



# **Tax Reform Alternatives For the 21st Century**

**October 2009**

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## Preface

The American Institute of Certified Public Accountants (AICPA)<sup>i</sup> is the national professional association of certified public accountants (CPAs) with approximately 360,000 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.<sup>ii</sup> In December 1995, the AICPA issued *Flat Taxes and Consumption Taxes: A Guide to the Debate*.<sup>iii</sup> Well-received by tax experts, this study is regarded as a comprehensive and balanced analysis of consumption tax alternatives. In September 2005, the AICPA revisited the tax reform debate and published *Understanding Tax Reform: A Guide to 21st Century Alternatives*.<sup>iv</sup> Although the debate was a bit different in 2005, many issues had not changed since 1995. The 2005 publication relied heavily on the earlier work done on consumption taxes but also included a summary of the leading alternatives for replacing or improving the current income tax.

It is the objective of this report to update the 2005 publication to reflect the leading studies, recommendations, and proposals since then. The current environment is dramatically changed from those in which earlier debates took place, and accordingly, any consideration of tax reform will necessarily reflect these changes. Some alternatives may become relatively more feasible and attractive, others may present challenges too great to overcome. It is our hope that revisiting these earlier works and including more recent events and statistics will offer some historical perspective on the ongoing tax reform debate as well as provide a useful guide.

The 1995 study described 4 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 2 leading proposals then under consideration and estimated the impact of these proposals on businesses and individuals. The 2005 study summarized the consumption tax material and updated the earlier work by including current proposals and discussing the major issues to be resolved in reforming the current income tax.

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. The panel's recommendations were released in November 2005 in

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<sup>i</sup> See [www.aicpa.org](http://www.aicpa.org).

<sup>ii</sup> The Tax Section serves the public interest by assisting AICPA members to be the most trusted professional providers of tax services, and by advocating sound tax policy and effective tax administration.

<sup>iii</sup> Available at <http://www.aicpa.org/taxreform/>.

<sup>iv</sup> *Ibid*

the form of 2 alternative plans.<sup>v</sup> During the period between the release of that report and the end of the Bush Administration, new concerns arose. Deficits grew because of increased defense spending and other pressures. Economic growth slowed and revenues declined as a result of the economy and stimulus-oriented tax reductions. The competitiveness of U.S. businesses became of greater concern with the clear trend toward globalization in trade and finance, leading to reports, recommendations, and proposed legislation that focused on corporate and international tax reform. Economic conditions worsened toward the end of the Bush Administration with the collapse of the housing market and the resulting failure of many financial institutions. The response has been more stimulative tax cuts and federal borrowing to back stop the financial sector. It is against this backdrop that any debate over tax reform will occur.

In early 2009, President Barack Obama called for the formation of a task force, chaired by former Federal Reserve Chairman Paul Volcker, to suggest reforms to the current income tax system that would simplify it, improve compliance, and reform the corporate income tax. Given the other initiatives the Administration is also pursuing, it is reasonable to assume that improving revenue collections is also an objective.

The ongoing attention devoted to the need and desire to improve our tax system encouraged the AICPA to publish this updated report to discuss recent developments and serve as a resource in the continuing tax reform debate. This report is designed to provide policymakers, our members, and interested individuals with a clear understanding of the issues and alternatives involved in federal tax reform. Although the focus of the tax reform debate has changed, many of the reasons for dissatisfaction with the current tax system remain the same. The economic context surrounding any tax reform effort has led to greater consideration of hybrid reform approaches that encompass either (1) a combination of income and consumption taxes or (2) significant elements of each.

Given the current economic conditions, historically high federal debt and deficits, and struggling states and localities, it is unlikely that the nation would undertake a significant change in tax structure requiring a long transition period and entailing significant risk of further economic disruption. Accordingly, attention may well focus on reform of the current income tax to simplify it and improve its potential for promoting economic growth and efficiency as well as to improve its administrability. Revenue needs may eventually provide the stimulus for the addition of a moderate federal consumption tax, long debated as a potentially necessary element in the federal system.

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, nor do we take positions on the appropriate level of federal revenues. The goal of our 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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<sup>v</sup> President's Advisory Panel on Federal Tax Reform (2005). Simple, Fair, & Pro-Growth Proposals to Fix America's Tax System, November 2005.

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### Tax Reform Task Force

Judyth A. Swingen, Chair

W. Val Oveson

Pamela J. Pecarich

Gerald W. Padwe

Jay Starkman

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Eve Elgin

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Brian T. Whitlock

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Melbert E. Schwarz, II

C. Clinton Stretch

Judyth A. Swingen

Carol E. Zurcher

### **AICPA Tax Division Staff**

Thomas P. Ochsenschlager, Vice President—Tax

Edward S. Karl, Director

Jean E. Trompeter, Technical Manager



## Executive Summary

In December 1995, the AICPA 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. In 2005, tax reform was in the forefront again. Central to the debate was President George W. Bush announcing his intent to make tax reform a key priority in his second term. In response to that focus, the AICPA updated its 1995 report and included the leading alternatives for improving as well as replacing the current income taxes. Published in September 2005, it was titled *Understanding Tax Reform: A Guide to 21st Century Alternatives*.

In November 2005, the Advisory Panel appointed by President George W. Bush issued its recommendations for “*Simple, Fair, & Pro-Growth Proposals to Fix America’s Tax System*” in the form of 2 alternative plans. Both would move the current system closer to consumption tax principles. Greater consideration has been given since the mid-1990’s to hybrid reform approaches—that is, a system with either (1) a combination of income and consumption taxes or (2) significant elements of each.

In March 2009, President Barack Obama called for the formation of a task force, chaired by former Federal Reserve Chairman Paul Volcker, to review the current income tax system and suggest ways to simplify it and improve compliance and to reform the corporate tax.

Given the continued focus on the need and desire to improve our current tax system by both the Administration and Congressional leaders, the AICPA has undertaken this 2009 report to serve as a resource to those engaged or interested in the current tax reform debate. Our objectives are to provide policymakers and 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 reform debate, suggests a balanced approach for analyzing tax reform proposals, and summarizes key issues to be addressed whether taxing income or consumption or both. 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 and 2009 reports are also posted at this address. In the period since 2005, the Joint Committee on Taxation and the Department of Treasury have published reports and recommendations for reform, and legislation has been proposed by the chairs and some members of the tax writing committees of Congress.

Any serious consideration of tax reform undertaken in the near future will by necessity be influenced by the issues currently facing the country. The United States is anticipating significant events that have begun to affect federal tax revenues:

1. The baby boom generation is starting to retire, placing additional burdens on already strained entitlement programs including those where the costs of providing for health care continue to increase.

2. The 2001 and 2003 tax cuts will expire in 2010, generating additional government revenues without corresponding examination of appropriate and fair tax burdens.
3. The reach of the alternative minimum tax will grow exponentially, subjecting millions of taxpayers to unintended, higher levels of taxation, requiring more and more costly adjustments to limit its effect to the intended taxpayer group.
4. Revenue needs will increase substantially to address historic levels of debt and annual deficits as a result of defense spending, the recent economic challenges, and financing new policy initiatives such as health care reform.

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. These events and concerns, along with a raft of long standing criticisms of our current tax system, provide the impetus for undertaking consideration of federal tax reform.

Three general approaches to tax reform have emerged over time. The first approach would entail significant changes to the current system. Under this approach, current law would be adjusted as necessary to achieve the goals of reform.

The report outlines efforts to improve the current system without changing its fundamental character as an income tax having significant consumption tax elements. These include wide-ranging simplification efforts, increasing fairness, reducing revenue lost from tax evasion (known as the *tax gap*), and broadening the tax base. These proposals address economic growth by improving economic efficiency through greater neutrality, creating incentives for capital formation, accelerating depreciation, eliminating double taxation of corporate profits, simplifying and increasing tax-preferred savings options, and reforming counterproductive characteristics of the tax system as applied to domestic corporations and international businesses. Other areas of taxation, such as reform of the Social Security system 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*,<sup>vi</sup> and, jointly with the American Bar Association and other interested organizations, the *Report on Reform of Federal Wealth Transfer Taxes*.<sup>vii</sup>

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 is referred to herein as *replacement* of the current tax system. A consumption tax system is the most frequently proposed substitute.

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<sup>vi</sup> AICPA, *Understanding Social Security Reform: The Issues and Alternatives*, March 2005, 2nd Edition. Available at [www.aicpa.org/members/socsec.htm](http://www.aicpa.org/members/socsec.htm).

<sup>vii</sup> Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes*, 2004.

The report examines the five major consumption tax alternatives:

1. Retail sales tax
2. Credit-invoice value-added tax (VAT)
3. Subtraction method VAT
4. “Flat tax” (a single-rate consumption tax)
5. Personal consumption tax

Despite considerable differences in appearance (for example, 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, and 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 proposals that would include significant changes to the current income tax and would add a consumption tax. The current income tax is often better characterized as a hybrid income-consumption tax, rather 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 rates (retirement plans, education savings accounts, certain important features of life insurance contracts). Accordingly, there may be a movement toward adding more elements of consumption taxation to the income tax or adding a separate consumption tax.

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. Transition to any significantly different tax regime could change many existing relationships between the federal, state, and local governments and between the federal government and major sectors of society and the economy. As such, careful attention will need to be devoted to transition issues to avoid or minimize significant disruptions and unintended consequences.

Current economic conditions as well as future revenue needs will affect the debate on tax reform alternatives. Some options may become relatively more feasible and attractive, and others may present challenges too great to overcome or unacceptable levels of risk of further economic disruption.



## 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,<sup>viii</sup> 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*.<sup>ix</sup>

We recommend employing the following widely recognized indicators of good tax policy to analyze proposed changes. These 10 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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<sup>viii</sup> Available at <http://tax.aicpa.org/Resources/Tax+Advocacy+for+Members/Tax+Legislation+and+Policy/AICPA+Offers+Preliminary+Comments+to+Presidents+Advisory+Panel+on+Federal+Tax+Reform.htm>.

<sup>ix</sup> Available at [http://www.aicpa.org/download/members/div/tax/Tax\\_Policy\\_stmt1.pdf](http://www.aicpa.org/download/members/div/tax/Tax_Policy_stmt1.pdf).



## CONCLUSION

The AICPA 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

- Currently, there is strong, broad-based support for tax reform.
- Taxpayers and tax professionals are concerned about (1) tax law complexity, (2) a large tax gap, (3) uncertainties related to expiring provisions, and (4) the alternative minimum tax (AMT).
- Economists and policymakers are concerned about (1) low levels of savings, (2) international business competitiveness, (3) the lack of neutrality in the tax law, and (4) large deficits.
- The increasing demands of domestic policy objectives pose further challenges.

#### A. INTRODUCTION

##### *1. Broad-based Support for Reform*

The need for significant tax reform is a recurring theme that appears to be gaining a critical mass of support from taxpayers and politicians alike. During the 2009 tax filing season, 42 percent of taxpayers surveyed suggested that the tax system should be completely overhauled, and another 40 percent stated that the system needs major changes. Only 2 percent thought that things are fine the way they are.<sup>1</sup>

The 2008 platforms of both major political parties mentioned the size of the Internal Revenue Code (code) and called for reform to ensure fairness and transparency and to promote economic growth.

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<sup>1</sup> Moon (2009). *How Do Americans Feel About Taxes Today? Tax Foundation's 2009 Survey on U.S. Attitudes on Taxes, Government Spending and Wealth Distribution*, Tax Foundation Special Report 166, April 8, 2009.

## 2. *Presidential Priority*

In March 2009, President Barack Obama called for the formation of a tax reform task force. This task force has until December 4, 2009, to make recommendations that will simplify the code, reduce evasion, and also reduce “corporate welfare.”<sup>2</sup>

President George W. Bush also created a panel to review the tax code in January 2005.<sup>3</sup> The Bush panel held hearings and issued a lengthy report in November 2005.<sup>4</sup> One of the conclusions of the Bush panel was that the tax code “is in dire need of reform.”<sup>5</sup>

## 3. *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.<sup>6</sup>

The reasons for discussing tax reform in the past are largely the same concerns that led both Presidents Bush and Obama to call for tax reform: (1) the tax law is too complex, (2) the tax gap is too large, (3) domestic savings are too low, (4) the tax law makes it difficult for U.S. businesses to compete in international markets, and (5) the tax system’s impact on business decision making may not be neutral. Additional factors that are now making tax reform imperative include (1) large federal deficits, (2) growing demand for health care reform, (3) the impending retirements of the baby boom generation, (4) numerous tax provisions that will expire in the next few years, and (5) the applicability of the AMT to an increasing number of middle-income taxpayers.

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 reform approaches. The bibliography contains a more comprehensive list of tax reform resources.

## 4. *Design Features Versus Type of Tax*

The concerns about the current tax system (listed in the following sections) 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,

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<sup>2</sup> The White House (2009). *Press Briefing by Office of Management Budget Director Peter Orszag on House and Senate Budget Plans*, March 25, 2009.

<sup>3</sup> Executive Order on President’s Advisory Panel on Federal Tax Reform, Jan. 7, 2005; <http://www.whitehouse.gov/news/releases/2005/01/20050107-1.html>.

<sup>4</sup> President’s Advisory Panel on Federal Tax Reform (2005). *Simple, Fair and Pro-Growth: Proposals to Fix America’s Tax System*, November 2005.

<sup>5</sup> *Ibid*, p.16.

<sup>6</sup> See for example, Treasury’s 1977 *Blueprints for Basic Tax Reform*, the *Tax Restructuring Act of 1980* (H.R. 7015, 96th Congress), and the 1996 National Commission on Economic Growth and Tax Reform.

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 legal 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. RECURRING CONCERNS MOTIVATING MAJOR FEDERAL TAX REFORM**

### ***1. The Current System Is Too Complex***

The Annual Reports to Congress of the National Taxpayer Advocate regularly cite complexity of the tax law as a major problem. Specifically, compliance burdens for individual and business taxpayers are too heavy, both in terms of time required and out-of-pocket cost. Likewise, complexity increases administrative costs and may impair the efficiency of tax administration.

A 2006 report of the Inspector General for Tax Administration noted that complexity impacts both taxpayer compliance and tax administration. Honest taxpayers often make unintended errors due to tax law complexity. Complexity provides opportunities for dishonest taxpayers to exploit the system. Also, complexity makes it more difficult for the IRS to detect noncompliance.<sup>7</sup>

Two-thirds of the taxpayers participating in a 2005 Commerce Clearing House survey incorrectly answered questions pertaining to commonly encountered tax issues, such as gains on the sale of a home, claiming a dependent, education and retirement savings, capital gain, and the AMT.<sup>8</sup>

Since 1990, the Government Accountability Office has included enforcement of tax laws on its list of high risk areas.<sup>9</sup> The latest report states that complexity “offers opportunities to hide noncompliance” and suggests that “simplifying the tax code has the potential to help reduce the tax gap.”

The problem of complexity has been discussed for many years. In response to *The Tax Reform Act of 1976*,<sup>10</sup> the Joint Committee on Taxation (JCT) staff issued a report to the congressional

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<sup>7</sup> U.S. Department of the Treasury, Inspector General for Tax Administration (2006). *A Close Look at the Size and Sources of the Tax Gap*, Testimony of J. Russell George before the U.S. Senate, Committee on Finance, Subcommittee on Taxation and IRS Oversight, June 26, 2006.

<sup>8</sup> Commerce Clearing House, *CCH Complete Survey Suggests Taxpayers Confused by Tax Code Complexity*, March 16, 2005.

<sup>9</sup> U.S. Government Accountability Office (2009). *High Risk Series: An Update*, GAO-09-271, January 2009.

<sup>10</sup> P.L. 94-455.

tax committees explaining how the tax law had become complex and suggesting simplifications.<sup>11</sup> In April 2001, the JCT issued an extensive, 3 volume report, which reviewed the entire code and explained sources of complexity and possible solutions.<sup>12</sup> Virtually every tax act enacted since then has included a number of provisions that increase complexity, such as phase-outs with differing phase-out rates and thresholds, varying effective dates, temporary provisions, and inconsistent definitions of commonly used terms.

The AICPA has also issued reports and testified before Congress outlining the problems arising from tax law complexity and offering solutions.<sup>13</sup> In fact, the issue of simplifying our tax system has been of such importance to us that, in recent years, we have joined with the American Bar Association Section of Taxation and the Tax Executives Institute to urge Congress and the Treasury Department to make this subject a top priority. In promoting simplification of the tax law,<sup>14</sup> we agree with the National Taxpayer Advocate that “the confounding complexity of the tax code” is the most serious problem facing taxpayers today.<sup>15</sup>

## 2. *The Tax Gap Is Too Large*

The IRS estimates that the 2001 legal 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 percent and 17 percent. Enforcement and collection efforts reduced the uncollected amount to approximately \$290 billion.<sup>16</sup> Underreporting of individual income taxes is the largest source of the tax gap. Compliance is highest for items subject to withholding or third-party information reporting. According to the National Taxpayer Advocate, on average, each of 130 million individual taxpayers pays approximately \$2,000 annually to “subsidize” this noncompliance.

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<sup>11</sup> JCT, *Issues in Simplification of the Income Tax Laws*, JCS-57-77, September 19, 1977.

<sup>12</sup> JCT, *Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, JCS-3-01, April 2001.

<sup>13</sup> The AICPA has long been an advocate for tax law simplification. Over the last 2 decades, the AICPA has weighed in on simplification by (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.

<sup>14</sup> For example, in addition to joint simplification proposals made to Congress, the 3 organizations sponsored a simplification conference on Capitol Hill on December 4, 2001.

<sup>15</sup> National Taxpayer Advocate, *2008 Annual Report to Congress*.

<sup>16</sup> U.S. Department of the Treasury, Inspector General for Tax Administration (2006). *A Close Look at the Size and Sources of the Tax Gap*, Testimony of J. Russell George before the U.S. Senate, Committee on Finance, Subcommittee on Taxation and IRS Oversight, June 26, 2006.

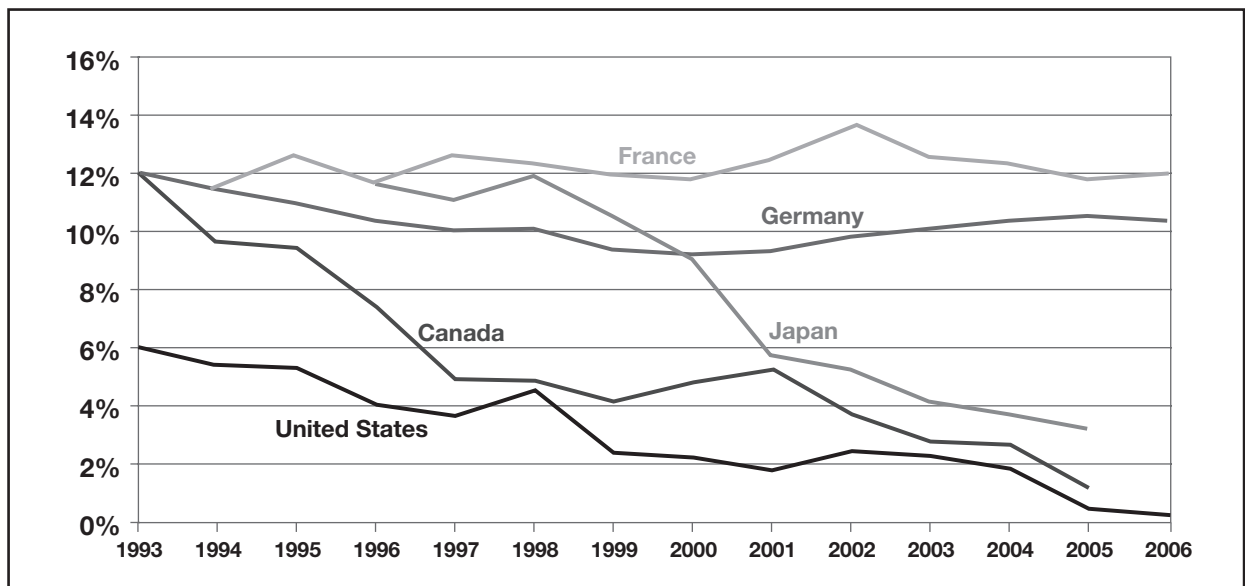
Over the last decade, public attitudes about cheating on tax returns have fluctuated.<sup>17</sup> In 1999, 11 percent of Americans indicated that it was okay to cheat at least a little on their tax return; that number increased to 13 percent in 2002 and 17 percent in 2003.<sup>18</sup> However, in 2008 only 6 percent thought that it was acceptable to cheat a little.<sup>19</sup> Eighty-one percent of taxpayers cite personal integrity as the primary motivation for honestly reporting and paying taxes. Only 35 percent state that fear of an audit motivates compliance.<sup>20</sup>

### 3. *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 Organization 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 for owner-occupied dwellings.

**Exhibit 1.1**

#### Household Saving Rates for Selected Countries



Source: Organization for Economic Cooperation and Development (2007)

OECD Economic Outlook: December No. 82—Volume 2007 Issue 2

<sup>17</sup> Davis, Hecht, and Perkins (2003), “Social Behaviors, Enforcement and Tax Compliance Dynamics,” *The Accounting Review*, vol. 78, No. 1, January, p. 39.

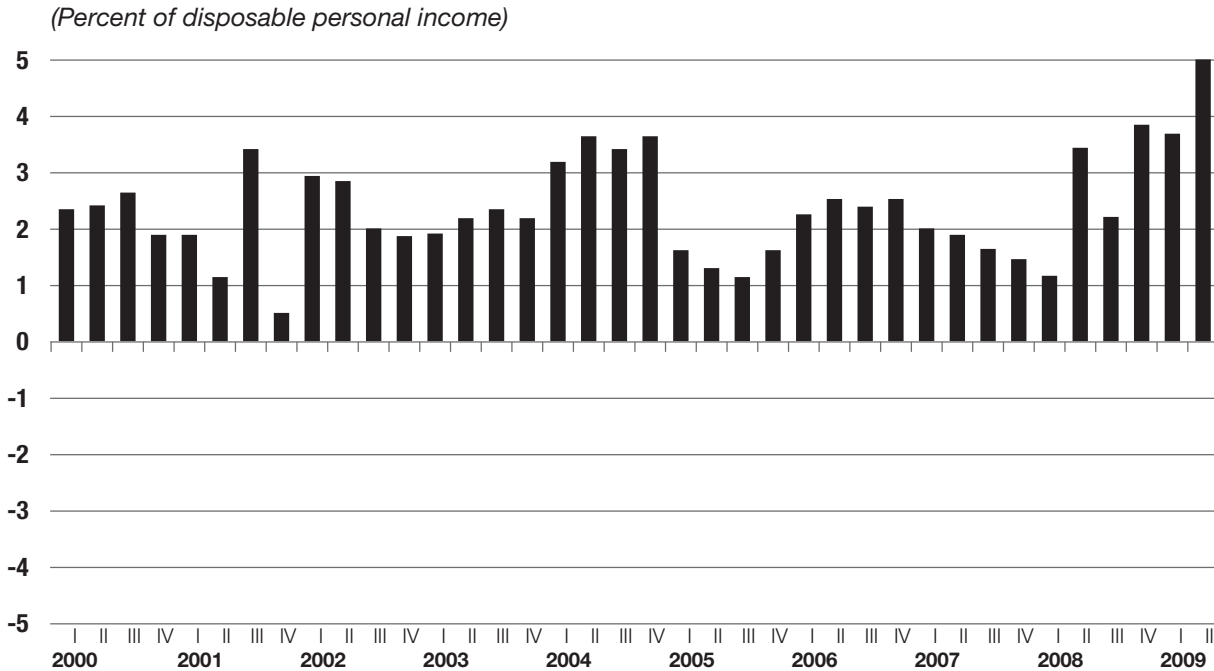
<sup>18</sup> IRS Oversight Board, FY2005/Special Report of March 2004, pp. 19–20.

<sup>19</sup> IRS Oversight Board (2009). *2008 Taxpayer Attitude Survey* (February 2009).

<sup>20</sup> *Idem*.

Exhibit 1.2 reports Bureau of Economic Analysis data that indicates that U.S. personal saving rates are now on the rise.<sup>21</sup>

**Exhibit 1.2**  
**Personal Saving Rate**



U.S. Bureau of Economic Analysis

#### 4. *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.

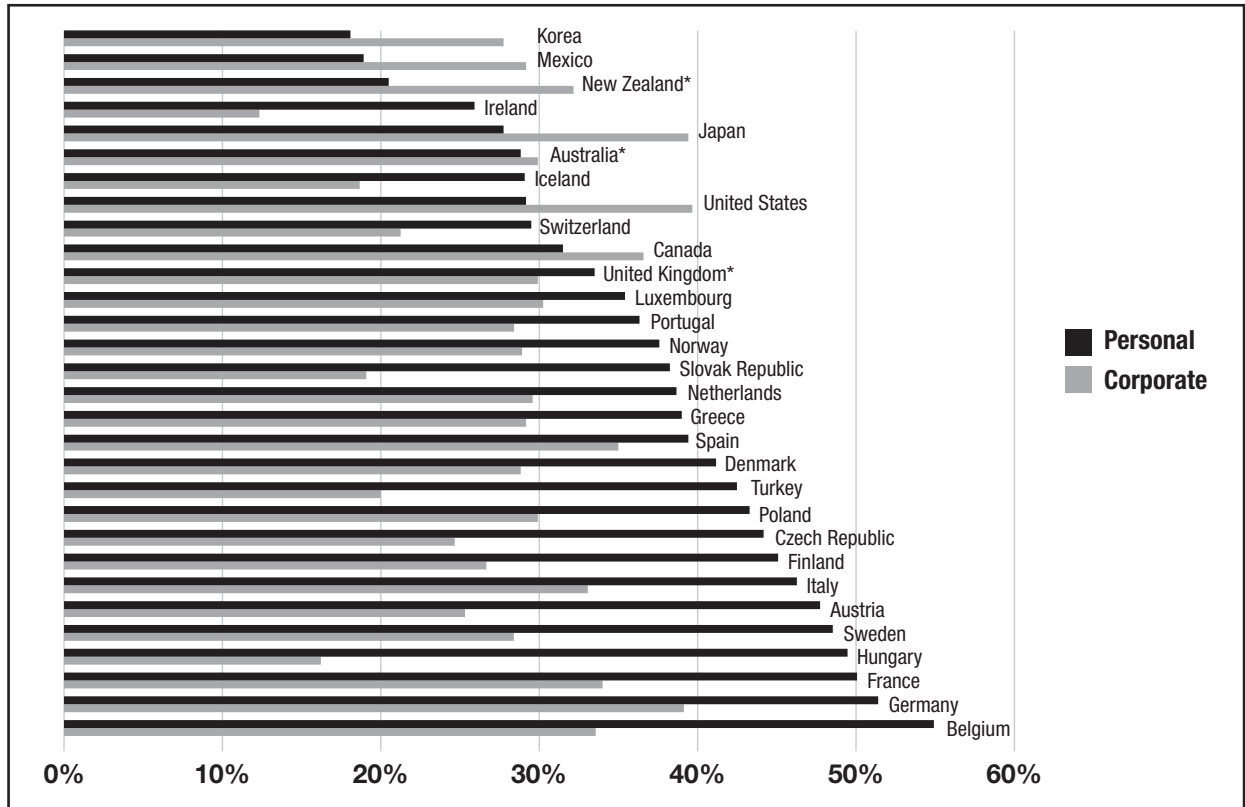
United States income taxes are not "border adjustable," whereas indirect taxes, such as value-added taxes (VATs), are imposed on imported goods and refunded for exports. All OECD countries, other than the United States, rely on a VAT *in addition to* an income tax.

Corporate tax rates are higher in the United States than in most developed countries. OECD data for 2005 indicate that only Japan had comparable corporate income tax rates. (See **exhibit 1.3.**)

<sup>21</sup> Personal savings rates in April through July of 2009 were 5.6 percent, 6.9 percent, 4.5 percent, and 4.2 percent, respectively. These were the highest saving rates in 15 years. One possible explanation for the upturn in personal savings may be concerns about the economy.



**Exhibit 1.3**  
**Mean Income Tax Rates in the Year 2005**  
**as a Percentage of Income by Country**



The United States does not have a VAT, but corporate income tax rates are high. Lower corporate income tax rates in certain countries may be possible because of the level of their VAT taxes. (See **exhibit 6.7** for OECD data on VAT rates.)

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.”<sup>22</sup> 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.

<sup>22</sup> 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. A July 8, 2003, hearing examined U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.-Based Operations.

## 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 it 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 dispense benefits or encourage certain behaviors, such as dispensing benefits to families.

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. There are a plethora of provisions intended to facilitate home ownership, to encourage higher education, and to assist low income families with costs related to raising their children. Often, the nuances of these deductions or credits are so complex that it is difficult for many taxpayers to determine their maximum allowable benefits.

## C. CURRENT CONCERNS MAKING TAX REFORM IMPERATIVE

### 1. *Growing Federal Deficits*

The primary purpose of any tax system is to raise adequate revenue to fund government programs. The current system is falling short of that goal. In January 2009, the Congressional Budget Office (CBO) estimated that the annual budget deficit would be \$1.2 trillion, or 2 and a half times the prior year’s deficit. By June 2009, that estimated deficit had increased to \$1.8 trillion or 13 percent of GDP. The CBO further concluded that “under the current law the federal budget is on an unsustainable path.”<sup>23</sup>

There are 2 possible approaches to deficit reduction. One is to reduce spending, and the other is to increase tax revenues. When larger and larger portions of the federal budget are devoted to entitlements, the expenditure reduction approach becomes increasingly difficult. For example, if laws are not changed, spending for Medicare and Medicaid will grow from a current 5 percent of GDP today to 10 percent by 2035.<sup>24</sup>

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<sup>23</sup> Congressional Budget Office, January 2009 and June 2009.

<sup>24</sup> *Ibid.*

## ***2. Demand for New Government Programs***

At the time this report was being drafted, Congress was considering major reform to the health care system. Several proposals have been introduced (affecting both individuals and businesses) to help pay for these reforms. Tax provisions to pay for these reforms will also have implications for tax administration and taxpayer compliance burdens.

As noted in **exhibit 1.3**, countries that provide more extensive government benefits for health care, retirement, and higher education tend to have higher individual income tax rates.

It is conceivable that within the next few months and years, there will be demand for other programs that will further increase federal deficits. Some likely possibilities include (1) further economic stimuli, (2) bailouts for budget-strapped states, and (3) the looming shortfall in Social Security.

## ***3. The Baby Boom Generation***

The Census Bureau classifies anyone born between 1946 and 1964 as part of the “baby boom generation.” In 2008, there were 77.3 million people in this age group. It is estimated that by 2030 individuals over the age of 65 will compose nearly 20 percent of the U.S.<sup>25</sup> Costs for the health insurance portion of Social Security already exceed inflows. The outflow for Old-Age, Survivors, and Disability Insurance (OASDI) is expected to exceed OASDI taxes collected plus interest income by 2025.<sup>26</sup>

The aging of the baby boom generation will make additional demands on the health care system. Although senior citizens are living longer and healthier lives, 80 percent of seniors have at least 1 chronic condition, and 50 percent have at least 2.<sup>27</sup>

Reforms are needed if the Social Security system is to remain fiscally viable in the long run. The impact of potential Social Security fund shortfalls on the overall tax system will be reduced if reform is enacted earlier rather than later.<sup>28</sup>

## ***4. Expanded Applicability of the Alternative Minimum Tax***

The AMT was originally created to ensure that all taxpayers pay a minimum amount of tax on their economic income. In 1970, only 20,000 individual taxpayers had to pay the AMT.<sup>29</sup>

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<sup>25</sup> He, Sengupta, Velkoff and DeBarrow (2005).

<sup>26</sup> *Annual Report of the Social Security Fund Trustees* (2009). Cash outflow for Old-Age, Survivors, and Disability Insurance (OASDI) will exceed current OASDI taxes collected in 2017.

<sup>27</sup> He, et. al. (2005).

<sup>28</sup> See AICPA (2005), *Understanding Social Security: The Issues and Alternatives, 2nd Edition*.

<sup>29</sup> Bauman, Koch, Leiserson and Rohaly (2008).

The number of taxpayers facing a potential AMT liability has expanded exponentially due to “bracket creep” and classifying as “tax preferences” the commonly used personal and dependency exemptions, standard deductions, and itemized deductions for taxes paid, some medical costs, and miscellaneous expenses.

By 2010, the number of AMT filers is projected to grow to 32.4 million.<sup>30</sup> Among taxpayers with incomes between \$100,000 and \$200,000, a staggering 80 percent are expected to be subject to the AMT.<sup>31</sup>

Even more notable, the AMT is projected to affect a higher percentage of taxpayers with incomes between \$75,000 and \$100,000 (50 percent) than taxpayers making more than \$1 million (39 percent).<sup>32</sup> According to these projections, approximately 5.7 million taxpayers will pay AMT in 2010 simply because they lose the benefit of personal exemptions under the AMT.<sup>33</sup>

As IRS National Taxpayer Advocate Nina Olson pointed out in her March 7, 2007, testimony on the individual AMT before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means,

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that each AMT taxpayer will owe, on average, an additional \$6,782 in tax in 2006. In terms of complexity and time, taxpayers often must complete a 16-line worksheet, read ten pages of instructions, and complete a 55-line form simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 77 percent of AMT taxpayers hire practitioners to prepare their returns.

The AICPA advocates the repeal of the AMT in order to simplify tax laws for individual taxpayers.<sup>34</sup>

## **5. *Expiring Provisions***

In recent years, Congress has enacted numerous expiring provisions. In some instances, these temporary laws target a short-term need or issue. In most cases, tax laws with a sunset date enable Congress to grant tax benefits to their constituents while staying within the balanced-budget rules. As a result, Congress must regularly decide whether or not to renew these expiring provisions.

Expiring provisions create considerable uncertainty for taxpayers and their tax advisors. It is difficult to do effective tax planning when tax rules for individuals, businesses, and estates may expire in

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<sup>30</sup> Leiserson & Rohaly (2006) *Table 1*.

<sup>31</sup> *Id.* at table 3.

<sup>32</sup> *Id.*

<sup>33</sup> Burman, Gale & Rohaly (2003).

<sup>34</sup> For further discussion of issues related to the AMT, see the AICPA proposal for simplifying the individual AMT at <http://tax.aicpa.org/Resources/Individual/AICPA+Individual+AMT+Proposal.htm>.

the near future. Some expiring provisions expire due to the lack of timely Congressional action but are then reinstated retroactively. This necessitates the redesign of tax forms and computer systems, the issuance of additional guidance, and the filing of amended returns. This causes expense and frustration for taxpayers and tax administrators alike.

In March 2009, the staff of the JCT identified 89 tax provisions expiring in 2009 and another 42 expiring in 2010.<sup>35</sup> These provisions involve deductions, credits, and tax rates for individual taxpayers as well as businesses. In most instances, the expiration of a particular provision will increase the taxpayers' liabilities.

#### **D. REPORT OVERVIEW**

These issues do not necessarily mandate repealing the income tax and replacing it with a different type of tax system. Instead, the 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 should be followed. In addition, efforts to simplify the tax system must be integral to reform.

This report considers a number of alternatives to reform the tax system.

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

Chapter 3 compares the 2 methods of undertaking tax reform—reform the current system or replace the current system—and covers the primary features of income versus consumption taxes.

Chapter 4 considers 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 5–9 each discuss 1 of 5 different consumption tax approaches: (1) a federal retail sales tax; (2) a credit-invoice VAT; (3) a subtraction method VAT; (4) a flat rate consumption tax option; (5) 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 our concluding remarks.

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<sup>35</sup> List available at <http://www.jct.gov/publications.html?func=startdown&id=1464>.



## Chapter 2

### Analyzing Tax Reform Proposals

#### SUMMARY

- 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.

#### A. INTRODUCTION

There are a variety of frameworks for evaluating tax reform proposals. In 2001, the AICPA developed a set of 10 guiding principles for good tax policy:<sup>36</sup>

1. Simplicity
2. Fairness
3. Economic growth and efficiency
4. Neutrality
5. Transparency
6. Minimizing noncompliance
7. Cost effective collection
8. Impact on government revenues
9. Certainty
10. 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.

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<sup>36</sup> AICPA (2001). *Tax Policy Concept Statement 1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*.

## B. TAX POLICY OBJECTIVES

### 1. *Simplicity*

Tax laws should be simple enough to enable taxpayers to understand the rules that apply to their situation 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. The tax laws that affect multinational corporations are more complex than those affecting the average individual, reflecting differences in the taxpayers' sophistication and the complexity of the transactions in which they engage.

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 often evaluated by looking at just horizontal and vertical equity. The AICPA proposes that there are seven dimensions of equity and fairness that should be evaluated when considering tax law proposals:<sup>37</sup>

1. *Exchange equity and fairness.* Over the long run, taxpayers receive appropriate value for the taxes they pay.
2. *Process equity and fairness.* Taxpayers have a voice in the tax system, are given due process, and are treated with respect by tax administrators.
3. *Horizontal equity and fairness.* Similarly situated taxpayers are taxed similarly.
4. *Vertical equity and fairness.* Taxes are based on the ability to pay.
5. *Time-related equity and fairness.* Taxes are not unduly distorted when income or wealth levels fluctuate over time.
6. *Inter-group equity and fairness.* No group of taxpayers is favored to the detriment of another without good cause.
7. *Compliance equity and fairness.* All taxpayers pay what they owe on a timely basis.

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<sup>37</sup> AICPA (2007). *Tax Policy Concept Statement 4, Guiding Principles for Tax Equity and Fairness.*



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, the system should be neutral in its determination of 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.<sup>38</sup>

### ***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

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<sup>38</sup> AICPA (2003). *Tax Policy Concept Statement 3, Guiding Principles for Tax Law Transparency*.

measures. Generally, a balance must be struck among the desired level of compliance and the costs and intrusiveness of enforcement.<sup>39</sup>

### **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; therefore, 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 liability. 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 in their knowledge of (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 best to collect the tax from the manufacturer, wholesaler, retailer, consumer, employer, or employee? Should the tax be collected annually, quarterly, monthly, or weekly?

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<sup>39</sup> GAO (1995). *Reducing the Tax Gap—Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June, p. 13.

The principles listed in this section are closely related and interactive. A change that simplifies the tax law may also improve certainty but be less fair. Likewise, a provision designed to enhance neutrality may deter economic growth. The challenge is to achieve the proper balance among these desirable but competing objectives.

### 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,” derived from the principles and objectives outlined, to compare competing tax reform proposals and provisions (see **appendix A**). We recommend evaluating both the overall structure and the implementing details of each tax reform proposal before making a final choice.



## 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, and consumption taxes are considered regressive but simpler and more conducive to economic growth. 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

Three general structural approaches to tax reform have emerged in the current debate. The first approach would make significant changes to the current system. To achieve fundamental reform using this approach, tax lawmakers would need to first agree on the overall objectives of tax 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.

A third approach would involve both significant changes to the current system and the addition of a new tax regime. Some economists have suggested that due to the downturn in the economy, the cost of healthcare reform, and impending obligations to the baby boom generation for Social Security and Medicare benefits, the federal government will soon need additional tax revenues.<sup>40</sup>

In addition to debating the proper *structural* approach to reform, one must also consider the *conceptual* debate about income taxation versus consumption taxation. Should the current income tax system be retained but substantially revised? Should the income tax be replaced by a consumption tax? Or should we follow the lead of our major trading partners and add a consumption tax to our existing 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 particular structural approach (significant changes to versus replacement of the current system) and choosing between an income and a consumption tax are not equivalent.

**Exhibit 3.1**  
**Overview of Tax Reform Proposals**

	<b>Tax Reform Proposal</b>	<b>Structural Approach Significant Changes or Replacement</b>	<b>Conceptual Approach Income or Consumption</b>
1	Retail Sales Tax	Replacement	Consumption
2	Value-Added Tax	Replacement	Consumption
3	Flat Tax	Replacement	Consumption
4	1986 Act	Significant Changes	Income
5	Simplification	Significant Changes	Income
6	Exempt Saving/ Expensing	Significant Changes	Consumption
7	CBIT / I-VAT	Replacement	Income PLUS Consumption
8	Add-on Consumption Tax	Significant Changes PLUS a New System	Income PLUS Consumption

<sup>40</sup> Altman (2009). “We’ll Need to Raise Taxes Soon,” *Wall Street Journal*, June 30, 2009 and Burman, L. (2009). *Statement before the Senate Committee on Finance, Roundtable on Financing Healthcare Reform*, The Urban Institute and Brookings Institution, Tax Policy Center, May 12, 2009.

Proposals 1–3 (retail sales tax, value-added tax (VAT), 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 4–5 (an overhaul of the income tax like the Tax Reform Act of 1986 or a 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.<sup>41</sup> This option is included to illustrate the range of possibilities.

Proposal 8 is a hybrid proposal that would add a VAT 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, and 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

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<sup>41</sup> The Treasury Department has considered a broad-based, flat *income* tax—called an income-based value-added tax—that combined a comprehensive business income tax-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 Assistant Secretary (Tax Policy), Pamela F. Olson*, November 7, 2002.

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.

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.<sup>42</sup>

## **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.<sup>43</sup>

## **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.<sup>44</sup> 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 antideferral rules.<sup>45</sup>

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<sup>42</sup> See AICPA (1995), chapter 6, pp. 50–55, for a more complete discussion.

<sup>43</sup> See AICPA (1995), chapter 7, pp. 58–64, for a more complete discussion.

<sup>44</sup> See AICPA (1995), chapter 17, pp. 207–213, for a more complete discussion.

<sup>45</sup> 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,<sup>46</sup> eliminating the complicated rules that give preferential tax treatment to pensions, IRAs, tax-exempt bonds, annuities, and life insurance.<sup>47</sup>

## 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 VAT, recordkeeping burdens may increase as businesses must retain records of taxes paid on all invoices to earn tax credits. Under a subtraction method VAT, taxpayers must revise their accounting procedures to differentiate between nondeductible internal costs and deductible external costs. A personal consumption tax would require taxpayers and tax authorities to maintain previously unrequired records of changes in taxpayers’ 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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<sup>46</sup> Excluding savings from the consumption tax base is the equivalent of exempting investment income from income tax. See chapters 5–9.

<sup>47</sup> Consumption taxes grant relief for investing in capital either by exempting investment income from tax or by allowing deductions for investments. See AICPA (1995), chapters 5–9.

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.<sup>48</sup> 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

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<sup>48</sup> 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.

local sales taxes may reduce consumption and lead to greater noncompliance, which in turn would result in lower state and local tax revenues.

Adding a federal retail sales tax or a credit-invoice 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 already higher combined federal and state tax rates 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.

### ***5. 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 the taxpayer is can also be difficult.

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

- 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 that are not always related to an asset's economic life.
- Subjecting many married taxpayers to higher tax rates than if they had each filed as single (the "marriage penalty").
- Geographic disparities in income and expenses causing tax provisions—particularly those with fixed dollar limitations—to have an uneven impact across the country.

- Children’s and student’s investment income being taxed at the parent’s higher tax rate (the “kiddie tax”).
- Effective reporting mechanisms not available for all types of income, causing some income to go unreported (one cause of the tax gap).

#### **D. TRANSITION ISSUES**

If the income tax system is replaced by a consumption tax, state income tax administration and compliance burdens will increase in states that rely on federal tax statutes and guidance to determine adjusted gross income or the tax base for state income tax purposes. States would need to create their own income tax rules.

Further, if the federal government implements a consumption tax, either as a replacement for or supplement to the income tax, the following issues may arise:

- 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.<sup>49</sup>
- 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.
- A replacement system would require new federal administration, guidance, forms, enforcement mechanisms, and the like.
- Complexity is added for businesses that will now collect tax on multiple tax bases.

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<sup>49</sup> See AICPA (1995), chapter 5, pp. 48 (table 5.2) and 57.

## Chapter 4

### Significant Changes to the Current System

#### SUMMARY

- Many goals of tax reform can be achieved by making significant changes to the current income tax system instead of replacing the current system with a new consumption tax.
- Significant simplification to the current income tax system can be achieved by eliminating alternative minimum taxes (AMTs), consolidating education and retirement savings incentives, replacing the 20-factor worker classification test, and simplifying the earned income tax credit (EITC).
- Avoiding the use of phase-out, temporary, and last-minute provisions in writing tax law and closing the tax gap would result in a more efficient tax system.
- The current federal income tax 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. Former Ways and Means Chairman William Archer's goal of "tearing the income tax out by its roots"<sup>50</sup> and Congressman John Linder's perennial "Fair Tax"<sup>51</sup> proposal espouse these sentiments. 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. Ways and Means Chairman Charles Rangel proposed broadening the income tax base to raise revenues, which would accomplish an overall simplification.<sup>52</sup>

<sup>50</sup> *Interview*, Bill Archer with Jim Lehrer, October 22, 1997.

<sup>51</sup> *Fair Tax Act of 2009*, 111th Congress, H.R. 25 with 56 co-sponsors proposed abolishing IRS and replacing all income, payroll, estate and gift taxes with a 23 percent tax.

<sup>52</sup> *Tax Reduction and Reform Act of 2007*, 110th Congress, H.R. 3970.

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 (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.

Most likely, the income tax would not be entirely replaced with a new consumption tax collected by business (such as a retail sales tax or a value-added tax). The income tax is unique in its ability to raise large amounts of revenue that could act as a weapon against inflation or as a tool to redistribute wealth. It can be used to influence savings, investment, and consumption or affect social and economic policies. No other single tax is so flexible. Therefore, we offer a review of the incremental modifications that could significantly simplify the current system and improve compliance.

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. TAX SIMPLIFICATION**

### ***1. The Need for Simplification***

There is widespread recognition that U.S. tax law is too complex. The National Taxpayer Advocate repeats in each annual report to Congress, “First and foremost among the most serious problems facing taxpayers is the complexity of the tax code.”<sup>53</sup> The Internal Revenue Code has recently been estimated to contain 3.7 million words. Income tax regulations are 11,700 pages.<sup>54</sup> 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.<sup>55</sup>

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<sup>53</sup> National Taxpayer Advocate, *2008 Annual Report to Congress*, vol. 1, p. v.

<sup>54</sup> *Ibid*, p. 4.

<sup>55</sup> AICPA/ABA/TEI February 12, 2001, transmittal letter to Treasury Secretary Paul O’Neil, accompanying, *10 Ways to Simplify the Tax Code, a Joint Initiative of the ABA Tax Section, TEI and AICPA*.

The Treasury Inspector General for Tax Administration tested 2003 tax return preparation software packages and discovered that 4 out of 5 prepared incorrect tax returns using facts presented in the tests. They didn't even flag some potential issues. Misapplication of the law is a very serious tax preparation weakness. IRS testing of tax return software concentrates on correct e-filing, not preparation.<sup>56</sup> Developing reliable software is made more difficult by the constantly changing complexity of tax laws.

The 2005 President's Advisory Panel on Federal Tax Reform quantified the compliance costs:<sup>57</sup>

- Taxpayers spend over 6 billion hours per year to comply with the tax system.
- Total compliance costs of the income tax have been estimated to be \$140 billion annually. One dollar is spent on compliance costs for every 7 dollars collected in federal income taxes.
- On average, individuals annually spend about 26 hours working on their taxes and \$166 per return on out-of-pocket costs for the services of tax professionals, filing fees, and software purchases.

The Treasury Department estimated that U.S. businesses with assets of over \$5 million incurred total compliance costs of nearly \$25 billion per year.<sup>58</sup>

## 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 that are not discussed here have been examined at length within the studies referenced in **exhibit 4.1**.

### a. **Repeal the Individual Alternative Minimum Tax**

Until 2008, the National Taxpayer Advocate's Annual Report focused on the AMT as the primary example of complexity. (In 2008, AMT was at least temporarily overtaken by cancellation of debt income.) The individual AMT causes 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.

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<sup>56</sup> Treasury Inspector General for Tax Administration, (2005). *Opportunities Exist to Improve Tax Software Packages*, Jan 2005, Ref. No. 2005-40-025.

<sup>57</sup> President's Advisory Panel on Federal Tax Reform, President's Advisory Panel on Federal Tax Reform, (2005). *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, November 2005, pp. 35–36.

<sup>58</sup> U.S. Department of the Treasury. (2005). *Fact Sheet: What are the Costs of Complying with the Federal Income Tax System?* April 8, 2005.



The number of taxpayers affected by the AMT will continue to rise because unlike the regular income tax, the AMT exemption levels are not indexed for inflation. The Joint Committee on Taxation estimated in 2007 that by 2010, almost 31 million individual income tax returns will have AMT liability or restricted use of credits totaling approximately \$119 billion. Treasury estimates this cost will rise to \$260 billion in 2018. AMT significantly increases complexity, not only for the millions subject to AMT, but also for additional millions who must complete AMT calculations simply to determine that they are *not* subject to AMT.

Repealing the individual AMT would result in significant tax simplification. Unfortunately, the cost of repeal is growing rapidly; some projections indicate that it might be less costly to the government to repeal the regular income tax than the AMT. The huge revenue loss makes it difficult to repeal AMT or enact a permanent adjustment.<sup>59</sup>

To reduce the ever-expanding number of taxpayers affected by the AMT, Congress each year increases the AMT exemption. As a result of such annual relief, IRS reports that of 143.0 million returns filed for 2007 “just” 4.1 million individual returns reported AMT liability, totaling \$20.9 billion.<sup>60</sup> Therefore, the revenue loss from AMT is a more manageable problem than raw projections would indicate.

#### **b. Avoid Multiple Incentives to Achieve the Same Policy Goal**

Tax incentives are meant to encourage certain types of economic behavior, but taxpayers will only respond if they are aware of and understand those incentives. 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 to them.

Multiple provisions aimed at achieving the same policy objective should be avoided. For example, a myriad of provisions appear throughout the tax code that relate to children, such as, the child tax credit, the child care credit, and dependency exemptions. A uniform definition of a child was enacted in 2004 for some but not all of these tax provisions. A 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.

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<sup>59</sup> Joint Committee on Taxation, (2007). *Present Law and Background Relating to the Individual Alternative Minimum Tax*, June 25, 2007, JCX-38-07. and U.S. Department of Treasury, Office of Tax Policy U.S. Department of Treasury, Office of Tax Policy *2008 Tax Relief Kit: The Toll of Two Taxes: The Regular Income Tax and the AMT*.

<sup>60</sup> Strudler and Parisi, (2009). “Individual Income Tax Returns, Preliminary Data, 2007,” *Statistics of Income Bulletin*, Spring 2009, p. 112.



The code contains 14 complex incentives to encourage saving for and spending on education.<sup>61</sup> Requirements, definitions, and income phase-outs vary from incentive to incentive. Tax benefits for higher education can be simplified by (1) combining the 2 tuition credits into 1, (2) eliminating or standardizing the income ranges required for eligibility, and (3) replacing many of the current tax benefits with a single universal education deduction or credit.

### **c. Avoid Temporary Provisions, Especially Last-Minute 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, necessitate filing amended returns, make long term planning difficult, and significantly increase complexity. Recent tax filing seasons witnessed new December/January tax legislation such as deductibility of sales tax in lieu of state income tax and Recovery Rebate Credits. Impressively, the IRS and the tax preparation community proved their ability to deal with these “after forms and instructions were printed” changes. The stress and resource diversion made these provisions particularly onerous.

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 in which 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 2 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. Corporate AMT isn't a major revenue source; the less than \$4 billion it produces annually is not enough to offset the burden it creates.<sup>62</sup>

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<sup>61</sup> The 14 education tax incentives are (1) nonitemized tuition deduction; (2) nonitemized college loan interest; (3) itemized deduction for work related education; (4) HOPE credit; (5) lifetime learning credit; (6) tax-free treatment of student loans canceled; (7) tax-free student loan repayment assistance; (8) tax exemption for scholarships used for tuition, fees, and books; (9) Coverdell education savings accounts; (10) penalty-free withdrawal from IRAs to pay for education; (11) interest exclusion for savings bonds used to finance college education; (12) Section 529 qualified tuition plans; (13) tax-free education benefits provided by employer plans; and (14) additional dependent exemption for students age 19–23. There is also one disincentive for saving outside these programs: full-time students age 19–23 can be taxed at their parents' marginal tax rate.

<sup>62</sup> Office of Tax Policy, U.S. Department of the Treasury, (2007). *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, December 20, 2007, pp. 102–106.

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. Even when IRS determines that a worker is not an employee, states may rule the opposite, which creates confusion after additional controversy expense.

Because worker status determines income reporting and employer withholding and payroll tax obligations, this is an area rife with abuse.<sup>63</sup> This complex and highly uncertain determination should be eliminated and replaced with a more objective test that applies to income and employment taxes, with a requirement for state uniformity as well. 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,<sup>64</sup> the deductibility of employees' work-related business expenses could be relaxed, and the Form 1099 reporting requirements could be expanded.<sup>65</sup>

**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.

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<sup>63</sup> For example, in 1984, the IRS found that more than 99 percent of the wage and salary income of workers classified as employees was reported. However, only 77 percent of gross income for independent contractors was reported on Form 1099, and only 29 percent of gross income was reported when no 1099 was filed.

<sup>64</sup> Withholding from independent contractors is among the proposals in the *Administration's Fiscal Year 2010 Revenue Proposals*, May 2009.

<sup>65</sup> The National Taxpayer Advocate devotes a lengthy section to this complex problem and proposed solutions. National Taxpayer Advocate, *2008 Annual Report to Congress*, I-375.

### g. Simplify the Earned Income Tax Credit

According to the Treasury Inspector General for Tax Administration, the number of taxpayers claiming the EITC grew from 6.2 million in 1975 to 22.4 million in 2006. During this period, amounts claimed rose from \$1.2 billion to \$43.7 billion.<sup>66</sup> Since its inception in 1975, the EITC has lifted millions of families above the poverty level, and it is now the largest mean-tested, antipoverty program in the United States.

The program has experienced a high rate of noncompliance. The IRS estimates that EITC overclaim rates for 2005 were between 23 percent and 28 percent of dollars claimed, or between \$9.6 and \$11.4 billion.<sup>67</sup> On the other hand, eligible taxpayers are not claiming all the benefits to which they are entitled. For example, the Taxpayer Advocate's 2004 study indicated that after audit reconsideration, 43 percent of taxpayers received additional EITC benefits that had been initially disallowed.<sup>68</sup>

The EITC's complexity, coupled with a lack of financial sophistication of many eligible families, present a major challenge for the IRS. Congress somewhat reduced EITC complexity by adopting a uniform definition of a qualifying child in the *Working Families Tax Relief Act of 2004*.<sup>69</sup> As a result of significant steps the IRS has taken to address many 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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<sup>66</sup> Treasury Inspector General for Tax Administration, (2008). *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments*, December 31, 2008, Ref. No. 2009-40-024.1.

<sup>67</sup> *Ibid.*

<sup>68</sup> National Taxpayer Advocate, *2004 Annual Report to Congress, Volume II—Earned Income Tax Credit (EITC) Audit Reconsideration Study*, Publication 2104 (Rev. 12-2004). And National Taxpayer Advocate, *2008 Report to Congress*, vol. 1, p. 8.

<sup>69</sup> H.R. 1308, Pub. L. No. 108-311.

Exhibit 4.1

Overview of Selected Simplification Proposals

PROPOSAL:	AICPA/ ABA/TEI 2001	JCT 2001	Tax Reform Panel 2005	NTA 2008 Report
Repeal the Individual AMT	X	X	X	X
Simplify Education Incentives	X	X	X	X
Avoid Temporary Provisions	X		X	X
Repeal the Corporate AMT	X		X	X
Simplify Worker Classification Rules		X	X	X
Eliminate or Consolidate Phase-Out Ranges	X	X	X	X
Simplify EITC	X	X	X	X
Simplify Retirement Savings Incentives		X	X	X
Institute Return-Free Filing		X		

**Sources:**

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

**JCT 2001:** Joint Committee on Taxation. Volume I: *Study of the Overall State of The Federal Tax System* and 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>.

**Tax Reform Panel 2005:** Report of the President’s Advisory Panel on Federal Tax Reform. *Simple, Fair, & Pro-Growth: Proposals to Fix America’s Tax System*, November 2005, available at <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html>.

**NTA 2008:** IRS, National Taxpayer Advocate. *2008 Annual Report to Congress*.

The following are additional tax reform studies not listed in the above table that made tax simplification proposals:

**JCT 2005:** Joint Committee on Taxation. *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-2-05), January 27, 2005, proposed simplifying education incentives, 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, proposed simplifying the EITC and the possibility of return-free filing, available at <http://www.ustreas.gov/offices/tax-policy/library/noreturn.pdf>.

**TREASURY 2007:** U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Office of Tax Policy, December 20, 2007, proposed repeal of the corporate minimum income tax, available at [http://www.treas.gov/press/releases/reports/hp749\\_approachesstudy.pdf](http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf).

**RANGEL 2007:** The Tax Reduction and Reform Act of 2007, 110th Congress, H.R. 3970, included a proposal to repeal the individual minimum income tax.

### 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.<sup>70</sup>

Other countries have implemented 2 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 taxpayers 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<sup>71</sup> 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.

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.<sup>72</sup> In addition, it might take months to calculate and send refunds because IRS doesn’t receive all W-2s until April 30 (due to W-2 filing extensions), which could generate discontent among some taxpayers.

<sup>70</sup> 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.

<sup>71</sup> U.S. Department of the Treasury. *Report to Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite*, December 2003.

<sup>72</sup> GAO (1996). *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, October. See also the May 17, 2005, testimony of Joseph Bankman, Grover G. Norquest and Eric J. Toder before the President’s Advisory Panel on Federal Tax Reform.

### C. CLOSING THE “TAX GAP”

The “tax gap” is the amount of tax on legal transactions for a given year that is not paid voluntarily and timely. After recovering \$55 billion through enforced collections and late payments, the tax gap for 2001 is estimated at \$290 billion, corresponding to a net noncompliance rate of 13.7 percent.<sup>73</sup>

The IRS divides the tax gap into 3 components: (1) under-reporting income, (2) underpaying taxes, and (3) nonfiling 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. Underpayment and nonfiling account for 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 IRS’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.<sup>74</sup> 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 steadily declined due to budget constraints and a shift in IRS priorities from enforcement to customer service. IRS Commissioner Douglas Shulman has noted the substantial increase in audit coverage from 0.58 percent in FY 2001 to 1.01 percent in FY 2008, including a 24 percent increase in the number of audits of individuals with income over \$200,000 in 2008 alone.<sup>75</sup> This should improve collections from those audited as well as compliance among those not being audited as word spreads that IRS has increased audit rates. Although indirect effects are difficult to measure, estimates indicate that examinations increase voluntary compliance by between 6 and 12 times the amount of proposed adjustments.<sup>76</sup>

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 1099s. Requiring businesses paying independent contractors to withhold estimated tax payments could also raise compliance levels.

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<sup>73</sup> IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, August 2, 2007.

<sup>74</sup> National Taxpayer Advocate, *2004 Annual Report to Congress*, vol II, p. 2.

<sup>75</sup> “Shulman Testifies on IRS Fiscal 2010 Budget,” *Tax Notes*, 2009 TNT 95-33 (May 19, 2009).

<sup>76</sup> Dubin, Graetz, and Wilde. “The Effects of Audit Rates on the Federal Individual Income Tax,” *National Tax Journal*, 1990, p. 395–405.



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 outweigh the benefit of more effective tax collection.

## D. INCOME TAX REFORM PROPOSALS

Although much 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 system change enacted to date, the landmark Tax Reform Act of 1986. A similar path could be followed again. The President's 2005 Advisory Panel on Federal Tax Reform proposed an even more dramatic set of system changes. The possible combinations border on the infinite.<sup>77</sup>

It should be noted that 130 million individual income tax returns filed in 2002 raised \$800 billion. Of these, 89 million returns paid a total of \$72 billion; the remaining 41 million paid \$728 billion. To put it another way, 65 percent of individual returns (representing married people earning under \$60,000 and singles under \$35,000) paid just 9 percent of the income tax (excluding the self-employment tax and EITCs). This is less than the revenue loss from repealing alternative minimum income tax. There is great potential in finding an income tax replacement or reporting alternatives for this majority of taxpayers.<sup>78</sup>

### 1. *Tax Reform Act of 1986 Approach*

The Tax Reform Act of 1986 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 percent to 28 percent and the top corporate rate from 46 percent 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 the Tax Reform Act of 1986 were to

- eliminate the investment tax credit;
- eliminate the capital gains exclusion;

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<sup>77</sup> See, for example, New York State Society of Certified Public Accountants, *The SET Tax: A Tax System for Our Future* (New York: 2005). The Simple Exact Transparent (SET) Tax is, technically speaking, a flat tax because 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, nonrefundable 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.

<sup>78</sup> Starkman, "Tax Simplification: Just Get Rid of 89 Million Tax Returns," 108 *Tax Notes* 823 (Aug. 15, 2005), pp. 823–828.

- add the uniform capitalization rules (section 263A);
- reduce depreciation deductions;
- strengthen the corporate and individual AMTs;
- restrict the ability of individuals to deduct passive investment losses, miscellaneous itemized deductions, business meals and entertainment expenses, and medical expenses;
- restrict the availability of IRAs;
- restrict the ability of state and local governments to issue bonds to finance private sector investments; and
- tighten antideferral 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 the Tax Reform Act of 1986 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.<sup>79</sup>

## ***2. President's Advisory Panel on Federal Tax Reform***

This landmark 2005 tax study proposed 2 solutions. The Simplified Income Tax Plan would clean out targeted tax breaks that clutter the system thereby dramatically simplifying our tax code. The Growth and Investment Tax Plan would build on the Simplified Income Tax Plan adding consumption tax features to make the current system more “hybrid.”<sup>80</sup> These proposals were quite lengthy and detailed.

The panel deemed its proposals revenue-neutral, conforming to a revenue baseline equal to roughly 18 percent of GDP, consistent with the historical average since the end of World War II. Some economists alleged that the proposal amounted to a dramatic and regressive tax cut, though they

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<sup>79</sup> See Joint Committee on Taxation (2001) and (2005) and ABA, AICPA, TEI (2001).

<sup>80</sup> *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, Report of the President's Advisory Panel on Federal Tax Reform, November 2005.



agreed that the report contained interesting and useful suggestions for tax reform.<sup>81</sup> The major proposals for the Simplified Income Tax Plan were as follows:

- Create 4 tax brackets from 15 percent to 33 percent with reduced marriage penalty.
- Allow 100 percent exclusion for dividend income and 75 percent exclusion for capital gains.
- Combine the personal exemption, standard deduction, and child tax credit into a “family credit” and coordinate with the EITC.
- Allow nonitemizers to deduct charitable contributions.
- Repeal the deduction for state and local taxes.
- Replace the home mortgage deduction with a 15 percent credit, limited to a mortgage on an average home in a given geographic area.
- Create a 1-page Form 1040-SIMPLE that could be used by most taxpayers.
- Allow purchase of individual health insurance with pretax dollars and limit the exclusion for employer-provided health insurance to an “average premium”.
- Repeal individual and corporate AMTs.<sup>82</sup>
- Simplify taxation of social security benefits.
- Make modifications to minimize the variety of education savings plans, health savings accounts, IRAs, and defined contribution plans.
- Allow small businesses to expense business assets in the year of purchase, except for land and buildings.
- Simplify recordkeeping for small business.
- Change our “worldwide” system to a “territorial tax system” for international taxation by only taxing income earned in the United States.

The Growth and Investment Plan expanded these provisions by setting 3 tax brackets (15 percent, 25 percent, and 30 percent), lowering tax rates in general and providing for a 15 percent tax rate on interest, dividend, and capital gain income. For business, it would lower tax rates, tax business on cash flow (rather than income), treat interest income as nontaxable and interest expense as nondeductible, and make international taxation destination based by requiring border adjustments. The business changes approach a modified subtraction method value-added tax.

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<sup>81</sup> Burman, “The Tax Reform Proposals: Some Good Ideas, but Show Me the Money,” *Economists’ Voice*, December, 2005. And Burman and Gale, “A Preliminary Evaluation of the Tax Reform Panel’s Report,” *Tax Notes*, December 5, 2005, p. 1349–1368.

<sup>82</sup> The panel specifically rejected eliminating the regular income tax in favor of the alternative minimum income tax (see Graetz Proposal in this section), giving a lengthy reason.

### 3. *Income Plus Consumption: Graetz Proposal*

Professor Michael Graetz proposed a replacement tax system<sup>83</sup> that would repeal the regular income tax, dramatically increase the AMT exemption to \$100,000 (\$50,000 for unmarried taxpayers, both indexed for inflation), and apply a flat rate of 25 percent to income exceeding the higher of (1) the exemption 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. Graetz estimates this would eliminate the need for over 100 million taxpayers to file individual tax returns.<sup>84</sup>

Graetz's proposal would 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. To pay for revenue lost by these reforms, the Graetz plan calls for an entirely new credit-invoice value-added tax with a rate in the 10 percent to 15 percent range.

### 4. *Comprehensive Business Income Tax*

The comprehensive business income tax (CBIT) is a 1992 Treasury proposal for equalizing the tax treatment of debt and equity.<sup>85</sup> The income of all business entities, corporate and noncorporate, 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. Capital assets would continue to be depreciated rather than expensed.

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.<sup>86</sup>

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<sup>83</sup> 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, and Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States*, Yale University Press (2008). Graetz served as Deputy Assistant Secretary of Treasury for Tax Policy from 1990 to 1992.

<sup>84</sup> Graetz's calculations are based on 1999 IRS data when approximately 125 million individual tax returns were filed. 143 million individual tax returns were filed in 2007. Strudler and Parisi, *Individual Income Tax Returns, Preliminary Data, 2007*.

<sup>85</sup> *Report of the Department of Treasury on Integration of the Individual and Corporate Tax Systems*. January 1992. Department of the Treasury, "A Recommendation for Integration of the Individual and Corporate Tax Systems," December 1992. See also, Sullivan, "Economic Analysis. The Tax Reform Plan that Wouldn't Sell," *Tax Notes*, 2005 TNT 39-7, March 1, 2005, Kenneth W. Gideon's testimony before the President's Advisory Panel on Federal Tax Reform.

<sup>86</sup> Tax reform materials memorandum for Secretary O'Neill from Assistant Secretary Pamela F. Olson, November 7, 2002.

## 5. *The Tariff*

The tariff is our oldest revenue source; it is a consumption tax that is easy to implement and administer. The tariff provided most of our nation's revenue in its first 150 years. Today it is barely 1 percent. The income tax has permitted supplanting of the tariff. Since World War II, the political climate has shifted toward free trade, which is often hampered by import quotas, bans, and other devices such as those that have financial, investment, and jobs protection goals that are not covered by trade treaties.<sup>87</sup>

Economists have started to write about new observations of how free trade hurts our economy. Among the observations are that trade liberalization contributes to multinational firms moving production processes abroad,<sup>88</sup> rising domestic income inequality, and widening the college and high school gap.<sup>89</sup>

Any consideration of consumption taxes should review our tariff policy and its revenue potential against potential retaliation by our trading partners and its effect on exports. With \$2.11 trillion of goods imported in 2008,<sup>90</sup> a 5 percent revenue tariff could theoretically raise \$100 billion annually with tax administration that is simpler than any other consumption tax. That revenue could substitute for nontariff barriers.

## E. 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 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 nonprofit 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.

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<sup>87</sup> Hufbauer and Stephenson, "Trade policy in a time of crisis: Suggestions for developing countries" *Policy Insight* No. 33, May 2009. Examples include the requirement that Troubled Asset Relief Program (TARP) recipients prefer domestic borrowers (financial); President Obama's pledge to stop giving tax breaks to corporations that ship jobs overseas (investment); and the requirement that TARP recipients must show they have not laid off American workers before they can hire foreign nationals (jobs protection).

<sup>88</sup> Navaretti, Haaland, and Venables, *Multinational Corporations and Global Productions Networks: The Implications for Trade Policy*. Centre for Economic Policy Research, March 8, 2002.

<sup>89</sup> Krugman, *Trade and Wages*, Revisited, Brookings Paper on Economic Activity, 2008 Spring Conference.

<sup>90</sup> *Annual 2008 Trade Highlights*, U.S. Census Bureau, Foreign Trade Statistics.

Investors meeting certain conditions and not exceeding specified income limits can also benefit from a bewildering 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 (regardless of whether 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 that savings would increase and that simplification would be better served by consolidating the current savings incentives and increasing their dollar limits and adding flexibility.

In his 2003–2005 budget proposals, President Bush proposed dramatic changes in the tax treatment of personal savings by creating retirement savings accounts (RSAs), lifetime savings accounts (LSAs), and employee retirement savings accounts (ERSAs) to replace the current retirement regime, including IRAs, Roth-IRAs, 401(k)s, Simplified Employee Pension plans (SEPs), and Savings Incentive Match Plans for Employees (SIMPLE IRAs). These new accounts proposed substantially simplifying rules for tax-favored savings accounts, offered expanded opportunities for tax-free saving, and disregarded or liberalized most age and contribution limitations. The President's 2005 Advisory Panel on Tax Reform expanded the scope of this simplification proposal by combining 15 different tax provisions for at-work savings, health saving, education saving, and retirement saving into 3 simple saving plans.<sup>91</sup>

## ***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.

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<sup>91</sup> *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, Report of the President's Advisory Panel on Federal Tax Reform, November 2005, pp. 89–93.

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 recent trend has been to tinker with immediate expensing of depreciable assets, allowing ever larger write-offs. Up to \$250,000 can be expensed for tax years beginning in 2008 (\$285,000 for qualified enterprise zone and renewal community property and an additional 50 percent first year depreciation deduction for qualified property).<sup>92</sup> Permanent extension of immediate expensing or a similar proposal for partial expensing and a vast simplification of the depreciation rules 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.”<sup>93</sup>

#### ***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 (for example, a deduction) or on the individual level for dividends received (for example, a credit or exclusion). *The Jobs and Growth Tax Relief Reconciliation Act of 2003* imposed a maximum 15 percent tax rate on dividend income received by individuals. This relief expires at the end of 2010.

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

## **F. THE PROS AND CONS OF SYSTEM CHANGES VERSUS REPLACEMENT 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.

<sup>92</sup> *Emergency Economic Stabilization Act of 2008* (P.L. 110-343). The *Job Creation and Worker Assistance Act of 2002* (P.L. 107-147) 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* (P.L. 108-27) increased bonus depreciation from 30 percent to 50 percent and extended it through December 31, 2004.

<sup>93</sup> Tax reform materials memorandum for Secretary O’Neill from Pamela F. Olson, November 7, 2002.

## **AICPA TAX REFORM ALTERNATIVES**

- 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.

## 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 low.
- In theory only final sales of goods and services by businesses to consumers are subject to tax, thus avoiding multiple layers of taxation.
- To avoid a disproportionate impact on low income taxpayers, most retail sales 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 collect the tax from customers, file sales tax returns, and remit the tax to state and local authorities. The tax is transactional rather than periodic, without an annual tabulation of how much tax a family has paid during the year.

From the perspective of promoting economic efficiency, a retail sales tax should tax all consumption equally to avoid distorting consumer choices and keep tax rates low. Only final sales by businesses to consumers should be subject to tax. Taxing sales by businesses to other businesses adds the sales tax in the cost of the intermediate product and is referred to as pyramiding. This “tax on a tax” effect should be avoided.<sup>94</sup> 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.

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<sup>94</sup> 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 (VATs).



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.<sup>95</sup>

## 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. Most state sales taxes are based on the sale of tangible personal property with specified services added to the tax base. States also provide broad exemptions for purchases at the wholesale level and purchases made by nonprofit organizations and government entities.

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.<sup>96</sup> 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 nontaxable sales to businesses would remain. State governments generally use 2 methods—both imperfect—to segregate sales: (1) grant “exemption certificates” to business

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<sup>95</sup> 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, under which 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.

<sup>96</sup> See, for example, U.S. Treasury (1984); and Cnossen (1989).



taxpayers; or (2) impose sales tax on some types of products regardless of the status of the purchaser. As a result of the bluntness of these tools, retail sales taxes overtax final sales of some products and under-tax sales of others. The exemption certificate process is basically self administered by the taxpayer and is very difficult to police.

### *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 6 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.<sup>97</sup>

The Council on State Taxation's annual study of business taxes by Ernst & Young reported that 22.2 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.<sup>98</sup>

### *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 overtaxed as a result of the difficulty exporters would have 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, that is often cited as a major reason for adopting value-added tax regimes.

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<sup>97</sup> Cascading is not an issue under either a credit-invoice or subtraction method VAT. 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.

<sup>98</sup> See Council on State Taxation and Ernst & Young, *Total State and Local Business Taxes*. January 2009.

## 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, only audits of individual companies can prevent 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’ Taxpayer Identification Numbers (TINs) 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.<sup>99</sup> 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.

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<sup>99</sup> 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.

## 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 comprising a few large sellers and 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 compliance burden is spread across all businesses, or the income tax, under which millions of taxpayers share the burden.<sup>100</sup>

There is an upper limit on the rate of a federal retail sales tax before tax evasion becomes a widespread 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 percent to 12 percent of gross receipts.<sup>101</sup> 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.<sup>102</sup> If the upper realistic limit is 10 percent 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.

## 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

Numerous national sales tax proposals have been introduced over the last 20 years. The most recent proposals are the Fair Tax Act of 2009 (H.R. 25) sponsored by Representative John Linder, (R-GA-7) and a companion bill (S. 1025) sponsored by Senator Saxby Chambliss (R-GA). A summary of these proposals follows:

- Repeal the income tax, employment tax, and estate and gift tax.
- Redesignate the Internal Revenue Code of 1986 as the Internal Revenue Code of 2009.

<sup>100</sup> Some commentators argue that significant exemptions (or subsidies) should be granted to small businesses because of the high compliance costs of a VAT. This would not be possible under a retail sales tax without a substantial loss of revenue.

<sup>101</sup> Buckley and Rogers, "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.

<sup>102</sup> Buckley and Rogers, (2004).

## **AICPA TAX REFORM ALTERNATIVES**

- Impose a national sales tax on the use or consumption in the United States of taxable property or services.
- Set the stated sales tax rate at 23 percent on the gross in 2011, which yields an effective rate of 30 percent, with adjustments to the rate in subsequent years.
- Allow exemptions from the tax for property or services purchased for business, export, or investment purposes and for state government functions.
- Set forth rules relating to (1) the collection and remittance of the sales tax and (2) credits and refunds.
- Allow a monthly sales tax rebate for families meeting certain size and income requirements.
- Grant states the primary authority for the collection of sales tax revenues and the remittance of such revenues to the Treasury.
- Set forth administrative provisions relating to (1) the filing of monthly reports and payments of tax; (2) accounting methods; (3) registration of sellers of goods and services responsible for reporting sales; (4) penalties for noncompliance; and (5) collections, appeals, and taxpayer rights.
- Direct the Secretary of the Treasury to allocate sales tax revenues among (1) the general revenue, (2) the old-age and survivors insurance trust fund, (3) the disability insurance trust fund, (4) the hospital insurance trust fund, and (5) the federal supplementary medical insurance trust fund.
- Prohibit the funding of the IRS after FY 2013.
- Establish in the Department of the Treasury (1) an Excise Tax Bureau to administer excise taxes not administered by the Bureau of Alcohol, Tobacco, Firearms, and Explosives; and (2) a Sales Tax Bureau to administer the national sales tax.
- Terminate the sales tax imposed by this act if the Sixteenth Amendment to the U.S. Constitution (authorizing an income tax) is not repealed within 7 years after the enactment of this act.

## **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 in its purest form, without 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.<sup>103</sup>
- 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.<sup>104</sup>

### Cons

- The retail sales tax is viewed as a regressive tax. However, the regressive effect could be mitigated by exempting necessities like food or providing offsetting assistance to lower income households.
- 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.
- 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.
- Replacing the federal income tax system with a national sales tax would also impair the ability of the states to administer their income tax systems. Federal assistance in the form of wage reporting information sharing and compliance are essential to state tax administration.

The combined state, local, and federal sales tax rate would be extremely high if a federal rate were imposed in the 20 percent to 30 percent range, raising questions about the ability to enforce the tax effectively.

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<sup>103</sup> The Streamlined Sales Tax Project is a multistate 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/>.

<sup>104</sup> 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 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 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**

<b>Income Statement</b>	
Sales	\$100
Less Payments to Other Businesses	\$ 40
Less Wages	\$ 50
Equals Profit	\$ 10
<b>A. Value Added by Subtraction</b>	
Sales	\$100
Less Payments to Other Businesses	\$ 40
Equals Value Added	\$ 60
<b>B. Value Added by Addition</b>	
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 and 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 recently modified Michigan Single Business Tax is an addition-method VAT.<sup>105</sup>

<sup>105</sup> See <http://www.michigan.gov/taxes/0,1607,7-238-46621---,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 cents. This amount of 20 cents is the farmer's value added.<sup>106</sup>

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

Link 3: The baker purchases the flour from the miller for 50 cents. The flour is then used to bake bread and sold to consumers for 1 dollar. The difference between the 1 dollar sale and the 50 cent 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. To make a VAT a consumption tax, it is essential to allow the expensing of capital purchases.

<sup>106</sup> If, instead of expensing, capital purchases were amortized using depreciation schedules reflecting their true decline in value, the value-added tax (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 2 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 nonexempt 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 2 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
<b>Sum</b>		<b>17</b>	<b>7</b>	<b>10</b>	<b>10</b>

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 reduces 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.<sup>107</sup>

#### **Exhibit 6.4**

##### **Invoice Information Retained by Buyers and Sellers for Each Transaction under a Credit-Invoice VAT**

- |   |
|---|
| <ul style="list-style-type: none"> <li>• Name and address of person issuing invoice</li> <li>• VAT registration number</li> <li>• Serial number of the invoice</li> <li>• Date and issue of the invoice</li> <li>• Date of supply of goods or services</li> <li>• Amount charged, excluding VAT</li> <li>• Rate of tax</li> <li>• Name and address of customer</li> </ul> |
|---|

<sup>107</sup> 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 and the like that are 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 VATs 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 below.

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.<sup>108</sup>

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 nonexempt business customers of an exempt business will pay VAT on purchases from the exempt business, but the customers will be unable to receive credits on their 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.

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<sup>108</sup> 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
<b>Farmer</b>				
Gross VAT	2	—	2	2
Credits	0	—	0	0
Net VAT	2	—	2	2
<b>Miller</b>				
Gross VAT	5	5	—	5
Credits	2	0	—	2
Net VAT	3	5	—	3
<b>Baker</b>				
Gross VAT	10	10	10	—
Credits	5	5	0	—
Net VAT	5	5	10	—
<b>Total VAT</b>	<b>10</b>	<b>10</b>	<b>12</b>	<b>5</b>

In general, the farther 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, which is applying a tax rate of zero to sales of selected goods or by selected businesses.<sup>109</sup> 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.

<sup>109</sup> 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 affect 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
<b>Farmer</b>				
Gross VAT	2	0	2	2
Credits	0	0	0	0
Net VAT	2	0	2	2
<b>Miller</b>				
Gross VAT	5	5	—	5
Credits	2	0	2	2
Net VAT	3	5	-2	3
<b>Baker</b>				
Gross VAT	10	10	10	0
Credits	5	5	0	5
Net VAT	5	5	10	-5
<b>Total VAT</b>	<b>10</b>	<b>10</b>	<b>10</b>	<b>0</b>

**C. ALL OTHER INDUSTRIALIZED COUNTRIES HAVE A VAT**

The United States is the only major economy without a VAT. (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.<sup>110</sup> Instead, a somewhat similar alternative—the subtraction method VAT—lies at the core of most VAT proposals discussed in the United States. (See **chapter 7**.)

### Exhibit 6.7

#### 2009 Value-Added Taxes in Countries in the Organization for Economic Co-operation and Development

Country	Value-Added Tax?	Standard Value-Added Tax Rate
Australia	Yes	10.0
Austria	Yes	20.0
Belgium	Yes	21.0
Canada	Yes	7.0
Czech Republic	Yes	19.0
Denmark	Yes	25.0
Finland	Yes	22.0
France	Yes	19.6
Germany	Yes	16.0
Greece	Yes	19.0
Hungary	Yes	20.0
Iceland	Yes	24.5
Ireland	Yes	21.5
Italy	Yes	20.0
Japan	Yes	5.0
Korea	Yes	10.0
Luxembourg	Yes	15.0
Mexico	Yes	15.0
Netherlands	Yes	19.0

(continued)

<sup>110</sup> Adding a credit-invoice VAT and 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 VAT getting any attention since is a plan, somewhat similar to Brady’s plan, by Professor Michael Graetz. See chapter 3.

## Exhibit 6.7

**2009 Value-Added Taxes in Countries in the Organization  
for Economic Co-operation and Development (continued)**

Country	Value-Added Tax?	Standard Value-Added Tax Rate
New Zealand	Yes	12.5
Norway	Yes	24.0
Poland	Yes	22.0
Poland	Yes	22.0
Portugal	Yes	21.0
Slovak Republic	Yes	19.0
Spain	Yes	16.0
Sweden	Yes	25.0
Switzerland	Yes	7.6
Turkey	Yes	18.0
United Kingdom	Yes	17.5
United States	No	—

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

**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.<sup>111</sup>
- 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.

<sup>111</sup> 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.



- 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, adopting 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. However, compared to the audit burden of the current federal income tax and the state retail sales tax, this burden may be lower.
- Replacing the current federal income tax system with a credit-invoice VAT involves significant transition issues.



## Chapter 7

### The Subtraction Method Value-Added Tax

#### SUMMARY

- Like the credit-invoice value-added tax (VAT), the subtraction method 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 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 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 VAT. Using the same tax rate, the subtraction and credit-invoice method VATs would collect the same amount of tax. (See **exhibit 7.1.**)

## Exhibit 7.1

## Comparison of Subtraction and Credit-Invoice Method VATs

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

Under the subtraction method, gross receipts do not include financial income or other proceeds from sale of financial assets.<sup>112</sup> 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.

<sup>112</sup> This feature of consumption taxes makes it especially difficult to design an appropriate tax regime for financial institutions. See chapter 10 for a discussion of this issue.

## 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	—
<b>Total Gross Receipts</b>	105	90
Business Purchases (Other than capital)	35	35
Wages	45	—
Interest Expense	10	—
Depreciation	10	—
Capital Spending	—	15
<b>Total Deductions</b>	100	50
<b>Tax Base</b>	<b>5</b>	<b>40</b>

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 3 important areas: (1) compliance and administrative costs, (2) flexibility, and (3) perceived similarity to a retail sales 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 more detailed tax records on each purchase to claim deductions.

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 nondeductible 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.<sup>113</sup> 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 (for example, farmers, health care providers, state and local governments, and charitable and cultural organizations).

Like a retail sales tax or credit-invoice VAT, preferential treatment of products under a subtraction method VAT can be achieved 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 nonretail sales under a subtraction method VAT results in uneven taxation of final products. If nonretail 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** in which the intermediate producer (the miller) is exempt.

However, if nonretail sales get preferential treatment under a subtraction method *and* final sales are excluded (for example, exports and food), the final sales do better than being exempt or zero-rated; these sales are subsidized by a rebate for taxes not paid at prior levels. See example 2 of **exhibit 7.3**.

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<sup>113</sup> See Congressional Budget Office (1992), McLure (1987), and U.S. Treasury (1984).

**Exhibit 7.3**  
**Distortions from Exempting Intermediary Sales**  
**Under the Subtraction Method**

	<b>Example 1: Final Product Fully Taxable</b>	<b>Example 2: Final Product Exempt from Tax</b>
<b>Farmer—TAXABLE</b>		
Receipts	20	20
Purchases	0	0
Value Added	20	20
<b>VAT</b>	<b>2</b>	<b>2</b>
<b>Miller—EXEMPT</b>		
Receipts	50	50
Purchases	20	20
Value Added	30	30
<b>VAT</b>	<b>0</b>	<b>0</b>
<b>Baker—TAXABLE</b>		
Receipts	100	0
Purchases	50	50
Value Added	50	-50
<b>VAT (or Refund)</b>	<b>5</b>	<b>-5</b>
<b>Total VAT (or Refund)</b>	<b>7</b>	<b>-3</b>
<b>Note:</b> 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 (for example, exempting exports) or to provide relief for low income households (for example, exempting food and medical care). However, small businesses and farmers would have no relief from a potentially disproportionate compliance burden without special provisions.

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 VATs can also be 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, and others would replace all business income taxes with a business activity 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).<sup>114</sup> There is also controversy over the likely treatment of a subtraction method VAT under GATT.<sup>115</sup>

#### E. SUBTRACTION METHOD VAT PROPOSALS

##### 1. *Recent Proposals*

Several of the Congressional tax reform proposals over the last several years incorporate a business activity tax or a cash flow tax as a replacement for the corporate income tax and sometimes other

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<sup>114</sup> See [http://www.wto.org/english/tratop\\_e/gatt\\_e/gatt\\_e.htm](http://www.wto.org/english/tratop_e/gatt_e/gatt_e.htm).

<sup>115</sup> General Agreements on Tariffs and Trade (GATT) permits border adjustability (rebates on exports and taxation of imports) on indirect taxes. 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. Income taxes are direct taxes and not border-adjustable under the GATT. The United States has developed incentive provisions for exports in the corporate income tax, but each time these have been held to violate the GATT. See Treasury Assistant Secretary (Tax Policy) Les Samuels, *Whether a subtraction method VAT would survive a GATT challenge is an untested issue*, from June 7, 1995 recorded testimony (p. 28) before the House Committee on Ways and Means; 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." But see Hufbauer and 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, 2005. Institute for International Economics, p. 7 (a subtraction method tax would be border-adjustable, unlike the corporate income tax).



taxes as well. These are often modified subtraction method VATs in essence. By allowing a business deduction for labor expenses, some deviate importantly from the standard subtraction method VAT.

Most recently, Senator Specter introduced S. 741 (111th Congress, March 2009) that follows this approach. The 110th Congress saw several proposals that incorporated similar concepts, such as Senator Specter with S. 1081, Senator Shelby's S. 1040, and, in the House, Representative Burgess's H.R. 1040. Each of these proposals includes an individual tax on wage income with variations on the treatment of other income sources, the amounts of standard deductions provided, and whether any other deductions or exemptions are allowed. (See chapter 8 for more details on flat tax proposals.)

Also in 2007, Representative Phil English proposed H.R. 4159, the Simplified USA Tax Act of 2007, which would replace the corporate income tax with a cash-flow business tax. The tax base was a subtraction method VAT, gross receipts less purchases from other firms. Two tax rates were employed, 8 percent on the first \$150,000 of value added and 12 percent on the remainder. A credit was provided for the employer's federal payroll taxes. For individuals, the income tax would be replaced by a tax on consumed income.<sup>116</sup> H.R. 4159 is a reintroduced version of Congressman English's Simplified USA Tax Act of 2003, and both bills are successors to the English-Nunn-Domenici USA Tax proposals of 1995 and subsequent years.<sup>117</sup>

In 2005, the President's Advisory Panel on Federal Tax Reform proposed 2 alternative approaches, one of which was the Growth and Investment Tax Plan. It included a single rate tax on business cash flow, which was in essence another modified VAT proposal.

In 2007, in its report "Approaches to Improve Competitiveness of the U.S. Business Tax System for the 21st Century," the Treasury Department outlined 3 possible approaches to reform without making a recommendation. One of those would replace the business income tax on corporate and noncorporate businesses with a business activity tax designed as a subtraction method VAT.<sup>118</sup>

## 2. *Earlier Proposals*

### **English-Nunn-Domenici USA Tax**

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

<sup>116</sup> See chapter 9 for a discussion of the personal consumption tax component.

<sup>117</sup> Originally proposed by former Senators Sam Nunn and Pete Domenici in 1995 (USA Tax Act of 1995, S. 722, 104th Congress). USA refers to Unlimited Savings Allowance.

<sup>118</sup> The other two were (a) broadening the business tax base by eliminating special provisions in order to lower the statutory rate or permit partial expensing of new investment and (b) addressing specific longstanding problem areas of the business tax system, such as multiple taxation of profits, the bias toward debt financing, the taxation of international income, book-tax conformity, the treatment of losses, and so forth. ([http://www.treas.gov/press/releases/reprots/hp749\\_approachesstudy.pdf](http://www.treas.gov/press/releases/reprots/hp749_approachesstudy.pdf))

The business component would be an 11 percent subtraction method VAT, with some modifications from what would be considered a “pure” VAT. (1) There would be deductions for state and local taxes; (2) there would be 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.

### **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 VAT.<sup>119</sup> 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.<sup>120</sup>

## **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 because 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.<sup>121</sup>
- State governments might prefer the federal government to 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.

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<sup>119</sup> H.R. 4050, 104th Congress

<sup>120</sup> Although Gibbons attempted to simplify the burden adjustment, his proposal was in effect an income tax. With the side-by-side operation of a VAT and an income tax, the plan had much in common with the Graetz plan (see chapter 4).

<sup>121</sup> 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.

- 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.



## 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 noncorporate 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 the implementation of a flat tax with its distinction 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. The concept is hardly new. In the 1980s, former Senator Bill Bradley proposed a flat tax on income.<sup>122</sup> In the 1990s, former presidential candidate Steve Forbes<sup>123</sup> and former Congressman Richard Arney<sup>124</sup> proposed flat taxes on consumption.

<sup>122</sup> Bill Bradley, *The Fair Tax* (New York: Pocket Books, 1984).

<sup>123</sup> Steve Forbes; *A New Birth of Freedom: A Vision for America* (Regnery, 1999).

<sup>124</sup> *The Freedom and Fairness Restoration Act of 1994*, H.R. 4585, 103rd Congress. The Arney proposal is a direct descendent of what many consider the classic flat tax proposal by 2 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 we will examine in this chapter (S. 1040) was proposed by Senator Richard Shelby, R-Ala., in 2007.<sup>125</sup> A descendant of the Arme y flat tax proposal, S. 1040 is a type of value-added tax (VAT) collected from both businesses and individuals (other VATs 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 conceived, S.1040 would reduce complexity by eliminating dozens of targeted income tax preferences.

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

## B. THE INDIVIDUAL FLAT TAX

Under the Shelby flat tax proposal, individuals would pay a wage tax at a flat rate of 17 percent, after an initial tax rate of 19 percent for the first 2 years after implementation. The wage base would include pension benefits but exclude income earned abroad and employer-paid fringe benefits.<sup>126</sup> Life insurance proceeds and capital income (interest, dividends, capital gains, and the like) would not be taxed.<sup>127</sup> Large standard deductions and additional large deductions for dependents (see **exhibit 8.1**) would remove tens of millions of taxpayers from the tax rolls but not necessarily from filing obligations.<sup>128</sup>

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<sup>125</sup> *The Tax Simplification Act of 2007*, S.1040, 110th Congress. A variant is *The Freedom Flat Tax Act*, H.R. 1040, 110th Congress, introduced by Rep. Michael Burgess, R-Tex. The Burgess plan would allow a taxpayer to elect the flat tax instead of the present system. The election would be irrevocable, and the individual would remain a flat-tax taxpayer permanently once the election is made.

<sup>126</sup> However, employers could not deduct the cost of fringe benefits.

<sup>127</sup> As under current law, “inside build-up” of life insurance policies would also be tax exempt.

<sup>128</sup> Senator Arlen Specter, D-Pa., has also introduced similar flat tax legislation (*The Flat Tax Act of 2009*, S. 471, 111th Congress). The Specter plan has a higher rate—20 percent—and a slightly lower standard deduction—\$12,500 for single taxpayers; \$25,000 for married filing jointly; and an additional deduction of \$6,250 for each dependent. The Specter plan would allow deductions for up to \$3,125 annually for charitable contributions and for mortgage interest paid on up to \$125,000 of acquisition indebtedness.

**Exhibit 8.1****Standard Deduction under the Shelby Flat Tax  
(2007, indexed for inflation)**

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

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 Flat Tax**

- |   |
|---|
| <ul style="list-style-type: none"> <li>• Deduction for Mortgage Interest</li> <li>• Deduction for State and Local Taxes, including Property Taxes</li> <li>• Deduction for Charitable Contributions</li> <li>• Credit for Child Care and Dependent Expenses</li> <li>• Earned Income Tax Credit</li> <li>• Tax Credit for the Elderly and Disabled</li> <li>• Additional Standard Deduction for Blind and Elderly</li> <li>• Deduction for Casualty and Theft Losses</li> <li>• Exclusion of Employee Awards</li> <li>• Exclusion of Scholarship and Fellowship Income</li> </ul> |
|---|

The basic operation of the individual flat tax is illustrated in **exhibit 8.3**. For many taxpayers, filing under the S. 1040 proposal would be significantly simpler than under current law.

**Exhibit 8.3**

**Example of Application of 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’s wages 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, as with all significant changes in tax policy there are winners and losers. State and local governments, for example, 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 lose 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 disappear under the flat tax.

**Exhibit 8.4**

**Current Individual Tax Preferences Made Obsolete by Exempting All Capital Income**

- |   |
|---|
| <ul style="list-style-type: none"> <li>• Exclusion of Investment Income from Life Insurance and Annuity Contracts</li> <li>• Exclusion of Investment Income from Structured Settlement Accounts</li> <li>• Exclusion of Gain on Home Sales</li> <li>• Exclusion of Interest on State and Local Bonds</li> <li>• Incentive to Hold Appreciated Property Until Death, to Take Advantage of Stepped-up Basis</li> <li>• Deferral of Interest on Savings Bonds</li> </ul> |
|---|



### C. THE BUSINESS FLAT TAX

The business flat tax would be imposed on all corporate and noncorporate businesses at the entity level, including “flow-through” entities such as sole proprietorships or LLCs, 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
<i>Less</i>		
Materials Cost	\$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 (including such nondepreciable property as land).<sup>129</sup>

<sup>129</sup> 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 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 Controlled Foreign 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 2 sources. When combined, the 2 tax bases approximate a consumption tax base. In fact, if the individual tax did not allow standard deductions, the flat tax base proposed in S. 1040 would exactly replicate the tax base of a pure subtraction method VAT. See **exhibit 8.7**.

Under the 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, on the other hand, allows business to deduct employee compensation and then imposes tax on employees directly, including payroll taxes.

## Exhibit 8.7

## Comparison of a Subtraction Method VAT and the Shelby Flat Tax

Subtraction Method VAT		S. 1040 Flat Tax	
<i>Business Tax</i>		<i>Business Tax</i>	
Gross Receipts	100	Gross Receipts	100
<i>Less</i>		<i>Less</i>	
Materials Cost	20	Materials Cost	20
Capital Expenditure	10	Capital Expenditure	10
		Employee Compensation	40
Total Costs	30	Total Costs	70
<i>Equals—Tax Base</i>	70	<i>Equals—Tax Base</i>	30
17 Percent Tax	11.90	17 Percent Tax	5.10
<i>Individual Tax</i>		<i>Individual Tax</i>	
—None		Employee Compensation	40
		<i>Less</i>	
		Standard Deductions	15
		<i>Equals—Tax Base</i>	25
17 Percent Tax	0.00	17 Percent Tax	4.25
<b>TOTAL TAX</b>	<b>11.90</b>	<b>TOTAL TAX</b>	<b>9.35</b>
		<b>Note:</b> Total Tax <i>without standard deductions</i>	11.90

## E. ISSUES FOR POLICYMAKERS

Because of its substantial equivalence to a subtraction method VAT, the flat tax 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 lower wages to employees. Thus, a consumption tax will have a greater impact on low income households that 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.

One may fairly question why the flat tax has not caught on more in other countries' tax systems if it is being advocated for adoption in the United States. Interestingly, the concept has seen some gain in popularity over the past decade or so, primarily in countries of Eastern Europe and Asia. The online encyclopedia Wikipedia notes 23 countries<sup>130</sup> that have adopted some variant of a flat tax, but none (with the possible exception of Russia) could be considered an important industrialized nation. With substantially different economic and cultural systems from the United States, and a limited amount of time using a flat tax approach, their experiences cannot be considered particularly relevant in our current considerations.

Finally, taxpayer perceptions would 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.

## **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. And, the political problems caused by the taxpayer perception issue previously noted may make it impossible to enact a tax system that completely eliminates investment income from the tax base.

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.

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<sup>130</sup> Albania, Bosnia and Herzegovina, Bulgaria, Czech Republic, Estonia, Georgia, Guernsey, Iceland, Iraq, Jersey, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Mauritius, Mongolia, Montenegro, Romania, Russia, Serbia, Slovakia, and Ukraine.

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

### Pros

- A flat tax is fairly simple and could ease compliance burdens for many taxpayers.
- Its administrative systems are familiar to taxpayers.
- A flat tax generally eliminates bias against capital formation.<sup>131</sup>
- It 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

- Although some business flat tax proposals are border adjustable (the Shelby example is specifically territorial), to the extent they are seen as substitutes for a subtraction VAT they raise the same issues under the GATT as discussed in chapter 7.
- Flat taxes are substantially more regressive than the current income tax due to such factors as the rate structure itself, and eliminating deductions and the earned income tax credit.
- A flat tax looks too much like an income tax for individuals, and so they will expect to have the current set of deductions and credits.
- Because a flat tax is in substance a wage tax on individuals, it may be perceived as inequitable by those having little or no investment income.
- Although the tax is simple in concept, transition rules would likely be quite complex.
- A flat tax would significantly rearrange business incentives and disincentives.

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<sup>131</sup> 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, and 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 had been previously taxed under our income tax system, which would result 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 low income households, and deductions for mortgage interest, charitable contributions, and the like.

#### A. INTRODUCTION

Retail sales taxes and value-added taxes (VATs) are consumption taxes collected by or from businesses, although they are ultimately imposed upon individuals. In contrast, a personal consumption tax<sup>132</sup> 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 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**.

<sup>132</sup> A personal consumption tax is sometimes also referred to as an *individual consumption tax* or an *expenditures tax*.

## Exhibit 9.1

Calculation of the Personal Consumption Tax<sup>133</sup>

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

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 of income not used for consumption. After adding and subtracting from loan and savings balances, this family has \$95 available for consumption. This formula determines that annual consumption is derived from (1) income that is not saved (\$100); (2) net loan proceeds (\$5); plus (3) net reductions in savings accounts (−\$10).

A personal consumption tax is probably the most complex type of consumption tax due to the required recordkeeping,<sup>134</sup> but personal consumption taxes remain an attractive option. Because the tax is levied on households, applying a progressive rate structure is fairly straight-forward.<sup>135</sup> This advantage (potential progressivity) along with the perceived benefits of a consumption tax base would raise expectations that the system should be attractive for some countries. However, except for brief temporary appearances in India and Sri Lanka, tax authorities around the world have had no experience with a personal consumption tax.<sup>136</sup>

The primary difficulty of a personal consumption tax is finding a workable method to calculate the deduction for net annual additions to saving. Another significant transition issue is whether or how

<sup>133</sup> 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 the tax base, then the portion saved or reinvested would be accounted for in the savings calculation.

<sup>134</sup> See for example Graetz (1979), Kuttner (1987), and Toder (1995).

<sup>135</sup> 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.

<sup>136</sup> AICPA (1995), chapter 5, p. 42.



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, regardless of whether the withdrawals were earnings or reduction of principal.<sup>137</sup>

Conversely, proceeds from new loans or other forms of indebtedness would be taxable, to the extent not reinvested in a savings vehicle, while both interest and principal payments would be deductible. Shifting of the funds from one investment to another without taking anything out for consumption, such as depositing a dividend or part of the loan proceeds 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**

Savings accumulated before enactment raise 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. Assume a retired taxpayer who has built up some wealth through savings during her working career. That wealth, derived largely from wages and investments, has already been subject to income tax (and wages have also been subject to payroll taxes) under our present system. Without transition relief, those same amounts will be now subject to personal consumption tax as they are spent for normal living expenses, vacations, gifts to grandchildren, and the like.

Because of the huge dollars at stake when a personal consumption tax system takes effect and the newness of the system, there will be substantial governmental concern to balance equity to older taxpayers with ability to prevent or minimize evasion. The complexities of managing an

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<sup>137</sup> The tax basis in new savings is zero—by virtue of deducting the entire value of the initial investment—therefore, the entire amount withdrawn from savings is subject to tax.

anti-evasion regime could be enormous. For example, it might be theoretically possible to require taxpayers electing to utilize the system to declare their outstanding cash and asset balances at the outset, but it is unclear how such a requirement would be audited or otherwise enforced. A variant 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.<sup>138</sup> 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 tax workable.

Second, a significant portion of old saving receives favorable treatment under the income tax, for example, 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 which, after all, would be the equivalent result if we were to adopt a VAT or a retail sales tax.

#### **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 low income families, more steeply graduated rates would be required to achieve the same degree of progressivity as that achieved under an income tax.

#### **E. PERSONAL CONSUMPTION TAX PROPOSALS**

##### **1. *The USA Tax***

As originally proposed by former Senators Sam Nunn and Pete Domenici,<sup>139</sup> 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 incomes 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

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<sup>138</sup> 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.

<sup>139</sup> S. 722, 104th Congress. USA refers to “Unlimited Savings Allowance.”

itemized deductions *in addition to* the standard deduction. Mortgage interest, education expenses, and charitable contributions could be deducted in the same manner 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 percent to 40 percent.<sup>140</sup>

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 preexisting assets.

## ***2. The Simplified USA Tax***

The most recent version of the Nunn-Domenici proposal is the Simplified USA Tax Act of 2007, introduced by Ways and Means Committee member Phil English, R-Pa.<sup>141</sup> Individual tax rates are less progressive, ranging from 15 percent to 30 percent. Businesses would pay tax at 8 percent for the first \$150,000 of value added, (gross receipts reduced by purchases outside the firm) and 12 percent on additional value-added amounts as well as on all imports. Essentially, the business tax would be a subtraction VAT.

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 after five years, 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 income on an after-tax basis.

## ***3. The Growth and Investment Tax Plan***

An unusual approach to taxing personal consumption may be seen in the final report of President George W. Bush's 2005 Advisory Panel on Federal Tax Reform.<sup>142</sup> The panel expressed its preference for a classic personal consumption tax, eliminating tax on investment and capital income but recognized the political difficulties of such a formal recommendation. Instead, it supported an across-the-board 15 percent tax rate on all income from assets held outside special Save at Work accounts. Thus, as under present law (which sunsets at the end of 2010), dividends and capital gains would continue to be taxed at 15 percent; however, interest income would also attract a maximum 15 percent rate.

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<sup>140</sup> 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.

<sup>141</sup> H.R. 4159, 110th Congress.

<sup>142</sup> President's Advisory Panel on Federal Tax Reform, Connie Mack and John Breaux co-chairs, Final Report issued November 1, 2005.

Wages and compensation, as well as other defined income items, would be subject to a 3-tier progressive rate structure, with the top 30 percent bracket applying to income exceeding \$140,000. However, in addition to Save at Work accounts (roughly equivalent to an employer's Roth-style 401(k) plan) individuals could invest up to \$10,000 annually in a Save for Retirement account (on an after-tax basis) and up to an additional \$10,000 (also after-tax) to fund future medical, educational, or first-home down payments. Withdrawals from these accounts, on a timely basis and for qualified purposes, would be tax free, and internal growth of the accounts would also escape taxation.

Here, then, is a hybrid income-consumption tax with progressive rates on wages and reduced rates on investment. The business side of this proposal is a modified subtraction VAT with an even stronger nod to consumption by allowing immediate expensing of fixed assets. However, in what may be another nod to political reality, a business may deduct compensation paid to its employees. A classic subtraction VAT would not allow such a deduction.

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

### **Pros**

- A personal consumption tax can have a progressive rate structure in order to alleviate the regressive nature of consumption taxes; it also permits the exemption of low income households from taxation because it requires an annual filing (as under current law).
- Under a personal consumption tax, “net new savings” are exempt from tax, thereby encouraging greater savings.<sup>143</sup>
- 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 than some of the other reform approaches discussed to lead to a one-time price level increase.

### **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.

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<sup>143</sup> 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.

- 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 its complexities were better understood, it might be perceived as inequitable.



## 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 certain sectors of our economy, particularly charities, 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.<sup>144</sup> The United States has transitioned before

<sup>144</sup> 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.

when it converted to income tax withholding in 1943, requiring payment of 1942 and 1943 taxes at oppressively high war rates in a single year.<sup>145</sup>

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 study *Flat Taxes and Consumption Taxes: A Guide to the Debate*, 1995.<sup>146</sup>

## **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 prior savings, a burden that would fall primarily on the elderly who draw down their savings during retirement.<sup>147</sup>

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 ensure 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**

Under a replacement consumption tax, the undepreciated portion of existing assets would no longer be deductible. This would cause existing assets to bear a greater tax burden than under current law or compared to newly purchased assets that, 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, and those making the same investment shortly after enactment will be effectively tax exempt.

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<sup>145</sup> Beardsley Ruml, treasurer of R.H. Macy & Company and chairman of the Federal Reserve Bank of New York, proposed that 1942 taxes be forgiven and correctly pointed out that the new withholding tax would produce more revenue than the forgiven 1942 taxes. A compromise was reached whereby 75 percent of the lower of 1942 or 1943 taxes would be forgiven (100 percent if \$50 or less). The unforgiven tax was payable in 2 installments, half on March 15, 1944, and half on March 15, 1945.

<sup>146</sup> Available at <http://www.aicpa.org/taxreform/>.

<sup>147</sup> 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.



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, preenactment 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.

#### **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 availability of net operating loss carryforwards (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 prepaid 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, such as the following 5 most important impacts:

- 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.
- 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 increases in state sales tax rates, 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 5 percent to 6 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.<sup>148</sup>

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 2007, individuals deducted \$446.4 billion in itemized tax deductions on their federal returns.<sup>149</sup> If the average marginal federal income tax rate is 25 percent, this deduction represents a \$112 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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<sup>148</sup> See Spiro, "Estimating the Underground Economy: A Critical Evaluation of the Monetary Approach," *Canadian Tax Journal* 42 (1994): pp. 1059–1081; and Tanzi, "The Underground Economy in the United States: Annual Estimates, 1930-80," International Monetary Fund Staff Paper no. 30, June 1983, pp. 283–305.

<sup>149</sup> Strudler and Parisi, "Individual Income Tax Returns, Preliminary Data, 2007," *Statistics of Income Bulletin*.

#### ***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 chapter 7, these 2 approaches have different effects, and zero-rating is likely to provide more complete relief.<sup>150</sup>

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. However, 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 lower yields 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.

#### ***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

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<sup>150</sup> For further discussion of this issue, see chapter 3 and p. 203 of the AICPA’s *Flat Taxes and Consumption Taxes: A Guide to the Debate*, 1995.

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 and then computing their state tax using an income tax base.

## ***7. Conclusions Concerning 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***

Tax deductibility of charitable donations reduces the economic cost to the donor of his or her donation and, therefore, encourages charitable giving. Anecdotal evidence suggests that changes in the tax rates and in the alternative minimum tax treatment of appreciated property have a significant impact on the timing and amounts of charitable giving.<sup>151</sup>

In 2006, individuals deducted approximately \$186.6 billion in charitable contributions.<sup>152</sup> Eliminating this incentive could be particularly burdensome, especially if government reduces future spending for charitable purposes, thereby increasing the demand for private funding sources.

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.

### ***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 and

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<sup>151</sup> Joint Committee on Taxation, *Description and Analysis of Present Law and Proposals to Expand Federal Tax Incentives for Charitable Giving*, 2001, pp. 12-18. Steuerle, "Charitable Giving In 1993" *Tax Notes* 93 TNT 182-105 (September 1, 1993).

<sup>152</sup> *Individual Income Tax Returns 2006*, IRS Pub. 1304 (Rev. 07-2008), p. 78.

medical services provided by hospitals) would be included in the new consumption tax base or exempt under zero-rating or an exemption system.<sup>153</sup>

### ***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 Concerning 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. Granting exemptions, though, raises administrative and compliance problems.

## **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 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, regardless of whether produced domestically or abroad, to the same tax.

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<sup>153</sup> See chapter 6, section B.6, “Zero-Rating as an Alternative to Exemptions.”

Neutrality is maintained in foreign markets where domestically tax-exempt exports are subject to the same tax as goods produced in the foreign markets in which they compete.<sup>154</sup>

Presently, our trading partners that impose a VAT refund the tax upon export. Because the United States does not impose a VAT and has negotiated free-trade treaties that deny us tariff flexibility, many foreign goods sell in the United States for less than in their country of origin.<sup>155</sup> Domestically manufactured goods are subject to income tax here and are subject to VAT in many export markets. Foreign-manufactured goods are subject to neither when sold here, creating a competitive advantage for imports. But for free-trade treaties, this imbalance could be resolved with a tariff instead of adopting a VAT.

## 2. *Savings and 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 the dollar causes its 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

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<sup>154</sup> The recent House-passed *Waxman-Markey Cap-and-Trade Bill* contains a border tax adjustment provision to foster neutrality in domestic markets. §766(a)(1)(B), H.R. 2454, 111th Congress. Scott C. Ganz, "Carbon Leakage: Making the Best of a Second-Best Policy," *Tax Notes*, 2009 TNT 122-10 (June 29, 2009). For the economics of border adjustments, see Viard, "Border Tax Adjustments Won't Stimulate Exports," 122 *Tax Notes* 1139 (Mar. 2, 2009), 2009 TNT 39-21.

<sup>155</sup> For example, in Japan, a base Toyota Prius starts at ¥2,450,000 (about \$25,750) (<http://toyota.jp/prius/concept/grade/index.html>). It lists for \$22,000 in the United States.



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.<sup>156</sup>

If a personal consumption tax is adopted that 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.

## 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.<sup>157</sup> 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 an individual.

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<sup>158</sup> 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.

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<sup>156</sup> In 2005, this was estimated to be a \$72.6 billion tax expenditure. *Estimates of Federal Tax Expenditures for Fiscal Year 2004-2009*, JCS-1-05, p. 33. For a more detailed discussion, see chapter 14 of the AICPA (1995).

<sup>157</sup> 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 (for example, 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.

<sup>158</sup> Defining the tax base poses a great problem in taxing banks and insurance companies under a consumption tax, especially in a global economy in which capital flows freely between borders. See AICPA, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, 1995, chapter 15.

## 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.<sup>159</sup>

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 its 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-delineated consumption tax cannot be exhaustively discussed or even fully identified. As the foregoing 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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<sup>159</sup> For a more detailed discussion and illustrations, see AICPA, (1995,) pp. 6–10.



## Chapter 11

### Concluding Remarks

- An organized, logical debate of the issues surrounding the need for tax reform is currently 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.
- However, 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 for reform. Without this understanding, it will be difficult, if not impossible, to identify what changes are truly needed and which will reach 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 face the competitive global challenges facing its businesses and workers. Others believe we are underinvesting 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. The 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 that hinder the competitiveness of U.S. firms have, in part, motivated businesses to transfer headquarters, operations, and jobs abroad, and motivated new businesses to incorporate 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. The practical effects of this complexity were recently spelled out by the IRS's Taxpayer Advocate, Nina Olson, in her 2008 year-end report to Congress:

The largest source of compliance burdens for taxpayers is the complexity of the tax code. IRS data show that taxpayers and businesses spend 7.6 billion hours a year complying with tax-filing requirements. To place this in context, it would require 3.8 million full-time employees to work 7.6 billion hours. In dollar terms, we estimate that taxpayers spend \$193 billion a year complying with income tax requirements, which amounts to 14 percent of aggregate income tax receipts. One count shows the number of words in the tax code has reached 3.7 million, and over the past eight years, changes to the tax code have been made at a rate of more than one a day—including more than 500 changes in 2008 alone. All of this complexity imposes additional monetary costs on taxpayers—about 60 percent of individual taxpayers pay practitioners to prepare their returns and an additional 22 percent purchase tax software to assist them. Perhaps most troubling, tax law complexity leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them either to overpay their tax or to become subject to IRS enforcement action for mistaken underpayments of tax. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities.<sup>160</sup>

Selecting the optimum approach for federal tax reform involves multifaceted 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 of, or adding a new consumption tax to, the current income tax system may reduce these effects. However, 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. Unless these modifications are significant and broad, simplification may not improve economic efficiency or prove lasting.

Alan Greenspan, then chairman of the Federal Reserve Board, summarized the challenge of balancing reform objectives against the dilemma of choosing a method of reform as follows:

[O]ne of the first decisions that 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.<sup>161</sup>

<sup>160</sup> National Taxpayer Advocate, *2008 Annual Report to Congress, Executive Summary*, p. 1.

<sup>161</sup> Testimony of Alan Greenspan before the President's Advisory Panel on Federal Tax Reform, March 3, 2005, excerpted in "On Revamping the Tax Code," *Journal of Accountancy*, July 2005, p. 16.

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, for example, (1) whether and how to tax inherited wealth, (2) using the tax system to encourage employers to provide benefits 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 overall 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 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 does not undermine the states' systems?

As the tax reform discussion takes shape, it is critical to make uniform comparisons. 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. In a 2005 interview with the AICPA's *Journal of Accountancy*, IRS Commissioner Mark Everson emphasized that "we need to be careful not to evaluate a sub-optimized existing system against a perfect theoretical system."<sup>162</sup> 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 allowed to erode 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 a 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, the proposed replacement system's potential for imperfection must be considered.

It requires political capacity and determination to produce a major overhaul, as was last demonstrated in 1986. Changes in the political environment and, particularly, the dramatic contraction of the American economy (the 2 are not independent of each other), may be leading to a broader public consensus on the need to improve our tax system. However, there is much less consensus on what should be done. The options include (1) completely reforming the current income tax system; (2) moving the current system further toward a consumption tax by changing the tax treatment of savings and investment; (3) simplifying the current income tax system and adding a consumption tax component; or (4) replacing the income tax system with a consumption tax.

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<sup>162</sup> "With Integrity and Fairness: An Interview With Mark W. Everson," *Journal of Accountancy*, April 2005, p. 27, at 32.

## **AICPA TAX REFORM ALTERNATIVES**

Whichever option is pursued, to be credible with the public it should move our system toward the goals of a simpler, fairer, and more economically efficient one. Only then can we expect to stimulate economic growth and encourage greater tax compliance.

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

## 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?\*
- 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 Department 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

- Will taxpayers perceive that, over the long run, they receive appropriate value for the taxes they pay? Are similarly situated taxpayers taxed similarly?
- Are taxes based on the ability of a taxpayer to pay?
- Are the taxes of a particular taxpayer distorted when their income fluctuates over time?
- Is any group of taxpayers favored to the detriment of another group?
- Does the proposed change improve compliance with and administration of the tax system?
- If the proposal converts the income tax to a consumption tax, what transitional relief, if any, will be provided to address issues (primarily of retired individuals who will pay tax again when they spend funds saved during the era of the income tax)?

#### 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?

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\* Section 4022 of the IRS Restructuring and Reform Act of 1998 (P.L. 105-206).

## **AICPA TAX REFORM ALTERNATIVES**

- 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 nonneutral 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**

- Have taxpayers and their elected representatives been given adequate time to provide input on the proposed changes?
- Will taxpayers know about the tax, understand how it is imposed and calculated, and know 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 in which 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?

### **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 affected 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 and 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 the taxpayers 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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