy/library/noreturn.pdf.

i. Institute a System of Return-Free Filing

Under a "return-free" income tax system, individuals with relatively simple tax returns would be exempt from filing a tax return. For example, taxpayers who currently file Forms 1040-EZ would likely be eligible to participate. However, taxpayers with self-employment income or who itemize their deductions would not be able to participate.[45]

Other countries have implemented two basic approaches for a return-free system. Under the first approach, the IRS would use W-2 and information returns to compute tax liability for individuals with simple tax situations, and the taxpayer could challenge this calculation. Under the second approach – the "exact withholding model" – a taxpayer's ultimate tax liability is withheld at the source. In general, the exact withholding model is considered more difficult to implement.

A 2003 Treasury report to Congress[46] stressed that a return-free system would shift many of the burdens of determining tax liability from individuals to employers, financial institutions, state governments, and the IRS, and opined that return-free filing was unlikely to provide widespread benefits unless the current system was significantly simplified. The report also estimated the number of individuals who might qualify under a return-free system, summarized in **Exhibit 4.2**.

Exhibit 4.2

Treasury Estimates of Taxpayers Eligible for Return-Free System (1999 levels, in millions)

No Return Required:	Additional Taxpayers	Cumulative Total
Under unmodified current wage withholding and requirements	7	7
If current wage-withholding formula is more precise and employees must provide more personal information to employers	15	22
If income taxes must be withheld on interest, dividends, and pension benefits	13	35
If EITC is allowed without filing a return	13	48
Source: U.S. Department of the Treasury. Report to Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite, December 2003, available at http://www.ustreas.gov/offices/tax-policy/library/noreturn.pdf.		

45 In Section 2004 of the *Internal Revenue Service Restructuring and Reform Act of 1998* (P.L 105-206), Congress required the Treasury Department to develop procedures for implementing a return-free system for "appropriate" individuals by 2007. Treasury issued an interim report in 2003.

46 U.S. Department of the Treasury (2003). *Report to Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite*, December. Available at http://www.ustreas.gov/offices/tax-policy/library/noreturn.pdf.

Although promising, many are concerned that taxpayers would not trust the IRS to make the calculations and process refunds promptly, suggesting that some period of transition and adjustment would be necessary. Some states are beginning to test return-free systems, and their experience may provide useful insights for the IRS.[47]

D. CLOSING THE 'TAX GAP'

The "tax gap" is the difference between what taxpayers should pay and what they actually pay on a timely basis. A recently released IRS analysis indicates that the 2001 tax gap was between $312 and $353 billion.[48] Enforcement activities, coupled with late payments, recover about $55 billion of the tax gap, leaving a net tax gap of between $257 and $298 billion.

The IRS divides the tax gap into three components: (1) under-reporting income; (2) underpaying taxes; and (3) non-filing of returns. Under-reporting is by far the largest component of the tax gap, accounting for more than 80 percent of the total tax gap, with underpayment and non-filing at about 10 percent each.

The individual income tax is the single largest source of the tax gap, accounting for about two-thirds of the total. Over 80 percent of under-reporting comes from understating income, rather than overstating deductions. Consistent with the Service's general observation that compliance rates are highest when third parties report or withhold, most understated income is business income generated by small businesses and self-employed individuals, rather than wages or investment income. The National Taxpayer Advocate likewise points out that the cash economy and a lack of document matching for many other types of payments are the biggest sources of the tax gap.[49] The tax gap results in an annual revenue shortfall equal to approximately $2,000 per individual tax return filed, raising fundamental issues of fairness.

Two major approaches to reducing the tax gap are increasing IRS examinations and increasing information reporting and withholding. Until recently, IRS audit rates have steadily declined due to budget constraints and a shift in IRS priorities from enforcement to customer service. Increasing audit coverage would affect revenue directly by increasing collections. Although indirect effects are difficult to measure, estimates indicate that examinations would increase voluntary compliance by between six and twelve times the amount of proposed adjustments.[50]

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47 GAO (1996). *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, October, available at http://www.gao.gov/archive/1997/gg97006.pdf. See also, Bankman, Norquest and Toder (2005). Testimony before the President's Advisory Panel on Federal Tax Reform, available at http://www.taxreformpanel.gov/meetings/meeting-05172005.shtml.

48 Internal Revenue Service (2005), *Understanding the Tax Gap*, FS-2005-14, March. Available at http://www.irs.gov/newsroom/article/0,,id=137247,00.html.

49 National Taxpayer Advocate, *2004 Annual Report*, p. II-2.

50 Jeffery A. Dubin, Michael J. Graetz, and Lois L. Wilde (1990). The Effects of Audit Rates on the Federal Individual Income Tax, *National Tax Journal*, pp. 395-405.

In addition to better-targeted audits, the National Taxpayer Advocate has suggested strengthening withholding and information reporting requirements – particularly for payments to self-employed individuals – by raising penalties for failing to file Forms 1099 and reducing or eliminating threshold requirements for filing Forms 1099. Requiring businesses paying independent contractors to withhold estimated tax payments could also raise compliance levels.

All efforts to reduce the tax gap by adding new reporting and withholding requirements would impose additional burdens on taxpayers and third parties. The cost of these new burdens should not overwhelm the benefit of more effective tax collection.

E. 'BOTTOM-UP' INCOME TAX REFORM PROPOSALS

Although most tax reform discussion over the past decade has centered on some form of consumption tax, income tax reform was the basis of the most significant tax reform enacted to date, the landmark *Tax Reform Act of 1986* (*TRA 86*, P.L. 99-514). A similar path could be followed again. And the possible combinations border on the infinite.[51]

1. Tax Reform Act of 1986 Approach

TRA 86 broadened the tax base and used revenue generated from eliminating or reducing numerous tax credits, exclusions, and deductions to reduce the highest individual tax rate from 50 to 28 percent and the top corporate rate from 46 to 34 percent. The resulting top rate inversion was the first time in U.S. history that the maximum corporate income tax rate exceeded the maximum individual income tax rate.

The major revenue-raising provisions of *TRA 86* were:

- Eliminating the investment tax credit;
- Eliminating the capital gains exclusion;
- Adding the uniform capitalization rules (section 263A);
- Reducing depreciation deductions;
- Strengthening the corporate and individual alternative minimum taxes;
- Restricting the ability of individuals to deduct passive investment losses, miscellaneous itemized deductions, business meals and entertainment expenses, and medical expenses;

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[51] See, for example, New York State Society of Certified Public Accountants (2005). *The SET Tax: A Tax System for Our Future*. The Simple Exact Transparent (SET) Tax is, technically speaking, a flat tax, since only a single rate of tax is applied. However, it is designed to allow Congress substantial flexibility in arriving at the tax base. The SET Tax starts with a broad definition of gross income, then re-engineers today's deductions, exclusions, non-refundable credits and multiple-rate tables as "exclusions." Congress then determines which exclusions are used to reduce gross income, and which single tax rate is applied to calculate the taxes due. For example, setting the size of an individual lump-sum exclusion could eliminate or greatly reduce income taxes for those who can least afford them. Available at http://www.nysscpa.org/pdfs/set.pdf.

- Restricting the availability of Individual Retirement Accounts;
- Restricting the ability of state and local governments to issue bonds to finance private-sector investments; and
- Tightening anti-deferral and source rules pertaining to foreign source income.

Many of these provisions have since been repealed, reconstituted or reinstated in a limited form, including the tax treatment of capital gains, business meals, IRAs, losses on real estate investment, accelerated depreciation, and foreign source income. Legislative changes since 1986 have eroded the top rate inversion; the maximum individual rate once again exceeds the maximum corporate rate.

A similar approach to *TRA 86* could be taken to reform our current system by eliminating some tax preferences, increasing the standard deduction, and reducing tax rates for revenue neutrality, as suggested by various reports of Joint Committee on Taxation staff reports and others.[52]

2. Income Plus Consumption: Graetz Proposal

Yale Law School Professor Michael Graetz has proposed a tax reform plan[53] that would repeal the regular income tax, dramatically expand the AMT exemption (called a "family allowance"), and apply a flat rate of 25 percent to income exceeding the higher of (1) the family allowance or (2) a narrow set of itemized deductions. Graetz's plan would retain itemized deductions for charitable contributions, home mortgage interest, medical expenses, and employee business expenses. All other itemized deductions would be disallowed.

If the family allowance were set at $100,000 ($50,000 for unmarried taxpayers) and indexed for inflation, Graetz estimates that his plan would eliminate the need for over 100 million taxpayers to file individual tax returns.[54] This would restore the individual income tax to its pre-World War II status as a tax that applied to a relatively small group of high-income individuals.

Graetz's proposal intends to simplify the corporate income tax by more closely aligning tax and financial accounting and applying the same 25-percent tax rate to corporations as to individuals. The corporate AMT would be repealed.

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52 See JCT (2001), at http://www.house.gov/jct/pubs01.html; JCT (2005), at http://www.house.gov/jct/s-2-05.pdf; ABA, AICPA, TEI (2001), at http://www.abanet.org/tax/pubpolicy/2001/01simple.

53 Michael J. Graetz. 100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System, *Yale Law Journal*, Vol. 112, No. 2, November 2000, pp. 263-312, and testimony before the President's Advisory Panel on Federal Tax Reform, available at http://www.taxreformpanel.gov/meetings/meeting-05_11-12_2005.shtml. Graetz served as Deputy Assistant Secretary of Treasury for Tax Policy from 1990 to 1992.

54 Graetz's calculations are based on 1999 IRS data when approximately 125 million individual tax returns were filed. The IRS projects that approximately 133 million individual tax returns will be filed in 2005. See, Selected Returns and Forms Filed or to Be Filed by Type During Specified Calendar Years, 1980-2004, *SOI Bulletin*, January 2005, available at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133536,00.html.

To pay for revenue lost by reforming the individual and corporate income taxes, the Graetz plan would include an entirely new credit-invoice value-added tax with a rate in the 10-15 percent range.

A similar proposal was offered by former Congressman Sam Gibbons in 1996.[55]

3. Comprehensive Business Income Tax

Proposed by the Treasury Department in 1992,[56] the comprehensive business income tax (CBIT) represents a very long-term, comprehensive option for equalizing the tax treatment of debt and equity. The income of all business entities – corporate and non-corporate – would be taxed at the entity level at a flat rate of tax, but when business income is distributed as interest or dividends, it would not be taxed when received by investors or debt-holders. Under the 1992 approach, capital assets would continue to be depreciated, rather than expensed.

The CBIT tax base would approximate the current corporate income tax base, without deducting interest expense and excluding dividend and interest income from other entities. Businesses would generally be allowed the same tax preferences and foreign tax credits (modified for the non-deductibility of interest) as under current law.

Recent cuts in the tax rates for capital gains and dividend income have reduced double taxation of corporate income and can be viewed as a move toward the CBIT approach. As outlined in the 1992 Treasury proposal, the CBIT has no individual component. Combining the CBIT with an individual tax with flat tax features would move the U.S. tax system close to a full consumption tax.[57]

F. INCREASING THE CONSUMPTION TAX ASPECTS OF OUR CURRENT HYBRID TAX SYSTEM

1. Introduction: The Current Hybrid System

The most important difference between an income tax and a consumption tax is that a consumption tax eliminates the tax burden on income from saving and investment. In short, capital income is exempt. Many features of the current tax system reduce or eliminate taxes on saving and investment. For example, interest from state and municipal bonds and the cash

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[55] H.R. 4050, 104th Congress. See Chapter 7 of this report, p. 59.

[56] *Report of the Department of Treasury on Integration of the Individual and Corporate Tax Systems*. January 1992. Available at http://www.ustreas.gov/offices/tax-policy/library/integration-paper. Department of the Treasury, "A Recommendation for Integration of the Individual and Corporate Tax Systems," December 1992. Available at http://www.ustreas.gov/offices/tax-policy/library/integration-paper/recommendation-for-integration.pdf. See also, Martin A. Sullivan, Economic Analysis: The Tax Reform Plan that Wouldn't Sell, *Tax Notes*, 2005 TNT 39-7, March 1, 2005; Kenneth Gideon's testimony before the President's Advisory Panel on Federal Tax Reform, available at http://www.taxreformpanel.gov/meetings/meeting-05_11-12_2005.shtml.

[57] Tax reform materials memorandum for Secretary O'Neill from Pamela F. Olson, November 7, 2002, available at http://thepriceofloyalty.ronsuskind.com/thebushfiles/archives/000093.html.

surrender value build-up in life insurance contracts are tax-free, and employer contributions to an employee's retirement savings plan are tax-deferred. The investment income of universities, charities, and other non-profit organizations is also not subject to income tax. Capital gains income and dividends are, generally, subject to a current, reduced top rate of 15 percent.

Investors meeting certain conditions and not exceeding specified income limits can also benefit from a variety of tax-preferred savings vehicles – including traditional IRAs, Roth IRAs, section 529 education plans, and healthcare savings accounts.

Finally, the tax burden on income generated by businesses (whether or not subject to corporate income tax) can be significantly reduced through tax credits (such as the research credit) and accelerated deductions for depreciation and amortization.

The availability and the quantitative importance of these and other forms of tax relief for income from savings and investment suggest that our current income tax is better characterized as a hybrid income-consumption tax than a "pure" income tax. Recognizing this fact may be essential to understanding the next round of tax reform. The frequently cited need for the United States to move toward consumption taxation could be accomplished by a radical restructuring of the current tax system. It can also be accomplished by a more moderate approach of expanding current tax breaks for savings (such as reducing restrictions on pensions and IRAs) or reducing taxes on capital.

2. Increasing Tax-Preferred Savings Options

Increasing incentives and options for tax-preferred saving is the most direct method of moving toward a consumption tax within an income tax system. Adding options may be preferable to replacing well-known and widely used incentive saving plans. For example, exclusions for investment income would partially address some criticisms of the income tax. Others believe savings would increase and simplification would be better served by consolidating the current savings incentives while increasing their dollar limits and adding flexibility.

For example, in his 2003-2005 budget proposals, the President proposed dramatic changes in the tax treatment of personal savings by creating three new types of tax-favored accounts that would replace current retirement savings accounts, including IRAs, 401(k)s, and SEPs. These proposed accounts would substantially simplify rules for tax-favored savings accounts, offer expanded opportunities for tax-free saving, and disregard or liberalize most age and contribution limitations.

Retirement savings accounts (RSAs) would replace traditional and Roth IRAs. Unlike IRAs, these accounts would have no income or age limits for contributions, and no minimum distribution requirements. Annual contributions would be limited to $5,000 (indexed to inflation). Like Roth IRAs, contributions would not be deductible, but distributions after age 58 would be tax-free. Although taxpayers would not be required to convert traditional IRAs to RSAs, no future contributions to IRAs would be allowed. Traditional IRAs could be converted to RSAs without limits, but the conversion proceeds would be taxable when converted.

Lifetime savings accounts (LSAs) would provide another $5,000 (indexed) of tax-advantaged savings. These accounts would be similar to RSAs except that the funds could be used any time before or after retirement. This unlimited ability to distribute funds – that is, the lack of both minimum holding period and minimum age requirements – is the greatest departure from current law. Employee retirement savings accounts (ERSAs) are modeled after 401(k) plans and would function as a replacement for most defined contribution plans, including 401(k)s, Simplified Employee Pension Plans (SEPs), and SIMPLE IRAs. The proposal would simplify many complex rules in an attempt to encourage executives and business owners to provide pension benefits to rank-and-file employees.

3. Accelerated Depreciation

Under a pure income tax, depreciation deductions would exactly follow the true decline in an asset's economic value, effectively taxing capital at the statutory tax rate. Since 1954, taxpayers have been permitted to depreciate assets more rapidly than economic depreciation as an incentive to capital formation.

Any acceleration of depreciation is a step closer to consumption taxation. The most accelerated form of depreciation is expensing. Under certain conditions, the advantage of accelerated tax deductions from expensing results in an effective tax rate on capital of zero. Not taxing capital is equivalent to a consumption tax. Therefore, allowing expensing instead of economic depreciation can be a way of moving an income tax structure toward a consumption tax model.

The Job Creation and Worker Assistance Act of 2002[58] allowed taxpayers to temporarily deduct "bonus depreciation" of an additional 30 percent of an asset's basis in its first year of service. *The Jobs and Growth Tax Relief Reconciliation Act of 2003*[59] increased bonus depreciation from 30 percent to 50 percent and extended it through December 31, 2004. Permanent extension of bonus depreciation[60] or a similar proposal for partial expensing could be an important part of any plan to reform the current tax system and move it "toward a broad based consumption tax by reducing the tax burden on capital income."[61]

4. Eliminating the Double Taxation of Corporate Profits

The "classic" income tax system subjects corporate profits first to an entity-level tax and, when those already taxed profits are paid out as dividends, to an individual-level tax. The double taxation of corporate profit can be reduced by either providing tax relief at the corporate level on dividends paid (e.g., a deduction) or on the individual level for dividends received (e.g., a credit or an exclusion). *The Jobs and Growth Tax Relief Reconciliation Act of 2003* imposed a

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58 P.L. 107-147.

59 P.L. 108-27.

60 *The Bonus Depreciation Extension Act of 2005* (H.R. 364), introduced by Rep. Joe Wilson, R-S.C., on January 25, 2005, would extend bonus depreciation for an additional two years.

61 Tax reform materials memorandum for Secretary O'Neill from Pamela F. Olson, November 7, 2002, available at http://thepriceofloyalty.ronsuskind.com/thebushfiles/archives/000093.html.

maximum 15-percent tax rate on dividend income received by individuals. This relief expires at the end of 2008.

Eliminating this double tax on corporate profits is referred to as "integration" of the individual and corporate income taxes.[62] Any discussion of tax reform must consider integration as a logical first step in moving from an income tax to a consumption tax.

G. THE PROS AND CONS OF 'BOTTOM-UP' REFORM OF THE FEDERAL INCOME TAX SYSTEM

Pros:

- Reforming the current income tax system allows for a simpler transition to a new system and is less disruptive to taxpayers and the economy.
- Some argue that taxing income rather than consumption better reflects the principle of aligning tax burdens with "ability to pay."
- If reform moved the current income tax system further towards a consumption tax, many of the economic benefits associated with consumption taxes could be realized.
- Taxpayers are already familiar with the administrative, guidance, forms and enforcement mechanisms.
- Popular tax incentives – mortgage interest and charitable donation deductions – are maintained or continued.

Cons:

- An income tax system is inherently complex, and this complexity breeds noncompliance, sophisticated evasion schemes, and disputes with taxpayers.
- An income tax system imposes heavy compliance burdens on businesses and some or all individual taxpayers.
- Without changes, the income tax imposes a heavier tax burden on savings and capital formation, which critics claim reduces economic growth.
- Income-based tax systems require greater complexity in order to measure income from capital.
- An income tax system has inherent enforcement difficulties.
- An income tax system is not border adjustable.

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[62] For more information on corporate integrations, see AICPA (1993). *Statement of Tax Policy No. 10: Integration of the Corporate and Shareholder Tax Systems*.

Chapter 5

Retail Sales Tax

SUMMARY

- Ideally, a retail sales tax should tax all consumption equally to avoid distorting consumer choices and keep tax rates lower.
- Only final sales of goods and services by businesses to consumers are subject to tax, thus avoiding over-taxation.
- To avoid a disproportionate impact on low-income taxpayers, most retail sale tax systems exempt necessities and government and charitable services, thereby increasing administrative and compliance burdens.
- Enforcement difficulties include concerns about evasion by business and retail purchasers – particularly at high combined federal and state tax rates.

A. INTRODUCTION

Retail sales taxes are encountered by most Americans every day. Forty-five states and numerous local jurisdictions levy sales taxes. These taxes are highly visible because they are stated separately from the purchase price on each taxable sales receipt. Retail businesses file sales tax returns and make sales tax payments to state and local authorities. The tax is transactional rather than periodic, without an annual tabulation of how much tax a family has paid in over the year.

From the perspective of promoting economic efficiency, a retail sales tax should tax all consumption equally to avoid distorting consumer choices and to keep tax rates low. Only final sales by businesses to consumers should be subject to tax. Taxing sales by businesses to other businesses would result in over-taxation due to the pyramiding of tax in that the cost of the product would include the sales tax paid by the seller. This "tax on a tax" effect should be avoided.[63] In practice, states' retail sales taxes fall short of the ideal of taxing all consumption once. States often exempt many final goods and services and levy tax on many intermediate goods. This results in under-taxation of some sectors and over-taxation of others.

63 Because final sales would bear not only retail sales tax but also the costs of whatever taxes are paid on inputs used to produce, market, or distribute consumer products, the over-taxation of consumption that can occur is a major issue with sales taxes. This over-taxation of certain products was a major factor contributing to the adoption of European and Canadian value-added taxes.

Because retail sales taxes are imposed on final sales *within* a taxing jurisdiction, goods produced outside and consumed inside the jurisdiction would be taxed, but goods produced within but sold outside that jurisdiction would be exempt. Thus, a federal retail sales tax would exempt exports and impose a tax on imports. This feature, shared with many consumption taxes, is particularly attractive to domestic businesses competing in the international market place.[64]

B. STATUTORY EXEMPTIONS

A sales tax, in general, is regressive. State governments exempt many goods and services from sales tax, especially items considered to be necessities, such as food, clothing, and housing to reduce regressivity. Because purchases of necessities generally represent a larger fraction of income for the poor than for the wealthy, such exemptions confer proportionately greater tax relief for low-income households. Services provided by governments and charitable organizations and many types of financial services are exempt because it is difficult to place a dollar amount on these services. Finally, other goods are exempt because they are considered "merit" goods that deserve public support – such as education and health care. State sales taxes often provide broad exemptions for services and for purchases made by non-profit organizations.

Exemptions generally increase tax authorities' administrative burdens and taxpayers' compliance burdens. The administrative costs of a retail sales tax would be greatly reduced if no exemptions or special rates were allowed.[65] Retail businesses must distinguish taxable from nontaxable sales, and service providers must allocate total charges between taxable products and nontaxable services.

This complexity is not inherent in the structure of a retail sales tax; however, a federal retail sales tax will likely include tax relief for certain sectors. All states with sales taxes – as well as almost every country with a retail sales tax or value-added tax – include preferential treatment for certain goods and services.

C. TAXATION OF INTERMEDIATE GOODS

Even if all exemptions for consumer products were eliminated, the problem of separating taxable sales to consumers from non-taxable sales to businesses would remain. State governments generally use two methods – both imperfect – to segregate sales: (1) grant "exemption certificates" to business taxpayers; or (2) impose sales tax on some types of products regardless of the status of the purchaser. By using these blunt tools, retail sales taxes overtax final sales of some products at the same time they under-tax sales of others.

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[64] Sales taxes that include imports and exclude exports are said to operate on the "destination principle." (In theory, a sales tax may operate under the "origin principle" where imports are excluded and exports are included in the tax base.) Most economists believe that taxes should be imposed under the destination principle to avoid distorting consumer choices between imports and domestically produced goods.

[65] See, for example, U.S. Treasury (1984); and Cnossen (1989).

1. 'Cascading'

When intermediate goods are taxed, the purchase price of the final product includes the tax on the final sale and the tax on each of the inputs to the final product. For example, if a 5-percent state sales tax is imposed on a cup of coffee and on the beans and machinery used to make the cup of coffee, the effective sales tax rate to the retail consumer will exceed 5 percent. If the already-taxed inputs account for 20 percent of the final price, the effective tax rate is six percent. This is referred to as tax "cascading." Cascading can result in higher tax burdens on products that include more taxable intermediate goods, resulting in a cost advantage for firms that supply their own intermediate inputs over competitors that must purchase intermediate inputs in taxable transactions.[66]

The Treasury Department's 1984 consumption tax study reported that approximately 20 percent of state sales taxes were collected on intermediate goods. Certain products – such as gasoline, tools, and office equipment – are sometimes taxed regardless of whether they are purchased by a business or by a consumer. A retail sales tax that required a thorough sorting of business-to-business sales from consumer sales would add complexity and increase compliance costs.[67]

2. Exports

The tax treatment of exports may be problematic when a sales tax system includes business-to-business sales, because it lacks a mechanism for rebating business-paid taxes on exports. Rebates under a retail sales tax could only be implemented using a rough estimate of the amounts of tax paid at intermediate levels.

If exporters bear the burden of proof about tax paid at intermediate levels, exports would be over-taxed as a result of the difficulty exporters would have in identifying and documenting taxes paid by all their suppliers. On the other hand, governments could promote exports by using generous estimates of intermediate level taxes.

Foreign governments that have relied heavily on sales taxes have recognized cascading as a problem – particularly in the context of international trade – often cited as a major reason for adopting value-added tax regimes.

D. EVASION BY BUSINESS PURCHASERS

Under a retail sales tax, businesses – especially closely held businesses – are able to improperly claim exemption on items used for personal consumption. States usually grant businesses "exemption certificates" that allow them to make purchases without paying sales tax. However,

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66 Cascading is not an issue under either a credit-invoice or subtraction method value-added tax. For example, under the credit-invoice method, any taxes paid on intermediate sales between businesses would be rebated to the business making sales to consumers.

67 See, for example, U.S. Treasury (1984); and Cnossen (1989).

no enforcement mechanism prevents exemption certificate holders from purchasing items used for personal consumption.

It is not reasonable to expect sellers to aid in enforcement beyond checking an exemption certificate's validity. Sellers cannot read buyers' minds or audit their business operations to ascertain the intended use of purchased items.

Unless special precautions are taken, a retail sales tax also places little burden of proof on business purchasers. Business purchases can only be audited if (1) the seller retains records of business purchases that include the purchasers' tax identification numbers; and (2) auditors compare those records to the purchasers' tax returns. Even with such extensive record keeping, the threat of audit would be minor, given the small amount of tax any single purchaser could evade from a single retailer. Although state-level mechanisms are in place to address sales tax avoidance, attempts at evasion may increase at the higher combined levels of federal and state sales taxes.

Although auditing big-ticket items – such as automobiles and personal computers – that have extensive business and personal use is more feasible, detection of evasion would require auditing both sellers and purchasers. Alternatively the government could consider rebates payable upon presentation of valid invoices to tax authorities instead of allowing businesses to use exemption certificates for large ticket items. However, rebates would increase administrative costs.

The problem of distinguishing business items from personal-use items is not exclusively a retail sales tax problem. Evasion by overstating business expenses is a significant concern under most tax systems.[68] Under the current income tax, small business owners have similar incentives to claim business deductions for personal use items and services. However, under the income tax, businesses must stand ready to defend all deductions claimed, and even valid business deductions can be disallowed if improperly documented.

A critical difference exists for detecting evasion under a retail sales tax versus other tax regimes: Evasion by retail sales tax purchasers would require auditing multiple taxpayers. Under other tax systems, evasion can be detected by auditing only the purchaser. Therefore, the problem of evasion by business purchasers under a retail sales tax cannot be easily dismissed.

E. EVASION BY RETAIL SELLERS

Perhaps the most cited difficulty with a federal retail sales tax is lack of compliance by retail sellers, a sector comprised of innumerable small businesses. Compliance by small business is already an issue under both the federal income tax and state sales taxes. The entire compliance burden of a retail sales tax is imposed at the point of final sale, unlike a VAT, under which the

[68] Under a credit-invoice VAT, businesses may attempt to claim credits on items purchased for personal use. Similarly, under a personal consumption tax or a subtraction method VAT, closely held businesses may attempt to deduct the cost of items purchased for personal consumption as business expenses.

compliance burden is spread across all businesses, or the income tax, where millions of taxpayers share the burden.[69]

There is an upper limit on the rate of a federal retail sales tax before tax evasion becomes a wide-spread issue threatening revenue levels. Most tax administrators believe that the maximum tax burden (federal, state and local) that may be imposed on small businesses before evasion becomes a wide-spread problem is 10 to 12 percent of gross receipts.[70] A federal retail sales tax rate in excess of 20 percent would be necessary to replace the revenue generated by the current federal income tax.[71] If the upper realistic limit is 10 to 12 percent, there is little room for adding a federal sales tax on top of state and local sales taxes without generating significant compliance problems for both state and federal tax collectors. Nevertheless, a federal retail sales tax cannot be ignored as an add-on to the income tax.

F. COMPLIANCE REQUIREMENT FOR CONSUMERS

As with state sales tax systems, a use tax would likely be needed for a retail sales tax to ensure that the consumer pays any tax not collected when the consumer purchases are made. For example, when a consumer purchases taxable goods and services from a non-U.S. vendor, the consumer would be required to self-assess the equivalent use tax. Although the number of federal-level use tax transactions would likely be smaller than those dealt with by the states, a sales tax compliance and tax gap problem would still result.

G. RETAIL SALES TAX PROPOSALS

In 1996, *The Schaefer-Tauzin National Retail Sales Tax Act of 1996*, introduced by Congressmen Dan Schaefer, R-Colo., Billy Tauzin, R-La., and Dick Chrysler, R-Mich., proposed replacing the current income tax system with a retail sales tax.[72] The plan would repeal the individual and corporate income taxes, estate and gift taxes, and most excise taxes, substituting a 15 percent flat rate tax on retail sales of goods and services.

Congressman John Linder, R-Ga., introduced a retail sales tax proposal similar to the Tauzin plan, *The Fair Tax Act of 2004*.[73] The Linder plan would also repeal payroll taxes and use a higher tax rate of 23 percent.

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69 Some commentators argue that significant exemptions – or subsidies – should be granted to small businesses because of the high compliance costs of a VAT tax. This would not be possible under a retail sales tax without a substantial loss of revenue.

70 Buckley, John, and Diane Lim Rogers (2004), Is a National Sales Tax in Our Future? *Tax Notes Magazine*, September 14, 2004, 1277, 1285; McLure (1987), p.107; and Tanzi (1994), pp. 48-52.

71 Buckley and Rogers (2004), pp. 1277, 1284.

72 H.R. 3039, 104th Congress.

73 H.R. 25, 108th Congress.

The Individual Tax Freedom Act of 2004,[74] introduced by Rep. Tauzin, would impose a 15 percent rate. Low-income families would be paid a rebate calculated by multiplying the sales tax rate by the lesser of (1) the poverty level adjusted for family size; or (2) the family's wage income. Businesses collecting the sales tax would keep one-half percent of tax collected to offset their compliance costs. Under this proposal, a state could choose to administer the federal tax within its borders by conforming its sales tax base to the federal tax base. In return, the state would receive an administration fee equal to one percent of the federal tax collected.

H. PROS AND CONS OF REPLACING THE FEDERAL INCOME TAX WITH A 'GENERIC' RETAIL SALES TAX

Pros:

- The basic concepts of the retail sales tax are familiar to US citizens.
- A retail sales tax is relatively uncomplicated, unless there are numerous exemptions.
- A federal retail sales tax could provide an impetus for creating a uniform, common tax base among the states and the federal government, thereby reducing compliance costs and burdens.[75]
- A retail sales tax does not have any individual filing requirements.
- A retail sales tax can be structured to be border adjustable.
- Just like other consumption taxes, a retail sales tax removes a bias against savings inherent in the income tax.[76]

Cons:

- The retail sales tax is viewed as a regressive tax. The regressive effect could be mitigated by exempting necessities like food and/or providing offsetting assistance to lower income households. However, exemptions would increase complexity and may require a higher overall tax rate.
- A federal retail sales tax would increase the compliance burden placed on retailers and businesses.
- Retail sales taxes are a primary revenue source for many state and local governments. A federal retail sales tax could create conflicts and pressures on state revenues.

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74 H.R. 4168, 108th Congress.

75 The Streamlined Sales Tax Project is a multi-state effort to "develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes." For more information go to http://www.streamlinedsalestax.org/.

76 If increased saving does occur, increased economic growth and improved trade balance should follow. However, economists are divided over the effect of taxes on savings rates and, therefore, on whether a switch to consumption taxes will lead to significant economic gains.

- Different tax bases and tax rates between federal and the states retail sales taxes would add complexity.
- The impetus for evasion of retail sales tax increases with the tax rate and, unlike the credit-invoice VAT, sales tax evasion at the retail level results in total evasion of the tax.
- Replacing the current federal income tax system with a retail sales tax involves significant transition issues.

Chapter 6

The Credit-Invoice Method Value-Added Tax

SUMMARY

- The credit-invoice method value-added tax (VAT) is the consumption tax most widely used outside the United States.
- A business's "value added" is measured by the final sales price of its goods and services, less the cost of the goods and services purchased by the business.
- A credit-invoice VAT looks like a retail sales tax, but every business pays tax on the gross value of its sales, not just retailers. However, unlike a retail sales tax, businesses may receive credits for taxes paid on their purchases.
- A credit-invoice VAT can shift the tax burden by using exemptions or zero tax rates for specific goods, sellers or purchasers. The consequences vary, depending on the method used.
- Both buyers and sellers must keep records of the tax liabilities associated with any given transaction, thereby allowing tax authorities to cross-check buyers' credit claims with sellers' records.

A. INTRODUCTION

The credit-invoice method value-added tax (VAT) is the consumption tax most widely used by foreign governments. Although few U.S. tax proposals contemplate using a credit-invoice VAT, its similarity to other consumption tax proposals suggests that the United States can benefit greatly from the experience of other countries.

1. The Concept of 'Value Added'

Each business "adds value" by contributing its labor and its capital to national output. Value added can be measured either by subtraction or addition. Under the subtraction method, value added is the difference between the firm's sales and the firm's purchases from other businesses. Under the addition method, value added is the sum of a firm's payments to its workers and returns to its owners and lenders for the use of their capital. The difference between the two methods is illustrated in the following example:

Exhibit 6.1

Calculation of Value Added by Subtraction and by Addition

Income Statement	
Sales	$100
Less Payments to Other Businesses	$40
Less Wages	$50
Equals Profit	$10
A. Value Added by Subtraction	
Sales	$100
Less Payments to Other Businesses	$40
Equals Value Added	$60
B. Value Added by Addition	
Wages	$50
Plus Profit	$10
Equals Value Added	$60

In this example, value added equals $60 whether measured under the subtraction method or the addition method. In either situation, the business remits VAT on the $60 of its value added. Under the subtraction method, it first calculates its value added, then calculates the total VAT due. Under the credit-invoice method, the business collects VAT on the $100 of sales, takes a credit for the VAT paid on its $40 of purchases, and remits the net VAT on $60.

Financial flows – payment and receipt of investment income and any increase or decrease in investment balances – between businesses are not included in the calculation. Most notably, interest income is not included in gross receipts and interest payments are not deductible.

The addition method is rarely applied in other countries, although the Michigan Single Business Tax is an addition-method VAT.[77]

[77] See http://www.michigan.gov/treasury/0,1607,7-121-1750_2143_2153_3222-105194--,00.html.

2. The Equivalence of Final Sale Price to Total Value Added

Most consumer products are brought to market through a chain of production and distribution in which a business purchases goods and services from other businesses and uses them as inputs to the goods and services provided by that business to its own customers. At the end of the chain, retailers sell goods and services to household consumers. At each link in the production-distribution chain the business adds value to its purchased inputs. **Exhibit 6.2** outlines how the sum of the values added equals the retail price of the goods sold to the final consumer.

Exhibit 6.2
The Chain of Value Added

Business	Sales	Purchases	Value Added
Link 1: Farmer	20	0	20
Link 2: Miller	50	20	30
Link 3: Baker	100	50	50
Sum			100

Link 1: In this simple example, the farmer uses his own land and seed and purchases no inputs from other businesses. He sells his wheat for $20. This $20 is the farmer's value added.[78]

Link 2: The miller purchases the wheat from the farmer for $20. The wheat is then ground into flour and sold to the baker for $50. The difference between the $50 sale and the $20 cost is the miller's value added.

Link 3: The baker purchases the flour from the miller for $50. The flour is then used to bake bread and sold to consumers for $100. The difference between the $100 in sales and the $50 cost is the baker's value added.

By not specifying how the cost of "purchases" would be measured, the above example detracts from the important issue of capital cost recovery. Proposals for VATs, as well as most VATs currently in force throughout the world, allow capital expenditures to be deducted fully in the year of purchase, instead of recovering the cost over the asset's life. In order to make a value-added tax a consumption tax, it is essential to allow the expensing of capital purchases If, instead of expensing, capital purchases were amortized using depreciation schedules reflecting their true decline in value, the VAT would be equivalent to an income tax.

[78] If, instead of expensing, capital purchases were amortized using depreciation schedules reflecting their true decline in value, the VAT would be equivalent to an income tax.

B. OVERVIEW OF THE CREDIT-INVOICE METHOD

1. The Basic Mechanics

A credit-invoice method VAT taxes each firm's gross receipts. Tax credits are available to the extent that a business can demonstrate that its suppliers paid tax on its purchases, as evidenced by invoices reporting the amount of creditable taxes paid by the suppliers. Under a credit-invoice VAT, most businesses would receive nearly full refunds of VAT paid because a significant portion of their purchases would be from other businesses.

Calculating tax liability under the credit-invoice method involves two steps: (1) calculating the gross VAT – which is similar to a retail sales tax; and (2) calculating the credit. For example, if the tax rate in **Exhibit 6.2** is 10 percent, the miller pays $5 of VAT on its gross receipts and receives $2 of credit for VAT paid by the farmer and reported on the invoice provided to the miller.

2. Similarity to a Retail Sales Tax

The tax liability under a credit-invoice VAT requires, first, calculating the gross VAT, and then calculating the credit. Calculating the gross credit-invoice VAT looks the same as a retail sales tax – both apply the tax rate to gross taxable sales and are, usually, separately stated at the cash register. Taxpayers must differentiate sales of exempt and non-exempt products under both taxes. In addition, both taxes routinely exempt exports.

Because a retail sales tax and a credit-invoice VAT using the same rate generally impose the same amount of tax on the same tax base (see **Exhibit 6.3**), many economists believe that these two taxes would have largely the same impacts on saving, international trade, and the distribution of income. To economists, the primary differences between a retail sales tax and a credit-invoice VAT are ease of administration and likely compliance levels.

Exhibit 6.3

The Operation of a 10-Percent Credit-Invoice VAT
Compared to a 10-Percent Retail Sales Tax

Business	Sales	Gross VAT	Credits	Net VAT	Retail Sales Tax
Link #1: Farmer	20	2	0	2	0
Link #2: Miller	50	5	2	3	0
Link #3: Baker	100	10	5	5	10
Sum		**17**	**7**	**10**	**10**

However, gross VAT and retail sales tax calculations differ in some important ways. A VAT applies to all businesses, but a retail sales tax only applies to retailers. Under a VAT, there is no need to distinguish whether a sale is made to a business or a consumer, because all sales are taxable. The tax will be creditable to a business purchaser without the need to present a resale exemption certificate to the seller, thereby eliminating one of the most vexing administrative problems of a retail sales tax.

3. Tax Credits: Calculation and Compliance

The most important distinguishing feature of the credit-invoice method is calculating the credits which substantially reduce businesses' gross tax liabilities. Credits are only allowed for taxes paid by other businesses for which the credit-seeker has a verifiable record of taxes paid by the seller.

This unique interdependence of tax liability is important for administration and compliance. Both buyers and sellers must keep records of the tax liabilities associated with any given transaction. A VAT credit can be denied if the buyer does not maintain sufficiently detailed records of the transaction. (See **Exhibit 6.4** for information requirements.) Tax authorities like this feature, because all credit claims can be cross-checked with sellers' records, creating a better audit trail than exists for other types of consumption or income taxes. However, the credit-invoice VAT requires businesses to keep records documenting the taxes they have paid on their business purchases.[79]

Exhibit 6.4

Invoice Information Retained by Buyers and Sellers for Each Transaction Under a Credit-Invoice VAT

- Name and address of person issuing invoice
- VAT registration number
- Serial number of the invoice
- Date and issue of the invoice
- Date of supply of goods or services
- Amount charged, excluding VAT
- Rate of tax
- Name and address of customer

[79] Although some critics may argue that this constitutes a greater and unwarranted burden on business, a fair comparison must include analysis of competing proposals using the number of exemptions, etc, proposed and taking into consideration what records would no longer need to be maintained.

4. Exemptions from a Credit-Invoice Value-Added Tax

There are two basic methods of providing tax relief under a VAT – exemption and zero-rating. In practice, most value-added taxes employ both exemptions and special rates. Under an income tax or most other consumption taxes, exemptions affect only the exempted taxpayers, and – in general – reduce overall tax receipts. However, under the credit-invoice VAT, exemptions can have impacts that extend far beyond the exempted parties and may even result in increased tax revenues, as illustrated in **Exhibit 6.5**.

Sectors and products most frequently receiving tax relief under a VAT include food, housing, medical care, small business (including farmers), exports, used goods, state and local governments, financial intermediaries, and charitable organizations.[80]

Although exemption appears to be the most straightforward way of relieving administrative burdens, its impact on the associated tax burden can be markedly uneven. As a rough rule of thumb, businesses that provide goods and services to consumers will generally benefit from exemption, but businesses that provide goods and services to other businesses will generally be hurt by exemption. This result occurs because non-exempt business customers of an exempt business will pay VAT on purchases from the exempt business, but be unable to receive credits on its purchases from the exempt business. In a competitive market, the exempt business that gives its customers invoices without credits will have to reduce its prices or lose sales.

Exempting a business from a credit-invoice VAT could increase, reduce or not affect its tax burden, as illustrated in **Exhibit 6.5**. How the burden of a credit-invoice VAT shifts depends on where in the production-distribution chain an exemption is granted, and this may result in inconsistent burdens across businesses.

- If a business at the beginning of the production chain is exempt, no tax is paid by the exempt business, but an additional amount of tax is paid by the next business in the chain that exactly offsets this. In this case, total VAT liability is the same as without exemptions.

- If an intermediate business is exempt from tax, the business making purchases from that exempt business cannot credit any taxes paid by any businesses earlier in the chain. Thus, the purchaser from an exempt business pays the full tax as if no tax were previously paid. In this case, total VAT liability is greater than without exemptions.

- If a retailer making final sales is exempt from tax, all taxes on value added prior to purchases by the retailer are properly paid and the value added by the retailer is exempt from tax. In this case, total VAT liability is less than without exemptions.

[80] See McLure (1987), recognizing that a credit-invoice VAT has a superior ability to accommodate special treatment for some sectors or products.

Exhibit 6.5

The Effects of Exemption at Various Stages of Production Under a Credit-Invoice Method

	No Exemptions	Exempt Farmer	Exempt Miller	Exempt Baker
Farmer				
Gross VAT	2	-	2	2
Credits	0	-	0	0
Net VAT	2	-	2	2
Miller				
Gross VAT	5	5	-	5
Credits	2	0	-	2
Net VAT	3	5	-	3
Baker				
Gross VAT	10	10	10	-
Credits	5	5	0	-
Net VAT	5	5	10	-
Total VAT	**10**	**10**	**12**	**5**

In general, the further the exempted business is from the retail consumer, the smaller the degree of over-taxation that will be associated with the final product. Thus, exempting small farmers making relatively small purchases from other businesses is unlikely to result in significant over-taxation of food, and might result in a significant reduction in compliance and administrative costs.

5. 'Zero-Rating' as an Alternative to Exemptions

The potential for large and uneven economic distortions that can result from exemptions have led to the alternative of "zero-rating" – applying a tax rate of zero to sales of selected goods or by selected businesses.[81] When a business's sales are zero-rated, the business must still participate in the VAT system and file annual returns. However, the business has a smaller compliance burden overall because, as a zero-rated taxpayer, it is eligible for refunds. Under most VAT systems where exemptions are allowed, many businesses opt to remain zero-rated taxpayers.

[81] The differences between exemption and zero-rating also serve to highlight some important differences between the credit-invoice and subtraction methods of calculating VAT.

In addition to benefiting the zero-rated firm, zero-rating results in more even economic impacts than a system of exemptions. Any zero-rating before the retail stage does not impact the total tax liability of a final product, and zero-rating at the retail stage results in complete exemption of a product. (See **Exhibit 6.6**.)

Exhibit 6.6

The Effects of Zero-Rating at Various Stages of Production Under a Credit-Invoice Method
(Negative numbers indicate refunds.)

	No Exemptions	Zero-Rating Farmer	Zero-Rating Miller	Zero-Rating Baker
Farmer				
Gross VAT	2	0	2	2
Credits	0	0	0	0
Net VAT	2	0	2	2
Miller				
Gross VAT	5	5	-	5
Credits	2	0	2	2
Net VAT	3	5	-2	3
Baker				
Gross VAT	10	10	10	0
Credits	5	5	0	5
Net VAT	5	5	10	-5
Total VAT	**10**	**10**	**10**	**0**

C. ALL OTHER INDUSTRIALIZED COUNTRIES HAVE A VAT

The United States is the only major economy without a value-added tax. (See **Exhibit 6.7**.) Except for Japan – which uses the subtraction method – all other major industrialized countries have a credit-invoice VAT. Although the Canadian government proposed a subtraction-method VAT in the 1980s, it ultimately adopted a credit-invoice VAT in 1991.

Despite widespread acceptance throughout the rest of the industrialized world, the credit-invoice method has not played a prominent part in the current consumption tax debate in the United States because of concerns about high compliance costs and a perceived similarity to sales taxation.[82] Instead, a somewhat similar alternative – the subtraction-method VAT – lies at the core of most value-added tax proposals discussed in the United States. (See Chapter 7.)

Exhibit 6.7
2003 Value-Added Taxes in Top 20 Countries in the OECD

Rank By Size of Economy	Country	Value-Added Tax?	Standard Value-Added Tax Rate
1	United States	No	-
2	Japan	Yes	5.0
3	Germany	Yes	16.0
4	United Kingdom	Yes	17.5
5	France	Yes	19.6
6	Italy	Yes	20.0
7	Canada	Yes	7.0
8	Spain	Yes	16.0
9	Korea	Yes	10.0
10	Mexico	Yes	15.0
11	Australia	Yes	10.0
12	Netherlands	Yes	19.0
13	Switzerland	Yes	7.6
14	Belgium	Yes	21.0
15	Sweden	Yes	25.0
16	Austria	Yes	20.0
17	Norway	Yes	24.0
18	Denmark	Yes	25.0
19	Turkey	Yes	18.0
20	Poland	Yes	22.0

Source: Organization for Economic Cooperation and Development. Available on-line at (http://www.oecd.org/topic/0,2686,en_2649_37427_1_1_1_1_37427,00.html.

[82] Adding a credit-invoice VAT while reducing the scope of the income tax was first outlined in 1992. See Treasury Secretary Nicholas Brady, Remarks Before the Columbia University School of Business, *Tax Notes Today*, December 11, 1992 (92 TNT 247-33).) The only current proposal for a credit-invoice value-added tax getting any attention since is a plan, somewhat similar to Brady's plan, by Yale Law School Professor Michael Graetz. See Chapter 4 of this report.

D. PROS AND CONS OF REPLACING THE FEDERAL INCOME TAX WITH A CREDIT-INVOICE METHOD VALUE-ADDED TAX

Pros:

- Credit-invoice VATs are used in all other industrial countries; they are approved by the World Trade Organization; and they serve as a means of encouraging exports and taxing imports.
- Just like other consumption taxes, a credit-invoice VAT removes a bias against savings inherent in the income tax.[83]
- Credit-invoice VATs are efficient mechanisms for collecting tax revenue.
- Compliance with a credit-invoice VAT is audited through cross-checking taxes paid by sellers with credits claimed by buyers; it eliminates the need for retailers to distinguish between sales to business and sales to consumers.
- A credit-invoice VAT could reduce overall compliance costs and burdens by providing the impetus for states to abandon a retail sales tax and implement VATs and adopt a uniform tax base among themselves and the federal government.
- The credit-invoice VAT does not require individuals to file personal tax returns.

Cons:

- Compliance burdens increase if tax rates vary or exemptions are provided.
- As with all consumption taxes, a credit-invoice VAT is viewed as regressive.
- If not separately stated at the cash register, the tax would be hidden to the consumer.
- Credit-invoice VATs increase the government's administration and enforcement burden because an audit of both the seller and buyer is needed to determine the correct tax.
- Replacing the current federal income tax system with a credit-invoice VAT involves significant transition issues.
- Most countries that use a VAT also have an income tax. A VAT is unlikely to become the only source of U.S. federal tax revenue, thus leaving taxpayers subject to the complexities of two tax systems.

[83] If increased saving does occur, increased economic growth and improved trade balance should follow. However, economists are divided over the effect of taxes on savings rates and, therefore, on whether a switch to consumption taxes will lead to significant economic gains.

Chapter 7

The Subtraction-method Value-Added Tax

SUMMARY

- Like the credit-invoice value-added tax (VAT), the subtraction-method VAT taxes the difference between a business's gross receipts and its purchases from other businesses; however, it modifies the tax base using deductions rather than credits.

- The subtraction-method VAT reduces the recordkeeping burden because taxes paid by purchasers can be calculated without reference to taxes paid by sellers.

- A subtraction-method VAT is less able to accommodate tax relief for particular products and business sectors than a credit-invoice VAT; applying exemptions at the intermediate seller level distorts consumer choices and can reduce the overall amount of tax collected.

- Unlike a credit-invoice VAT, a subtraction-method VAT does not look like a sales tax. Rather, it looks like a corporate income tax, but with fewer deductions.

A. INTRODUCTION

The subtraction-method value-added tax (VAT) has a great deal in common with the credit-invoice method VAT. The tax base is the difference between a business's gross receipts and its purchases from other businesses. However, instead of credits, the subtraction method uses deductions to modify a tax on gross receipts to a value-added tax. Using the same tax rate, the subtraction and credit-invoice method VATs would collect the same amount of tax. (See **Exhibit 7.1**, based on **Exhibit 6.2**.)

Exhibit 7.1

Comparison of Subtraction and Credit-Invoice Method VATs

10 percent Subtraction-method VAT		**10 percent Credit-Invoice VAT**	
Link #1: Farmer			
Sales	20	Sales	20
Purchased Inputs	0	Gross Tax	2
Value Added	20	Invoice Credits	0
VAT	2	VAT	2
Link #2: Miller			
Sales	50	Sales	50
Purchased Inputs	20	Gross Tax	5
Value Added	30	Invoice Credits	2
VAT	3	VAT	3
Link #3 Baker:			
Sales	100	Sales	100
Purchased Inputs	50	Gross Tax	10
Value Added	50	Invoice Credits	5
VAT	5	VAT	5
Total VAT	**10**	**Total VAT**	**10**

Under the subtraction method, gross receipts do not include financial income or other proceeds from sale of financial assets. Export sales are also excluded. Capital expenditures are written off when purchased. Inputs purchased from other businesses are deductible, even if they accumulate in inventory, but wages paid to employees and interest payments are not deductible.

See **Exhibit 7.2** for a simple comparison of the corporate income tax and the subtraction-method VAT.

Exhibit 7.2

Comparison of Corporate Income Tax and a Subtraction-method VAT

	Income Tax	VAT
Business Receipts – Domestic	90	90
Business Receipts – Exports	10	-
Interest Income	5	-
Total Gross Receipts	105	90
Business Purchases (Other than capital)	35	35
Wages	45	-
Interest Expense	10	-
Depreciation	10	-
Capital Spending	-	15
Total Deductions	100	50
Tax Base	**5**	**40**

The economic impacts of subtraction and credit-invoice method VATs do not differ significantly. Both tax consumption and, as such, have the same ability to increase capital formation and improve competitiveness. Both have the same potential impact on the distribution of the tax burden.

However, the credit-invoice and subtraction methods differ in three important areas: (1) compliance and administrative costs; (2) flexibility; and (3) perceived similarity to a corporate income tax.

B. ADMINISTRATION AND COMPLIANCE

Under the subtraction method, taxes paid by purchasers can be calculated without reference to taxes paid by sellers. Proponents argue that this reduces the compliance burden in two ways. First, sellers are not required to provide tax information on, or retain records of, invoices for business customers. Second, businesses buying products do not have to retain tax records on each purchase to claim credits.

Instead, businesses could calculate their tax liabilities using annual accounting flows similar to current financial and tax accounting rules. Although detailed records of each transaction are not required, some modifications to traditional accounting records would be necessary. For example, cost categories (such as cost of goods sold and advertising) would be divided between non-deductible internal costs and deductible purchases from other businesses. However, capital expenses and inventory would be deductible in the year of purchase, instead of being tracked and deducted over many years.

After implementation, a subtraction-method VAT appears to result in lower compliance costs for businesses than a credit-invoice VAT. This simplification may come at the cost of increased potential for evasion. Compliance with a subtraction-method VAT is likely to be lower than with a credit-invoice VAT because cross-checking business tax returns is more difficult under the subtraction method. Under a credit-invoice VAT, unreported sales can be more easily identified using the duplicate invoice records held by both sellers and business purchasers. Tax evasion by retailers failing to report sales to consumers would remain a problem under the subtraction method.

C. FLEXIBILITY

A credit-invoice VAT is better able to accommodate tax relief for particular products and business sectors than a subtraction method.[84] Some consider this lack of flexibility an advantage of the subtraction method because an absence of preferential treatment would reduce complexity and improve economic efficiency. On the other hand, this inflexibility is seen as a disadvantage where special relief is desirable or inevitable (e.g., farmers, health care providers, state and local governments, charitable and cultural organizations).

Like a retail sales tax or credit-invoice VAT, preferential treatment of products under a subtraction-method VAT can be effected by excluding those products from the tax base or imposing a preferential rate at the retail level. The critical difference between the subtraction and credit-invoice methods is if preferential treatment is introduced *before* the retail level. As shown in **Exhibit 6.6**, under a credit-invoice VAT sales by a zero-rated taxpayer escape tax and generate rebates for that taxpayer, but the overall tax on the final product is unchanged. As a result, the credit-invoice VAT does not distort consumer choice nor is it likely to confer any large benefits on the zero-rated business.

In contrast, preferential treatment of non-retail sales under a subtraction-method VAT results in uneven taxation of final products. If non-retail sales are exempt or subject to preferential rates, the seller's value added is not taxed. However, the lost tax revenue is not collected at a later point in the production chain. Thus, exemption at the intermediate level does result in lower tax paid on the final product. See Example 1 of **Exhibit 7.3** where the intermediate producer – the miller – is exempt.

However, if non-retail sales get preferential treatment under a subtraction method *and* final sales are excluded (e.g., exports, food), the final sales do better than being exempt or zero-rated –

[84] See, Congressional Budget Office (1992), McLure (1987), and U.S. Treasury (1984).

these sales are subsidized by a rebate for taxes not paid at prior levels. See Example 2 of **Exhibit 7.3**.

Exhibit 7.3

Distortions from Exempting Intermediary Sales Under the Subtraction Method

	Example 1: Final Product Fully Taxable	**Example 2: Final Product Exempt from Tax**
Farmer--TAXABLE		
Receipts	20	20
Purchases	0	0
Value Added	20	20
VAT	**2**	**2**
Miller--EXEMPT		
Receipts	50	50
Purchases	20	20
Value Added	30	30
VAT	**0**	**0**
Baker – TAXABLE		
Receipts	100	0
Purchases	50	50
Value Added	50	-50
VAT (or Refund)	**5**	**-5**
Total Value-Added Tax (or Refund)	**7**	**-3**
Note: VAT Using Credit-Invoice Method	10	0

There are three responses to the problem of exemption of intermediate product sales under a subtraction-method VAT. One is not allowing exemptions or preferential rates before the retail level. This restriction would not hinder implementing policies intended to promote trade (e.g., exempting exports) or to provide relief for low-income households (e.g., exempting food and medical care). However, small businesses and farmers would have no relief from a potentially disproportionate compliance burden.

The second response would be to disallow deductions for business purchases on which no tax was paid. Sellers must then report the amount of tax paid to buyers and both buyers and sellers would keep records of all transactions. The result would impose record keeping similar to that of a credit-invoice VAT.

Finally, if the tax difference is fairly small, the problem can be ignored and exemptions prior to the retail level allowed.

D. PERCEIVED SIMILARITY TO A CORPORATE INCOME TAX

One of the attractions of a subtraction-method VAT over a credit-invoice VAT is that it does not look like a sales tax, but it *does* look like a corporate income tax.

From the consumer's point of view, a retail sales tax and a credit-invoice VAT are indistinguishable. Both are collected at the cash register and stated separately from the prices of goods. Retail sales taxes are widely perceived as regressive.

Invisible to consumers, the subtraction-method VAT imposes tax liabilities on large businesses, like the corporate income tax. Indeed some proposals would use the revenues from a subtraction-method VAT to replace the corporate income tax. Consumers generally have few problems with taxing corporations. State governments may also be more willing to accept a subtraction-method VAT that does not visibly compete with their retail sales tax base over a credit-invoice VAT that does.

However, in the case of international trade, an "indirect" sales tax that can be rebated on exports is preferable to a "direct" corporate or individual income tax that cannot be rebated under the General Agreements on Tariffs and Trade (GATT).[85] There is also controversy over the likely treatment of a subtraction-method VAT under GATT.[86]

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85 See http://www.wto.org/english/tratop_e/gatt_e/gatt_e.htm.

86 GATT permits border adjustability – rebates on exports and taxation of imports – on indirect taxes. Income taxes are direct taxes and not border-adjustable under the GATT. Indirect taxes are imposed on products, such as a sales tax or credit-invoice VAT. Whether a subtraction method VAT would be treated similarly is unclear. See Joint Committee on Taxation (1991), *Factors Affecting the International Competitiveness of the United States*, (JCS-6-91), May 30, p. 304: "there is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT." [Available through http://www.house.gov/jct/pubs91.html.] But see, Gary Clyde Hufbauer and Paul L. E. Grieco (2005). *The Corporate Activity Tax (CAT): A Comprehensive Reform for US Business Taxation*, submitted to the President's Advisory Panel on Federal Tax Reform, April 21. Institute for International Economics, p. 7 (a subtraction method tax would be border-adjustable, unlike the corporate income tax). [Available at http://comments.taxreformpanel.gov/index.cfm?FuseAction=Home.View&Topic_id=3&FellowType_id=4.]

E. SUBTRACTION-METHOD VAT PROPOSALS

1. Gibbons Proposal

In 1996, former Congressman Sam Gibbons, then Ranking Member on the House Ways and Means Committee, introduced legislation to replace the individual and corporation income taxes and payroll taxes with a 20-percent, single-rate subtraction-method value-added tax.[87] A "burden adjustment" for taxpayers with incomes below $30,000 and above $75,000 was included to maintain distributional neutrality. Low-income taxpayers would receive a rebate (phased-out proportionally as incomes increase from zero to $30,000). A 17-percent tax rate would apply to any amounts of adjusted gross incomes in excess of $75,000.[88]

2. English-Nunn-Domenici USA Tax

The subtraction-method VAT proposal that has received the most attention is the business portion of the two-pronged approach to consumption taxation generally referred to as the "USA Tax:"[89] (1) a personal consumption tax would replace the individual income tax;[90] and (2) a subtraction-method VAT imposed on *all* businesses would replace the corporation tax.

The business component would be an 11-percent subtraction-method VAT, with some modifications from what would be considered a "pure" VAT: (1) deductions for state and local taxes; (2) a credit against the VAT for the employer portion of payroll taxes; and (3) although all new capital expenditures are expensed, existing capital would be depreciated under a more accelerated schedule than allowed under current law.

The most current version of the Nunn-Domenici proposal is the *Simplified USA Tax Act of 2003*, introduced by Ways and Means Committee Member Phil English, R-Pa.[91] Under the English plan, businesses would not pay a single flat rate, but would pay an 8-percent tax on their first $150,000 of value added and 12 percent on amounts above that.

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87 H.R. 4050, 104th Congress.

88 Although Gibbons attempted to simplify the "burden adjustment," his proposal was, in effect, a full-fledged income tax. The side-by-side operation of a VAT and an income tax means that the Gibbons plan had a great deal in common with the Graetz plan (see Chapter 4 of this report).

89 Originally proposed by former Senator Sam Nunn and Senator Pete Domenici, R-N.M., in 1995 (*USA Tax Act of 1995*, S. 722, 104th Congress). USA refers to "Unlimited Savings Allowance."

90 See Chapter 9 of this report for a discussion of the personal consumption tax component.

91 H.R. 269, 109th Congress.

F. PROS AND CONS OF REPLACING THE FEDERAL INCOME TAX WITH A SUBTRACTION-METHOD VAT

Pros:

- A subtraction-method VAT would look like the current corporate income tax system.
- The subtraction-method is simpler than the credit-invoice VAT since businesses can rely largely on existing books and accounts.
- Tax administration would be easier and more similar to current systems.
- Compliance burdens placed on businesses are similar to those imposed by the current tax system.
- Just like other consumption taxes, a subtraction-method VAT removes a bias against savings inherent in the income tax.[92]
- State governments might prefer that the federal government use a subtraction-method VAT that would not interfere with state-level retail sales taxes.

Cons:

- Subtraction-method VATs are not used internationally so there is little “real life” experience on which to rely.
- There is concern about whether a subtraction-method VAT would be border adjustable.
- As with all consumption taxes, a subtraction-method VAT is viewed as regressive.
- A subtraction-method VAT is not transparent, so the incidence of tax is hidden.
- Replacing the current federal income tax system with a subtraction-method VAT involves significant transition issues.

[92] If increased saving does occur, increased economic growth and improved trade balance should follow. However, economists are divided over the effect of taxes on savings rates and, therefore, on whether a switch to consumption taxes will lead to significant economic gains.

Chapter 8

The Flat Tax

SUMMARY

- In this report, a "flat tax" refers to a single-rate consumption tax collected from both individuals and businesses.
- A flat tax would tax individuals' wages, but not interest, dividends or capital gains; businesses would be taxed on gross receipts less materials, wages and capital expenditures.
- Most flat taxes would reduce complexity for individuals by eliminating dozens of targeted income tax provisions – including deductions for mortgage interest, state and local taxes, and charitable contributions – and substituting much larger standard deductions.
- The business flat tax typically would be imposed on *all* corporate and non-corporate businesses, including "flow-through" entities such as sole proprietorships, partnerships, and S corporations not currently subject to an entity level tax.
- Taxpayer perceptions may impede implementing a flat tax that distinguishes between the tax treatment of net wages (taxable) and investment income (exempt).

A. INTRODUCTION

A "flat tax" can describe either an income tax or a consumption tax that is imposed at a single rate for all taxpayers. In the 1980s, former Senator Bill Bradley proposed a flat income tax.[93] In the 1990s, former presidential candidate Steve Forbes[94] and former Congressman Richard Armey[95] proposed flat consumption taxes.

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93 Bill Bradley, *The Fair Tax* (New York: Pocket Books, 1984).

94 Steve Forbes; *A New Birth of Freedom: A Vision for America* (Regnery, 1999).

95 *The Freedom and Fairness Restoration Act of 1994*, H.R. 4585, 103rd Congress. . The Armey proposal is a direct descendent of a flat tax proposed by two Hoover Institution scholars, Robert Hall and Alvin Rabushka, in their 1983 book, *Low Tax, Simple Tax, Flat Tax*. The Hall-Rabushka proposal can be found in The Flat Tax, a 56-page special supplement to the August 4, 1995, edition of *Tax Notes*. See also http://www-hoover.stanford.edu/publications/books/flattax.html.

In this report, "flat tax" refers to a single rate *consumption* tax collected from both individuals and businesses. However, the term "flat tax" may not be the best description of proposals bearing that label. Many include a second, zero-rate bracket for low-income households and exempt all income from capital.

The flat tax example examined in this chapter was proposed by former Senator Richard Shelby, R-Ala., and Congressman Nick Smith, R-Mich., in 2003.[96] A descendant of the Armey flat tax proposal, Shelby-Smith is a type of value-added tax collected from both businesses and individuals. (Other value-added taxes are collected only from businesses.) This proposal would eliminate the individual and corporate income tax systems, retain current payroll taxes, repeal estate and gift taxes, and replace them with a consumption tax system unlike any other consumption tax in use. If enacted as currently conceived, Shelby-Smith would reduce complexity by eliminating dozens of targeted income tax preferences.

The Shelby-Smith flat tax has two components. Individuals would be taxed on the value added by labor through a wage tax. All other value-added tax would be collected from businesses using a subtraction-method VAT modified to allow deductions for wages.

B. THE INDIVIDUAL FLAT TAX

Under this flat tax, individuals would pay a wage tax at a flat rate of 17 percent, after an initial tax rate of 19 percent for the first two years after implementation. The wage base would be broadened to include pension benefits, but would continue to exclude income earned abroad and employer-paid fringe benefits.[97] Life insurance proceeds and capital income – interest, dividends, capital gains, etc. – would not be taxed, with the result that individuals whose primary income is from investments would owe little or no tax.[98] Large standard deductions and additional large deductions for dependents (see **Exhibit 8.1)** would remove tens of millions of low- and middle-income wage-earners from the tax rolls, but not necessarily from filing obligations.[99]

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[96] *The Tax Simplification Act of 2003,* S.1040 and H.R. 3060, 108th Congress (Rep. Smith has since retired). A more current version is *The Freedom Flat Tax Act*, H.R. 1040, 109th Congress, introduced by Rep. Michael Burgess, R-Tex.

[97] However, employers could not deduct the cost of fringe benefits.

[98] As under current law, "inside build-up" of life insurance policies would also be tax exempt.

[99] Senator Arlen Specter, R-Pa., also introduced similar flat tax legislation (*The Flat Tax Act of 2003,* S. 907, 108th Congress). The Specter plan has a higher rate – 20 percent – and a lower standard deduction – $10,000 for single taxpayers; $17,500 for married filing jointly; and an additional deduction of $5,000 for each dependent. The Specter plan would allow deductions for up to $2,500 annually for charitable contributions and for mortgage interest paid on up to $100,000 of acquisition indebtedness.

Exhibit 8.1

Standard Deduction Under the Shelby-Smith Flat Tax
(2003, indexed for inflation)

Types of Deduction	Amount
Standard Deduction	
Married Filing Jointly	$25,580
Head of Household	$16,330
Individual	$12,790
Married Filing Separately	$12,790
Additional Deduction Per Dependent	$5,510

Every itemized deduction and tax credit allowed under current law would be repealed, including deductions for mortgage interest, state and local taxes, charitable contributions, and the earned income tax credit. See **Exhibit 8.2**.

Exhibit 8.2

Special Tax Provisions Repealed Under the Shelby-Smith Flat Tax

- Deduction for Mortgage Interest
- Deduction for Property Taxes
- Deduction for State and Local Taxes
- Deduction for Charitable Contributions
- Credit for Child Care and Dependent Expenses
- Earned Income Tax Credit
- Tax Credit for the Elderly and Disabled
- Additional Standard Deduction for Blind and Elderly
- Deduction for Casualty and Theft Losses
- Exclusion of Employee Awards
- Exclusion of Scholarship and Fellowship Income

The basic operation of the individual flat tax is illustrated in **Exhibit 8.3**. For many taxpayers, filing under Shelby-Smith, as proposed, would be significantly simpler than under current law.

Exhibit 8.3

Example of Application of Shelby- Smith Flat Tax on a Family of Four

Wages		$70,000
Standard Deduction	$25,580	
Dependent Deductions	$11,020	
Total Deductions	$36,600	
Tax Base		$33,400
Tax (17 percent)		$5,678

Note however that the payroll tax imposed on this family would increase their effective tax rate on earnings significantly.

Complexity is reduced primarily by eliminating exceptions to general tax rules. Rules exempting certain types of capital income cease to be relevant because all capital income is exempt from tax. However, state and local governments would no longer enjoy any competitive advantage in capital markets because all bonds would produce tax-exempt interest and investing in municipal bonds would no longer offer a tax benefit over investing in corporate bonds. Likewise, life insurance companies would no longer have a tax advantage over their bank and mutual fund competitors because all investments would be tax exempt. **Exhibit 8.4** lists examples of tax preferences that would become obsolete under the flat tax.

Exhibit 8.4

Current Individual Tax Preferences Made Obsolete by Exempting All Capital Income

- Exclusion of Investment Income from Life Insurance and Annuity Contracts
- Exclusion of Investment Income from Structured Settlement Accounts
- Exclusion of Gain on Home Sales
- Exclusion of Interest on State and Local Bonds
- Preferential Tax Rate on Capital Gains and Dividends
- Exclusion of Capital Gains at Death
- Deferral of Interest on Savings Bonds

C. THE BUSINESS FLAT TAX

The business flat tax would be imposed on all corporate and non-corporate businesses at the entity level, including "flow-through" entities such as sole proprietorships, partnerships, and S corporations not currently subject to an entity level tax. The tax base – or "gross active income" – takes gross business receipts and deducts only (1) material inputs; (2) wages and compensation paid, including pension contributions but excluding other fringe benefits; and (3) investment in capital. The basic operation of the business flat tax is illustrated in **Exhibit 8.5**.

Exhibit 8.5

Basic Operation of the Business Flat Tax

Gross Receipts		$100,000
Less		
Materials Costs	$20,000	
Capital Expenditures	$20,000	
Employee Compensation	$30,000	
Total Costs	$70,000	
Tax Base		$30,000
Tax (17 percent)		$5,100

Many current tax preferences would become obsolete. See **Exhibit 8.6**. For example, deferral of tax on income generated by businesses operating abroad is no longer an advantage because the business tax is a territorial tax excluding all foreign source income. Similarly, generous depreciation provisions available under current law no longer provide a tax advantage because all capital expenditures are expensed.[100]

[100] Transition relief allowing for depreciation on capital in place before the date of enactment seems likely.

Exhibit 8.6

Current Business Tax Preferences Made Obsolete Under the Shelby-Smith Flat Tax

- Research Tax Credit
- Energy Tax Credits
- Rehabilitation Tax Credit
- Low-Income Housing Credit
- Tax Credit for Orphan Drug Research
- Targeted Jobs Tax Credit
- Deferral of Foreign Controlled Corporation Income
- Expensing of Exploration and Development Costs
- MACRS
- Section 179 Expensing
- Expensing of Magazine Circulation Expenses

D. EQUIVALENCE OF THE FLAT TAX TO A SUBTRACTION-METHOD VAT

One way of gaining insight into the operation of the flat tax is to view the business and individual taxes as a single tax collected from two sources. When combined, the two tax bases approximate a consumption tax base. In fact, if the individual tax did not allow standard deductions, the flat tax base would exactly replicate the tax base of a subtraction-method value-added tax. See **Exhibit 8.7**:

Exhibit 8.7

Comparison of a Subtraction-Method VAT and a Flat Tax

Subtraction-Method VAT			**Flat Tax**		
Business Tax			***Business Tax***		
Gross Receipts		100	Gross Receipts		100
Less			*Less*		
Materials Cost	20		Materials Cost	20	
Capital Expenditure	10		Capital Expenditure	10	
			Employee Compensation	40	
Total Costs	30		Total Costs	70	
Equals - Tax Base		70	*Equals* - Tax Base		30
17-Percent Tax		11.90	17-Percent Tax		5.10
Individual Tax			***Individual Tax***		
--None--			Employee Compensation		40
			Less		
			Standard Deductions		15
			Equals- Tax Base		25
17-Percent Tax		0.00	17-Percent Tax *with* standard deduction		4.25
			17-Percent Tax *without* standard deduction		6.80
			TOTAL TAX ***with standard deduction***		**9.35**
TOTAL TAX		**11.90**	**TOTAL TAX** ***without standard deduction***		**11.90**

Under a subtraction-method VAT, all tax is collected from businesses. Deductions are allowed for materials and capital expenditures but not for employee compensation. The flat tax allows business to deduct employee compensation, and then imposes taxes on employees directly, including payroll taxes. The purpose of this structure is to reduce the regressivity of a consumption tax by exempting wages, pension and unemployment compensation to individuals.

E. ISSUES FOR POLICYMAKERS

A flat tax is substantially equivalent to a subtraction-method value-added tax, and therefore has many economic effects equivalent to a broad-based consumption tax. For example, by eliminating the corporate income tax, the proposal generally eliminates bias against capital formation in the corporate sector. By not taxing income from capital, any general bias against capital formation is eliminated.

As with most consumption taxes, regressivity is a major impediment to implementing any flat tax. Businesses, in general, will pass on consumption taxes in the form of higher prices to customers or slower wage growth for employees. Thus, a consumption tax will have a greater impact on low-income households, who must spend a larger proportion of their incomes than do high-income households. However, a flat tax can mitigate regressivity by taxing wages at the employee's level rather than at the employer's and applying large, family exemptions.

Taxpayer perceptions may impede the implementation of a flat tax. For example, Family A has wages less the standard and dependent deductions of $100,000 and pays tax of $17,000. Family B has investment income of $100,000 pays no tax and does not need to file a tax return. Even though Family B pays some taxes indirectly, the public may not appreciate the distinction.

Finally, removing substantial numbers of low-income wage-earners and a significant portion of individuals with large amounts of investment income will narrow the tax base, thereby requiring a higher tax rate to achieve the same revenue goals.

F. PROSPECTS FOR SIMPLIFICATION

The primary attraction of this flat tax is its simplicity relative to current law. By eliminating (1) the corporate income tax; (2) the alternative minimum tax; (3) documentation requirements for depreciation, inventory, interest expense, charitable contributions, and state and local taxes; and (4) taxation of overseas earnings interest, dividends, and capital gains, arguably many individuals and businesses could file fairly simple tax returns.

However, a truly simple flat tax is unlikely to be implemented. Deductions slated for repeal represent significant economic interests, institutions and values. Both individuals and businesses have made long-term capital allocation decisions based on current and prior income tax incentives. Many current law issues would remain problematic under a flat tax, such as the lack of a bright line between business expenses and personal consumption for self-employed individuals.

Comparing an idealized and as-yet-unimplemented tax system to the current system can be misleading. The complexities of the Internal Revenue Code have arisen over the course of almost 90 years in response to changing public policy goals and revenue demands. Assuming that similar adjustments will not befall an otherwise simpler flat tax would be naïve and imprudent.

G. THE PROS AND CONS OF REPLACING THE FEDERAL INCOME TAX WITH A FLAT TAX

Pros:

- A flat tax is relatively simple and could ease compliance burdens for many taxpayers.
- Flat tax administrative systems are familiar to taxpayers.
- A flat tax generally eliminates bias against capital formation.[101]
- A flat tax would reduce recordkeeping burdens for individuals and businesses.
- A flat tax would pose less obvious conflict with the states than other consumption taxes.
- A flat rate eliminates the marriage penalty.

Cons:

- A flat tax may not be border adjustable, raising the same issues under the GATT as a subtraction-method VAT.
- Flat taxes raise significant progressivity issues in addition to the single–rate versus multiple-rates concern, including the loss of progressivity caused by eliminating deductions and the earned income tax credit.
- A flat tax looks too much like an income tax for individuals, and is likely to result in a high level of expectation that the current set of deductions and credits will remain.
- Because investment income is not taxed, a flat tax is in substance a wage tax for individuals, thus, it may be perceived as inequitable.
- To raise the necessary revenue, the tax rate would need to be higher to offset the narrower tax base.
- Transition rules would likely be needed, particularly for depreciable assets.
- A flat tax would significantly rearrange business incentives and disincentives.
- Issues in determining the tax base will remain.

[101] If increased saving does occur, increased economic growth and improved trade balance should follow. However, economists are divided over the effect of taxes on savings rates.

Chapter 9

The Personal Consumption Tax

SUMMARY

- Under a personal consumption tax, individuals have an unlimited deduction for net annual additions to saving – that is, additions to savings reduced by additional borrowing.
- New saving would be deducted when saved, and subject to tax only when withdrawn and not reinvested, whether the withdrawals were earnings or reduction of principal.
- Proceeds from new loans or other forms of indebtedness would be taxable when incurred, while both interest and principal payments on loans would be deducted when paid.
- A difficulty in moving to a personal consumption tax is whether or how to differentiate between "new saving" – additions to net wealth after enactment of the tax – and "old saving" – an individual's net wealth at enactment.
- Once a personal consumption tax came into effect, all withdrawals from savings would be taxed – even though the invested principal was previously taxed – resulting in large tax penalties for existing savings. However, allowing wholesale deductions for all existing savings would result in an enormous initial revenue loss.
- A personal consumption tax can accommodate progressive rates, exemptions for lower-income households, and deductions for mortgage interest, charitable contributions, etc.

A. INTRODUCTION

Retail sales taxes and value-added taxes are consumption taxes collected by or from businesses, although they are imposed upon individuals. In contrast, a personal consumption tax[102] is imposed directly on and collected from individuals. Under a personal consumption tax, individuals would file annual returns, but would be allowed an unlimited deduction for net

[102] A personal consumption tax is sometimes also referred to as an "individual consumption tax" or the "expenditures tax."

annual additions to saving. Additions to savings for the tax year must be reduced by dissavings in the form of additional borrowing. See **Exhibit 9.1**.

Exhibit 9.1

Calculation of the Personal Consumption Tax[103]

Income		$100
Plus		
New Loan for Automobile Purchase	$15	
Reduction in Mortgage Principal	($10)	
Net New Debt		$5
Less		
Beginning of Year Bank Balance	$40	
End of Year Bank Balance	($50)	
Increase in Saving		($10)
Equals Consumption Tax Base		$95

In this example, a family has $100 of wage and interest income. Because they have taken out a new car loan of $15 and paid off $10 of mortgage principal, their net new debt is $5. This adds $5 to their income available for consumption. The family was also able to increase their bank balance by $10. This is $10 was not used for consumption. After adding and subtracting from loan and savings balances, this family has $95 available for consumption.

A personal consumption tax is probably the most complex type of consumption tax due to the required recordkeeping,[104] but personal consumption taxes remain an attractive option. Because the tax is levied on households, applying a progressive rate structure is fairly straight-forward.[105]

A personal consumption tax appears to offer the best of both worlds – no need to trade equity for economic efficiency. A personal consumption tax can combine the economic benefits of a consumption tax base with the progressivity of the current income tax. However, except for

103 This Exhibit is a basic conceptual example. Specific proposals would define what constitutes income and detail how changes in savings and debt would be calculated, along with the transition relief needed to offset inequitable results. For example, all proceeds from sales of capital assets, not just capital gains, could be included in income, then the portion saved or reinvested would be accounted for in the savings calculation.

104 See, for example, Graetz (1979), Kuttner (1987), and Toder (1995).

105 Retail sales and value-added taxes (levied on businesses) can only alleviate regressivity through adjustments to the tax base and/or refundable credits which are not particularly effective in achieving distributional objectives.

brief temporary appearances in India and Sri Lanka, tax authorities around the world have had no experience with a personal consumption tax.[106]

The primary difficulty of a personal consumption tax is finding a workable method to calculate the deduction for net annual additions to saving. Another issue is whether or how to differentiate between "new saving" – additions to net wealth after enactment of the tax – and "old saving" – an individual's net wealth at enactment.

B. NEW SAVING

Under a personal consumption tax, new saving would be treated like deductible contributions to an IRA, but without limitations on the deductible amount or the timing of withdrawals. Taxpayers would deduct all income saved, including (1) net additions to bank, mutual fund, and brokerage accounts; (2) purchases of stocks, bonds and other financial instruments; and (3) investments in partnerships and proprietorships. When funds are withdrawn from these investments, they would be subject to tax – whether the withdrawals were earnings or reduction of principal.[107]

Conversely, proceeds from new loans or other forms of indebtedness would be taxable, while both interest and principal payments would be deducted. Shifting of the funds from one investment to another without taking anything out for consumption – such as depositing a dividend in a bank account – would have no tax consequences because the dissaving is exactly offset by the saving.

Computing the new deduction for saving would require reporting of the annual changes in each taxpayer's outstanding investment and indebtedness balances. Under a personal consumption tax, investment custodians and debt holders would report balances once a year as they now report interest earned and paid.

C. OLD SAVING

Saving accumulated before enactment raises two issues: compliance and fairness.

Once a personal consumption tax comes into effect, all additions to saving would be deductible and all withdrawals would be taxable. Reinvesting existing assets would neither decrease nor increase net savings and, thus, would have no tax effect. However, a large revenue loss could result if already existing wealth was undetected and the funds deducted when invested in new forms. To prevent evasion under the new system, taxpayers might be required to declare their outstanding cash balances at the outset, but it is unclear how such a requirement would be enforced.

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106 AICPA (1995), Chapter 5, p. 42.

107 The tax basis in new savings is zero – by virtue of deducting the entire value of the initial investment – therefore the entire amount of gain is subject to tax.

Under a personal consumption tax, all proceeds from saving – not just capital gains, dividends, interest and other capital income – are subject to tax, resulting in large tax penalties for already taxed, existing savings.[108] This burden would fall primarily on the elderly who draw down their savings during retirement.

Special transition relief is needed to avoid imposing a double tax burden on the elderly and others who consume old savings. One method would be to treat existing savings like new saving and allow a current deduction for the *basis* of saving existing at the time of enactment.[109] From that point, all proceeds can be taxed when the assets are withdrawn.

However, there are several potential objections to this type of transition relief. First, this wholesale deduction for all existing basis would result in an enormous revenue loss, likely increasing the tax rate needed to make a personal consumption workable.

Second, a significant portion of old saving receives favorable treatment under the income tax – IRAs, pensions, life insurance, annuities, and tax-exempt bonds. These tax-favored savings would not need "double taxation" relief.

Third, including transition relief for old saving does not increase incentives for new saving or simplify the tax system. Accordingly, some advocate moving to a new system without transition relief.

D. TAX RATES UNDER A PERSONAL CONSUMPTION TAX

In general, because total consumption is less than income, a personal consumption tax must use higher rates than an income tax unless the tax base is significantly broadened. Because upper-income families consume proportionately less of their income than lower-income families, more steeply graduated rates would be required to achieve the same degree of progressivity as under an income tax.

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108 Taxing old saving under a personal consumption tax without transition relief is equivalent to the result under a retail sales tax or a value-added tax.

109 Deducting basis is equivalent to selling the asset at enactment and paying income tax on any gain, and then reinvesting and deducting the entire proceeds.

E. PERSONAL CONSUMPTION TAX PROPOSALS

1. The USA Tax

As originally proposed by former Senator Sam Nunn and Senator Pete Domenici, R-N.M.,[110] the *USA Tax Act of 1995* would replace the individual income tax with a personal consumption tax and replace the corporate income tax with a single-rate subtraction-method VAT imposed on all businesses.

Individuals would compute their taxable income following current income tax rules to calculate adjusted gross income and subtract itemized deductions and personal allowances. Then, the USA tax would allow a deduction for additional saving. Individuals would also be permitted to claim itemized deductions *in addition to* the standard deduction. Mortgage interest, education expenses and charitable contributions could be deducted as under current law. However, no deductions would be allowed for state and local taxes. A refundable earned income tax credit would be available. Tax rates would be progressive – ranging from 9 to 40 percent.[111]

The core distinction is the USA Tax's treatment of personal savings: (1) net additions to savings are deductible; (2) net new borrowing is included in income (excluding most mortgage, automobile, and credit card indebtedness); (3) withdrawals from accounts and proceeds from sales are included in income; and (4) transition relief is offered for existing saving by allowing basis deductions for withdrawals of pre-existing assets.

2. The Simplified USA Tax

The most recent version of the Nunn-Domenici proposal is the *Simplified USA Tax* introduced by Ways and Means Committee member Phil English, R-Pa.[112] Individual tax rates are less progressive – ranging from 15 to 30 percent. Businesses would pay tax at 8 percent for the first $150,000 of value added and 12 percent on additional amounts.

The English proposal replaces the USA Tax's somewhat complicated savings deduction with a "USA Roth IRA" which does not allow a deduction for contributions but permits tax-free withdrawals, eliminating many current law restrictions. Despite their name, the accounts could be used for any purpose, not just retirement. In addition, there would be no contribution limits or restrictions based on age or income. All individuals would be eligible to contribute all or any portion of their current year's taxable income.

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110 S. 722, 104th Congress. USA refers to "Unlimited Savings Allowance."

111 The USA tax retained the payroll tax but allowed employees and employers a credit for the payroll taxes they paid; businesses also received a deduction for the taxes paid state and local governments, but individuals did not.

112 H.R. 269, 109th Congress.

F. PROS AND CONS OF REPLACING THE FEDERAL INCOME TAX WITH A PERSONAL CONSUMPTION TAX

Pros:

- A personal consumption tax can include a progressive rate structure to alleviate the regressive nature of consumption taxes, and exempt low income households from taxation.
- Under a personal consumption tax "net new savings" are exempt from tax, thereby encouraging greater savings.[113]
- A personal consumption tax is flexible enough to permit adjustments based on individual circumstances, such as deductions for mortgage interest and charitable donations.
- A personal consumption tax is less likely to lead to a one-time price level increase than are some of the other reform approaches.

Cons:

- A personal consumption tax is complex for individuals, especially the calculation of "net new savings."
- Personal consumption taxes are not used internationally so there is little "real life" experience to rely on.
- A personal consumption tax system is not expected to improve compliance.
- A personal consumption tax would increase the federal government's administrative burden.
- Replacing the current federal income tax system with a personal consumption tax involves significant transition issues.
- Once taxpayers understand a flat tax's complexities, they may perceive it as inequitable.

[113] If increased saving does occur, increased economic growth and improved trade balances should follow. However, economists are divided over the effect of taxes on savings rates and, therefore, on whether a switch to consumption taxes will lead to significant economic gains.

Chapter 10

Special Issues That Must Be Addressed Under Consumption Taxation

SUMMARY

- If a consumption tax were adopted to replace an income tax, transition rules would be required. The complexity and nature of those rules would vary depending on the type of tax system adopted, but all would be significant.
- Enacting a federal consumption tax would raise a number of critical issues with respect to the tax systems of state and local governments.
- The role of the tax system in providing subsidies for the charitable sector of our economy would need to be addressed.
- Special issues would arise regarding international trade, housing, and financial institutions.

A. TRANSITION TO A CONSUMPTION TAX

In the context of income tax legislation, "transition relief" often postpones or otherwise mitigates adverse tax changes. Special rules to facilitate a transition from an income tax to a consumption tax would be needed to prevent retroactive tax increases on existing investments. In their absence, many investments may be subject to unintended tax penalties.

Unfortunately, offering transition relief makes a replacement consumption tax more complex, even if the new tax system will ultimately be simpler than current law. Taxpayers would need to keep records during the transition period relating to both the old and new tax regimes.

Most consumption tax proposals include at least some transition relief. The major downside to offering transition relief is the revenue cost. Most proposals that include transition provisions contain higher tax rates during the transition period.[114]

[114] However, former Ranking Member of the Ways and Means Committee, Sam Gibbons of Florida, suggested offering no transition relief for switching from an income to a consumption tax. Other aspects of his proposal are discussed in Chapter 7 of this report.

This chapter contains summary discussions of the major areas where transition rules would be required. A more detailed treatment of transition issues can be found in the AICPA's 1995 study, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, 1995.[115]

1. Relief for Individuals

One reason to include transition rules is to avoid penalizing taxpayers caught between the old income tax and a new consumption tax. For example, under a personal consumption tax all proceeds from saving are subject to tax, but taxing the entire proceeds – not just capital income, interest, and dividends – would result in large tax penalties on existing savings of after-tax dollars under the income tax system. Thus, immediate application of consumption tax rules would result in harsh treatment of old savings, a burden that would fall primarily on the elderly who draw down their savings during retirement.[116]

For example, to avoid imposing a double tax burden on individuals who draw down their savings to consume, a provision for basis recovery on existing assets would likely be included to assure that only gains, not the entire proceeds from sales of existing capital, would be subject to the personal consumption tax. However, achieving precision in these calculations would be very complicated, given that some existing savings would have received tax-favored treatment under current law.

2. Relief for Businesses

a. Depreciation

If depreciation allowances outstanding when a replacement consumption tax is enacted can no longer be deducted, existing depreciable assets will bear a greater tax burden than under existing law or compared to newly-purchased capital which – due to availability of expensing – would be effectively exempt from tax. Without transition rules allowing continued depreciation of existing assets, businesses investing in assets shortly before the effective date will face a sharp tax increase, while those making the same investment shortly after enactment will be effectively tax exempt.

Many months or even years may transpire between enactment and the effective date of a new replacement consumption tax. In the absence of transition relief, pre-enactment business investment in capital assets would likely slow down significantly, followed by a rapid burst of investment once the new consumption tax regime became effective.

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115 Available at http://www.aicpa.org/taxreform/.

116 Consumption taxes per se would subject *all* consumption to tax regardless of the source of the spending. A personal consumption tax accommodates spending out of existing savings with an explicit, if complex, calculation. Other consumption taxes do not have such a mechanism and relief takes the form of a family size exemption or rebate.

b. Inventories

Most consumption tax proposals would allow inventory and similar capitalized items to be deducted when purchased or produced instead of when used. However, unlike under the income tax, current reductions in inventory values would not be deductible. To avoid penalizing businesses, the balance of inventories and other capital items existing on the date of enactment should be deductible when balances drop below the date-of-enactment levels. Otherwise, businesses will be denied deductions for legitimate costs.

c. Net Operating Loss/Tax Credit Carryforwards

The ability to carry forward net operating losses (NOLs) can be important to a business that expects to be profitable in the future. If NOLs could not be used under a new tax regime, there could be a substantial reduction in a firm's value. Similarly, the inability to apply unused business tax credits against a new business consumption tax could reduce the business's value.

Eliminating these pre-paid tax assets would require writing off that asset for financial statement purposes. The most prominent business credits under existing law are the alternative minimum tax credit, the foreign tax credit, the credit for research expenditures, the alternative fuels credit, and the targeted jobs tax credit.

d. Accrual to Cash Accounting Method

Many consumption tax proposals would effectively place most businesses on the cash method of accounting. Transition rules would again be needed to prevent double taxation. For example, income accrued on a transaction prior to the effective date of the consumption tax that is subsequently determined to be uncollectible might not be allowed as a bad debt deduction because that deduction is inconsistent with the cash method. Transition accounting issues could be quite complicated – for example, changing accounting periods and methods for a large number of existing transactions.

B. A FEDERAL CONSUMPTION TAX AND STATE AND LOCAL GOVERNMENTS

1. Introduction

Replacing the current federal income tax with a federal consumption tax would affect state and local governments when they face fiscal pressures, particularly in the following five areas:

- Infringement on state and local government sales tax bases;
- Loss of the federal deduction for state and local income and property taxes;
- Taxation of government activities;
- Loss of tax-favored status to investors in state and local government debt; and
- Loss of state income tax systems' ability to "piggyback" on the federal income tax calculations.

Any one of these changes could pose a major new burden on state and local governments. A consumption tax that does not provide relief from these problems would face opposition from state and local governments. Replacing the federal income tax system, while state and local governments retain their income and sales tax systems, will leave taxpayers with the cost of complying with multiple, disparate systems. The states would find it difficult to administer their income taxes without information sharing with the IRS.

2. Infringing on the Sales Tax Base

Problems posed for state and local governments by either a retail sales tax or a credit-invoice value-added tax (VAT) include difficulty in raising revenue through state sales tax rate increases in light of the already higher combined federal and state tax rates. For example, there may be less public tolerance for a sales tax increase from five to six percent if the federal government has imposed a new 15-percent – let alone a 25-percent – federal sales tax. Enforcement problems become much more significant when retail tax rates increase to double digits.[117]

State and local governments would also be under pressure to conform to the federal sales tax rules, thus simplifying taxpayer compliance. This would greatly reduce the ability of states and localities to achieve policy objectives by adjusting their sales tax bases. Even with total conformity in the underlying bases for imposing the tax, some further coordination would be needed. For example, a decision must be made about whether a federal sales tax should be calculated based on the retail price with or without including the state and local taxes.

Most of these problems disappear under a subtraction-method VAT or a personal consumption tax, unless the taxpaying public perceives them as a federal sales tax. Although most economists consider all consumption taxes to be largely equivalent, the public may perceive differences among the options.

3. Losing the Federal Income Tax Deduction for State and Local Income and Property Taxes

In 2002, individuals deducted $302.7 billion in state and local income and property taxes on their federal returns.[118] If the average marginal federal income tax rate is 30 percent, this deduction represents a $90 billion annual taxpayer benefit. Individuals would not be able to deduct these taxes under a retail sales tax or either type of VAT. However, state and local taxes can be made deductible under a personal consumption tax or a flat tax.

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[117] See Peter S. Spiro, Estimating the Underground Economy: A Critical Evaluation of the Monetary Approach, *Canadian Tax Journal* 42 (1994): pp. 1059-81; and Vito Tanzi, The Underground Economy in the United States: Annual Estimates, 1930-80, International Monetary Fund Staff Paper no. 30, June 1983, pp. 283-305.

[118] Michael Parisi and Scott Hollenbeck, Individual Income Tax Returns, 2002, *SOI Bull*etin, Fall 2004, available on-line at http://www.irs.gov/pub/irs-soi/02indtr.pdf.

4. Taxing Government Activities

In theory, goods and services provided by governments should be subject to a retail sales tax or a VAT at the same rates as those applied to the private sector. In practice, however, government goods and services are almost always excluded from tax, giving governments a competitive advantage.

Under a credit-invoice VAT, providing government with relief raises the issue of whether government should be (1) exempt from tax or (2) "zero-rated." As noted in **Exhibits 6.5 and 6.6**, these two approaches have different effects, and zero-rating is likely to provide more complete relief.[119]

A personal consumption tax effectively taxes all government services; however, relief is provided to the extent state and local services are financed by income and property taxes that are deductible under the tax regime. A flat tax is partially effective in taxing governments because wages are subject to tax under the individual component of the flat tax; and – because government is extremely labor-intensive – wages are a relatively accurate measure of value added in the government sector.

5. Eliminating the Advantage of Tax-Exempt State and Local Debt

Under a retail sales tax, value-added tax, and a flat tax, all interest income would be exempt from tax. Thus, state and local governments and investors in their securities would not lose the tax-exempt status of interest on state and local indebtedness; but removing current restrictions on issuing those securities would result in the loss of their current competitive advantage over other bonds. Because all investment interest would be equally tax-exempt, state and local governments would lose their ability to issue securities offering yields approximately 35 percent lower than comparable currently taxable securities, thereby removing the competitive advantage governments currently enjoy over various private offerings. The extent to which this may affect state and local government depends on how much overall interest rates decline as a result of a new tax regime. Interest rates are likely to decline, but not to the levels currently available to state and local governments as the only source of tax-exempt securities.

The impact of a personal consumption tax is more problematic. Under general principles of personal consumption taxation, all interest income would be subject to tax, but purchases of new securities – if they represented new saving – would be deductible. (In contrast, all interest income is exempt under a flat tax, but purchases of securities are not deductible.) Without special transition rules retaining a tax exemption for the interest income they generate, previously issued bonds (now subject to tax) would decline in value.

[119] For further discussion of this issue, see AICPA (1995), Chapter 3 and p. 203, available at http://www.aicpa.org/taxreform/.

6. Losing the Relationship Between Federal and State Income Taxes

Most states that collect income taxes rely heavily on the federal income tax to determine taxable income for state purposes and to benefit from federal enforcement efforts. Eliminating federal income taxation would increase the complexity and administrative cost of state income taxation, and likely increase pressure on states to reduce or reform their income taxes. States that conform their state income tax to a new federal consumption tax, while maintaining a state sales tax, will increase the regressivity of their total tax system. States that fail to conform to federal tax changes and retain their income tax systems will, under some consumption tax proposals, leave their citizens in the unhappy situation of preparing their federal tax returns on a consumption tax base, then computing their state tax using an income tax base.

7. Conclusions About State and Local Government Impacts

A federal consumption tax would create real challenges for state and local governments. Although there are ways to design the tax in a manner that would mitigate some concerns, others would persist. These remaining concerns could present a major impediment to enacting a consumption tax.

C. A FEDERAL CONSUMPTION TAX AND CHARITABLE ORGANIZATIONS

1. Eliminating the Charitable Contribution Deduction

Eliminating the charitable contribution deduction could have a profound impact on the charitable sector.[120] In 2002, individuals deducted approximately $140.6 billion in charitable contributions, representing tax incentives of approximately $42 billion annually.[121] Eliminating this incentive could be particularly burdensome when it appears likely that future government spending for charitable purposes will be reduced, increasing the demand for private funding sources.

Although charitable contributions might not change as a result of this loss of tax benefits, the charitable sector's recent experience is that changes in the tax rates and in the alternative minimum tax treatment of appreciated property had a significant impact on the timing and amounts of charitable giving.[122]

As with state and local taxes, a replacement retail sales tax or VAT would entirely eliminate the charitable deduction for individuals. However, the deduction could be made available under the individual component of a flat tax or personal consumption tax.

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[120] Joint Committee on Taxation, *Description and Analysis of Present Law and Proposals to Expand Federal Tax Incentives for Charitable Giving*, 2001, pp. 12-18, available at http://www.house.gov/jct/x-13-01.pdf; and Eugene Steuerle, Charitable Giving In 1993, *Tax Notes* .93 TNT 182-105, available at http://www.taxanalysts.com/www/econpers.nsf/0/319c98dba5bf8df7852566db0063da9c?OpenDocument.

[121] Parisi and Hollenbeck (2004). Individual Income Tax Returns, 2002, *Statistics of Income Bulletin*, Fall, p. 12. Available at http://www.irs.gov/pub/irs-soi/02indtr.pdf.

[122] JCT (2001), p. 12-18. Available at http://www.house.gov/jct/x-13-01.pdf.

2. Taxing Charitable Organization Activities

Business activities of charitable organizations that are unrelated to their exempt purpose are currently subject to unrelated business income tax (UBIT), and would almost certainly continue to be subject to tax under any consumption tax imposed on businesses. The question then becomes whether activities related to charitable purposes (educational services provided by universities, medical services provided by hospitals, etc.) would be included in the new consumption tax base or exempt under zero rating or an exemption system.

3. Eliminating the Advantage of Tax-Exempt Debt for Charitable Organizations

Many charitable organizations, like hospitals and universities, have been able to issue tax-exempt securities. As noted in the discussion about state and local government debt, a new consumption tax may result in new burdens for entities currently issuing – and investors currently holding – tax-exempt debt.

4. Conclusions About Charitable Organization Impacts

Like state and local governments, currently tax-exempt organizations could be severely affected by the imposition of a federal consumption tax. Putting charitable organization services into the "taxable" column could impose a particularly onerous burden in combination with reduced direct government support to these institutions.

D. INTERNATIONAL TRADE UNDER A CONSUMPTION TAX

A major issue in consumption taxation is whether the tax should be levied on domestic *production* or domestic *consumption*. If taxed on production, exports would be taxed and imports would be exempt (called the "origin principle"). If taxed on consumption, exports would be exempt and imports would be taxed (the "destination principle"). In practice, most consumption taxes are imposed only on domestic consumption under the destination principle.

1. Border Tax Adjustments

Applying the destination principle is relatively easy for some consumption taxes. Under a retail sales tax or a personal consumption tax, the taxation of purely domestic sales follows naturally from the mechanical application of the tax. Under value-added taxes, however, special rules – called border tax adjustments – must be implemented for both domestic production sold abroad (exports) and for foreign production sold domestically (imports). Businesses would exclude export sales from gross receipts, and duties would be imposed on imports at the border.

Border tax adjustments, in and of themselves, do not have significant impacts on trade, but are necessary to maintain a level playing field – rather than give an advantage – in international trade. Imposing import duties maintains economic neutrality in domestic markets by subjecting all goods – whether produced domestically or abroad – to the same tax. Neutrality is maintained in foreign markets where domestically tax-exempt exports are subject to the same tax as goods produced in the foreign markets.

2. Savings and Trade

Although border tax adjustments do not favor or penalize trade, consumption taxes may have a positive impact on the trade balance if consumption taxes increase overall savings – either by reducing income taxes and increasing private saving, or reducing the federal deficit and increasing public saving. To the extent that a consumption tax increases saving, there may be a positive effect on the trade balance, given the link between domestic saving and the value of the dollar, and, in turn, between the value of the dollar and the trade balance. If domestic saving increases, less foreign capital is needed to finance domestic investment. Reduced capital inflows into the United States also reduce foreign investors' need for U.S. currency. Reducing the demand for dollars causes the dollar's price to drop.

This decline in value – or depreciation – of the dollar is beneficial to U.S. trade. A depreciation of the dollar means that foreigners wishing to purchase U.S. goods (in dollars) will find these goods less expensive in their currency. Similarly, consumers in the United States will have to pay more in U.S. dollars for foreign goods (whose prices are denominated in foreign currency). Theoretically, this price increase means reduced imports. The combination of increased exports and reduced imports improves the trade balance.

E. HOUSING UNDER A CONSUMPTION TAX

Under consumption tax theory, the rental values of homes should be subject to tax on an ongoing basis, but this poses administrative and compliance problems. Alternatively, the tax may be "prepaid" by taxing the purchase price of homes. This could dramatically change the economics of home ownership if new home owners must also finance a sizeable up-front consumption tax in addition to the purchase price of the home. In most other countries with consumption taxes, new housing is taxed and existing housing is exempt. In the United States, housing would likely receive preferential treatment under a consumption tax option. The mortgage interest deduction is one of the most popular middle-class tax preferences, accounting for an estimated tax expenditure of $72.6 billion in 2005.[123]

If a personal consumption tax is adopted which subjects increases in indebtedness to tax, the current mortgage interest deduction benefit could be provided by continuing to allow deductions for mortgage interest and exempting additions to mortgage debt from gross income.

[123] JCT (2005). *Estimates of Federal Tax Expenditures for Fiscal Year 2004-2009*, JCS-1-05, p. 33, available at http://www.house.gov/jct/s-1-05.pdf. For a more detailed discussion, see Chapter 14 of AICPA (1995), available at http://www.aicpa.org/taxreform/.

F. FINANCIAL INSTITUTIONS UNDER A CONSUMPTION TAX

No country with a consumption tax has been able to tax financial services in a manner consistent with consumption tax principles, due to the difficulties in identifying and valuing services provided by financial institutions. The first difficulty is identifying the value of the service to be taxed.[124] Banks provide services – such as free checking – without explicit charges, instead paying lower rates of interest to depositors and charging higher rates of interest to borrowers. Implementing rules that reasonably approximate the correct amount of VAT or flat tax liability for financial services may be possible, but they would be complex and cumbersome. The administrative problems with this approach would be formidable.

Second, leaving financial services untaxed can lead to economic distortions. Some bank customers will be favored and others penalized, and certain types of financial institutions may be given a competitive advantage. Moreover, the nature of the distortion will depend on the type of tax, the method of relief, and whether the bank customer is a business or a consumer.

Finally, if special rules apply to financial intermediaries under a consumption tax, a workable definition of financial intermediaries would be needed. Banks and insurance companies[125] would be included, but questions may arise in the case of other financial institutions and service providers such as finance companies, mortgage companies, and securities dealers and brokers.

[124] In general, under a value-added tax, interest income is not included in the tax base and interest expense is not deductible. This makes sense for most businesses (e.g., manufacturers) because interest income does not emanate from any value generated by the business, but interest expense is a payment for capital used to generate value. However, the general rule makes less sense for traditional financial intermediaries that pay lower than market rate interest and receive higher than market rates that include implicit charges for services.

[125] Taxing insurance companies under a consumption tax is analogous to the problems with taxing banks. Standard VAT rules yield highly inaccurate measures of true VAT liability. To the extent insurance companies are exempt from a credit-invoice VAT, insurance services to business customers will be over-taxed, and those to consumers will be under-taxed. If insurance companies are exempt under a subtraction method, under-taxation results for services provided to both businesses and consumers.

Attempts to bring insurance companies into a VAT system encounter measurement problems. Insurance premiums are composed of three elements: (1) funding for current and future claims; (2) savings for the policyholder; and (3) compensation for the insurance company owners (profits), lenders (net interest), and employees (wages). Only wages represent value added. The difficulty in identifying pure interest makes it difficult to measure net interest under the credit-invoice method; the difficulty in identifying the value of implicit fees makes it difficult to measure gross receipts under the subtraction method.

G. CONCLUSION

Transition to a consumption tax would require developing complex rules and making decisions to resolve difficult measurement issues in some sectors of the economy. The complexity and nature of these rules, and the length of time required, would vary with the type of consumption tax adopted and the degree to which it replaced the current tax system.[126]

For example, replacing the income tax with certain consumption tax systems – such as a credit-invoice VAT or a retail sales tax – would require a greatly altered administrative system, new forms, and the time to educate taxpayers and tax administrators about unfamiliar compliance requirements. State governments would also need time to adjust to the likely effects of the new federal tax system on their revenues, particularly if a double-digit federal rate were levied at the point of sale.

A whole or partial replacement consumption tax would generate additional concerns about the tax's impact on the economy and on the reliability of federal revenue predictions, given a lack of experience with the new system. Significant attention and effort would be necessary – both during and after transition – to address concerns about the effects on specific industries, the winners and losers, and how to resolve these issues fairly and minimize economic disruption.

Adopting a new tax system – such as a personal consumption tax – would require substantial lead time before implementation. Because this change would significantly alter how individuals calculate their tax liabilities, it would require new and different record keeping, significant public education, and careful design of forms and instructions. In addition, transactions established under the current income tax may need to be modified once the new tax system is fully implemented. For example, alimony arrangements may need to be modified, as would strategies for short- and long-term investment planning.

In the abstract, transition issues presented by moving to an as-yet-defined consumption tax cannot be exhaustively discussed or even fully identified. As the preceding chapters illustrate, transition issues should not be taken lightly. In fact, transition issues appear so daunting that some commentators question whether undertaking a full substitution is even feasible.

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[126] For a more detailed discussion and illustrations, see AICPA (1995), available at http://www.aicpa.org/taxreform/.

Chapter 11

Concluding Comments

- An organized, logical debate of the issues surrounding the need for tax reform is urgently needed, and unifying goals should be established to make any reform rational, thoughtful and lasting.

- A reformed tax system should be simpler, fairer, and more economically efficient to stimulate economic growth and encourage tax compliance.

- A flawed proposal or a failed transition could disrupt the economy, impose high costs on individuals and business, and result in a loss of federal revenues.

Reforming the federal tax system to withstand the test of the coming decades is a daunting undertaking – economically, politically and technically. From the start of the debate, there must be a clear understanding of the basic goals and priorities of reform. Without this understanding, it will be difficult, if not impossible, to identify which changes are truly needed and which will achieve the goals. Lack of consistent criteria to guide the decision-making process will hamper evaluation of the trade-offs that will inevitably need to be made.

The challenges facing today's federal tax system are numerous. Some argue that reform is needed to allow the United States to better confront the competitive global challenges facing businesses and workers. Others believe we are under-investing in research and the technological excellence that propelled us to prominence – a distinction we are in danger of losing to countries that are quickly closing the knowledge gap. Some would argue that the current federal tax system offers outdated incentives and disincentives to U.S. companies and their workers.

Over time, the ability of the federal income tax to produce adequate revenues may decline to such an extent that corrective action is imperative. The ever-growing tax gap is evidence that the complexity and perceived lack of fairness of the current system has produced inadvertent and intentional noncompliance by U.S. businesses and individuals. There is also evidence that aspects of our current system can hinder the competitiveness of U.S. businesses and result in the transfer of operations and jobs abroad.

The dizzying complexity of the income tax rules – both for individuals and corporations – grows worse with almost annual changes, phase-outs, special provisions and tax preferences. As acknowledged by IRS Commissioner Mark Everson:

> Complexity is the enemy of compliance; if people can't understand the code, they're less likely to fulfill their obligation . . . . [W]e need to carefully consider the impact of

> any policy option on attitudes toward compliance; we want to see the willingness of the citizenry to comply improve.[127]

Selecting the optimum approach for federal tax reform involves multi-faceted and difficult choices. Wholesale replacement of the current tax system will give rise to adjustments in the economy, create new sets of winners and losers, and require a lengthy transition period and complex transition provisions. Partial replacement or adding a new consumption tax to the current income tax system may reduce these effects. Simplification and reform of the current system would be less disruptive, involve fewer transition issues, and require less dramatic change of the federal administrative system. However, unless these modifications are significant, simplification may not improve economic efficiency or prove lasting.

Federal Reserve Chairman Alan Greenspan summarized the challenge of balancing reform objectives against the dilemma of choosing a method of reform as follows:

> One of the first decisions you will confront is the choice of a tax base; possibilities include a comprehensive income tax, a consumption tax, or some combination of the two, as is done in many other countries. . . . [M]any economists believe that a consumption tax would be best from the perspective of promoting economic growth . . . because a consumption tax is likely to encourage saving and capital formation. However, getting from the current system to a consumption tax raises a challenging set of transition issues.
>
> In 1986, tax reformers considered a consumption tax base and despite the arguments in favor of such a system, they decided to enhance the comprehensiveness of the income tax system then in place. Circumstances are different today, and the right choice will require assessing anew the tradeoffs between complexity, fairness and economic growth.[128]

A country's tax system reflects its social and economic values. Each choice reflects – and may change – these values. Choosing a tax base allocates the tax burden across various income sources (labor versus capital) and income levels (single-rate or progressive rate structure). Choosing how to treat income and losses from taking economic risk affects the types of economic ventures undertaken. The impact of each choice ripples through the economy and the lives of individual taxpayers: (1) whether and how to tax inherited wealth; (2) using the tax system to encourage employers to provide health insurance to employees; (3) targeting tax benefits to specific industries and individuals; and (4) how taxes are collected and enforced.

The questions raised by tax reform are crucial. Is risk-taking rewarded? Are tax burdens fairly distributed among income levels and between labor and capital? How should corporations and foreign operations be taxed? Is the tax system a better method for dispensing benefits than a

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[127] See interview with Commissioner Mark W. Everson, *Journal of Accountancy*, April 2005, p. 32.

[128] Testimony of Alan Greenspan, Chairman of the Federal Reserve Board, before the President's Advisory Panel on Federal Tax Reform, March 3, 2005, available at http://www.federalreserve.gov/boarddocs/testimony/2005/20050303/default.htm.

more direct means? How much tax evasion can be tolerated before the system fails due to lack of integrity? Is it possible to design a reform plan that improves both the federal and state tax systems as a whole, or at least strengthen the state systems rather than undermine them?

As the tax reform debate takes shape, it is critical to compare "apples with apples." To ensure an objective and complete comparison, each option must be analyzed using the same criteria and questions. Chapter 2 identifies the key principles as: simplicity; fairness; economic growth and efficiency; neutrality; transparency; minimizing noncompliance; cost-effective collection; impact on government revenues; certainty; and payment convenience.

Comparing proposals will also be challenging. Commissioner Everson emphasized that "we need to be careful not to evaluate a sub-optimized existing system against a perfect theoretical system."[129] Any reform will be subject to future legislative change, therefore it is important to acknowledge that – like the income tax – a consumption tax may experience similar alterations that increase complexity, reduce fairness, and skew economic efficiency. How much can the base be eroded over time by the addition of special interest provisions, exemptions, and other modifications? What potential administrative problems could prove unworkable? How will compliance issues under certain consumption taxes – such as a flat tax or subtraction-method VAT – differ from those faced under the income tax? Given the proposed tax system's structure, what opportunities exist to develop special provisions to dispense benefits or provide tax relief to favored industries? Before choosing the "optimum" tax reform alternative, the proposed replacement system's potential for imperfection must be considered.

Not since 1986 have the conditions pressing toward dramatic change in our tax system been this compelling. A broad, public consensus may be developing to improve our tax system before the most severe inequities of the alternative minimum tax and other imbalanced provisions affect large numbers of taxpayers. However, there is much less consensus on what should be done. The options are: (1) reform the current income tax system; (2) move the current system further toward a consumption tax by changing the tax treatment of savings and investment; (3) reform the income tax to apply only to high-income taxpayers and add a consumption tax component; or (4) replace the income tax system with a consumption tax.

A reformed tax system must include the rewards of a simpler, fairer, and more economically efficient tax system that will stimulate economic growth and encourage tax compliance. However, we must beware of the high risk that a flawed proposal or a failed transition could disrupt the economy, impose high costs on individuals and business, and result in a loss of federal revenues.

The AICPA's objective is to inform and assist the tax reform debate and decision-making process, and to work with policymakers in adopting a rational, thoughtful and lasting set of reforms.

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129 Everson (2005).

Appendix A

Tax Reform Analysis Questionnaire

(Based on the AICPA's *Ten Principles of Good Tax Policy)*

1. Simplicity

- Has a complexity analysis (such as the one the Joint Committee on Taxation provides to Congress) been performed?[130]
- Have the simplest approaches to determination of the tax base and rates been determined?
- For tax expenditures, have more direct methods of dispensing the benefit been analyzed and compared to using the tax system?
- If large numbers of individuals who owe no tax are filing returns, have other alternatives been considered?
- Have tax practitioners been consulted to help in identifying complexities and finding simpler solutions?
- Have the IRS and Treasury been consulted to help identify simpler administrative approaches?
- Has the need for frequent changes to the law been reduced?
- Have consistent definitions and concepts been used throughout the tax system?
- Have the administrative costs in terms of time and other costs for the IRS and Treasury Department been minimized?
- Have rules of short duration been avoided?
- Have rules applicable to only a small number of taxpayers been avoided?
- If states that today piggyback off of the federal income tax system do not conform to the federal changes, will that complexity outweigh the simplification achieved?

2. Equity and Fairness

- Do economic and other analyses and forecasts of the distribution and effect of the proposal factor in all types of federal taxes paid by taxpayers?
- What are the average and marginal tax rates for taxpayers with similar economic incomes? With similar expenditures? With similar savings levels? What is the rationale for any differences?
- Are the proposed tax rates reasonable or do they impose an undue burden on certain taxpayers?
- What is the distribution of the tax burden under the proposal compared to the distribution prior to the proposed change?
- Does the proposal change the mix and degree of taxation of labor and capital? If yes, what are the likely effects on different types of taxpayers?
- Do the proposal itself and the accompanying transition relief minimize unintended inequities?

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130 Section 4022 of the *IRS Restructuring and Reform Act of 1998* (PL 105-206).

- Does the proposal treat different industries or types of companies differently? Is there is special benefit or detriment to certain types of taxpayers? If yes, what is the justification for doing so?
- Does the proposal make the overall tax system more (a) progressive or (b) regressive? Which is desired?
- What will be the likely perception of fairness of the proposed changes among different groups of taxpayers, including those from different geographic regions with different costs of living?

3. Economic Growth and Efficiency

- Has an economic analysis been performed to show the impact to taxpayers (of all types and income levels), the federal government and state governments?
- Will state governments be likely to conform their systems to the revised federal tax system? If not, will the economic goals be achieved?
- Are there transition plans to any proposed tax system and has there been an analysis of the likely impact to the economy of the transition?
- Are any preferences in the system targeted narrowly to achieve the intended purpose? Have alternative approaches to reach the goals outside of the tax system been evaluated against the tax preference?
- How do tax liabilities move in relationship to changes in economic conditions? For example, if there is an economic downturn, will tax liabilities drop as well?

4. Neutrality

- Does the proposal favor one industry or type of taxpayer over another? If yes, is there a legitimate reason? Will the effectiveness of the non-neutral provisions be assessed? Is there a termination date for the provision?
- Have the direct and indirect effects of the proposal been considered in determining if any type of taxpayer is favored or disadvantaged?

5. Transparency

- Will taxpayers know about the tax, understand how it is imposed and calculated, and when it is due?
- Is a taxpayer's effective marginal tax rate the same as the statutory tax rate?
- Have tax benefits that phase-out at different income levels been avoided?
- Have "interactive" provisions been avoided where different rules apply to some types of income and deductions (such as currently exists with investment interest limitations and the alternative minimum tax)?
- Have uniform definitions of terms for all statutory purposes been adopted?
- Have multiple effective dates and revenue-motivated sunset dates been avoided?

6. Minimize Noncompliance

- Will voluntary compliance improve?
- Are there fewer opportunities for noncompliance?
- Are the new provisions administrable and enforceable?
- What will be the fiscal impact on the tax gap?

7. Cost-Effective Collection

- Has an estimate been calculated for the compliance costs for taxpayers and administrative costs for the government of the new provision?
- Have less expensive alternatives been considered?
- How quickly can conversion to a new system be implemented?
- How much will implementing conversion cost taxpayers and tax administrators?

8. Impact on Government Revenues

- Is the proposal projected to be revenue neutral? If yes, over what time period? If no, does it reach the desired level of additional or decreased revenues and over what time period?
- Which level(s) of government will be impacted by the change and how?
- What will be the impact to state and local governments if provisions are eliminated that produce direct or indirect benefits to them, such as the deduction for state and local taxes paid, the exclusion for municipal bond interest income and enterprise zone credits?
- What will be the impact on state and local governments if they conform their income tax to the new federal provisions? Will they be able to conform?
- What will be the impact on state and local revenues if the federal government adopts a revenue source that historically has been primarily the province of state and local governments?
- Will the changes affect current revenue sources of the state and local governments?
- How will any new revenues be used?
- How will any revenue losses be remedied?
- Will revenues likely be stable over time? Will revenues grow as the economy grows?

9. Certainty

- Are the key principles stated along with specific rules so that taxpayers can determine how the rule applies to transactions not covered by the specific rules or examples?
- Will the IRS or other administrative agencies be able to get guidance out to taxpayers before they become subject to the new rules?

10. Payment Convenience

- Will more taxpayers or fewer taxpayers be required to file returns under the proposal?
- Have technological solutions been considered for the collection and assessment of the tax?
- Is the tax collected at the source?

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