

Tax Reform In the United States

**Overview to U.S. Tax System
Recent Reforms
Proposals for Fundamental Tax Reform
Current Taxation Issues
Political and Economic Perspectives
Federal and Subnational**

By

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"Tax reform is not for the timid."

Congressman Richard Arme

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I. Overview to Topic and Article

Contents—This article begins with an overview to the U.S. tax systems - the federal income tax system, rates, distribution of the tax burden, comparison of federal and subnational tax revenues, basics of the individuals and corporate income tax rules, and an overview to the operations of the IRS. Section III provides an overview to the types of reforms that have occurred in the past few years with respect to tax administration, the federal budget process, and periodic discussions of major federal tax reform over the past few decades. Section IV explains four areas of recent reforms in the U.S. including reform of the IRS and efforts to combat corporate tax shelters.

Section V, the longest section of this article, explains why "major" tax reform is being discussed in the U.S. and the types of tax proposals being considered. Many politicians, economists, and taxpayers view the federal income tax system as broken beyond repair such that it must be replaced with an entirely new system. The proposals on the table are "major" because they would change the tax base from one based on income to one based on consumption. The rationale for reform and the types of proposals under discussion and the impact they would have on individuals and businesses actually provides a very good overview to the U.S. tax system and its complexities. "Major" tax reform in the U.S. would most likely have significant effects on the U.S. and world economies. It is not obvious that the proposals will achieve all of the goals set out for reform. For example, it is not certain that a consumption tax in the U.S. would increase savings. In addition, given the complexity of some business transactions, it may be that a simple tax system is not possible. In addition, U.S. taxpayers and politicians have relied on the federal tax system to do more than just raise revenue. The law includes many incentives to encourage certain activity, such as making donations to charities and buying a home. It is not certain that taxpayers will want to get rid of these incentives. Section VI covers eight areas that are currently receiving significant attention in the U.S. to improve the tax system and address the realities of a changed business environment. These areas include the need to simplify the tax rules, fix Social Security underfunding problems, update the tax rules to deal with e-commerce, to modernize international tax rules, and to improve tax compliance.

Summary of tax issues facing individuals and businesses—Looking at the U.S. tax system from a distance, three problems stand out, as described below.

- Increasing complexity of the tax laws increase compliance costs, may lead to inefficient decision-making due to lack of clarity as to how the tax rules will apply to a transaction, and lead to a loss of confidence in the system which erodes voluntary compliance.
- The tax rules have not kept up with economic and societal changes. Federal and state tax rules were written for an economy where most transactions occurred within discrete borders and involved tangible property. The operation of state and federal tax rules in the global information economy is in need of updating in order to better deal with electronic commerce, increased global competition, and a changing workforce.
- Political debate and rhetoric often prevent discussions that could better lead to identification of the key concerns of taxpayers and how to fix them. For example, much of the tax reform discussions today have focused on the need to simplify the return filing process and improve savings. Thus, there has been an emphasis on having a "postcard" size tax return, when the emphasis should probably be on using technology in order to have paperless filing. Also, businesses today likely face their highest compliance costs dealing with tax rules of over 30,000 subnational jurisdictions, yet these concerns have for the most part been omitted from the federal tax debate. Finally, while there is much discussion on the need to improve trade, not enough attention is paid to the international tax rules that sometimes operate in opposition to U.S. trade policies.

II. Brief Overview to the U.S. Tax System

A. Federal versus Subnational

Types of taxes—At the federal level, the individual income tax and Social Security taxes are the major elements of the tax system. At the subnational level (50 States, District of Columbia, and cities), sales tax is significant, as well as individual income tax and property taxes. Most states adopted a sales tax during the depression years (early 1930's) as a revenue source and to replace property taxes that were being used as a local revenue source.¹ It was helpful as a revenue source in light of fact that high federal income tax rates left little room for increased state income taxes. In addition, the sales tax is viewed as a relatively easy tax to collect with a potentially large yield.

Revenue by source and level of government - 1994 (000,000)²

Type of Tax	Federal	State	Local	Total
Individual income tax	\$543,055	\$117,128	\$11,682	\$671,865
Corporate income tax	\$140,385	\$25,692	\$2,627	\$168,704
Property tax	\$0	\$8,386	\$188,754	\$197,140
Sales taxes	\$0	\$123,006	\$26,034	\$149,040
Other sales taxes & excises	\$48,207	\$62,865	\$11,723	\$122,795
Customs duties	\$20,264	\$0	\$0	\$20,264
Other taxes	\$22,181	\$24,407	\$10,461	\$57,049
Utility taxes	\$0	\$3,784	\$62,684	\$66,468
Social Security and Medicare	\$441,983	\$0	\$0	\$441,983
Unemployment compensation	\$27	\$29,707	\$194	\$29,928

B. Variations among the States

Sales tax—Among the states, sales tax rates and the percentage of revenue derived from sales tax varies significantly (see chart below). In addition, the tax base, filing procedures, audit procedures, and method of allocating the tax between state and local governments vary among the states. This degree of variation is important today as subnational governments and industries explore how to improve the functioning of sales tax in the realm of electronic commerce. Although only 46 of the 50 states have a sales tax, many cities and counties also impose such a tax. In fact, in the U.S. there are over 6,000 jurisdictions capable of assessing sales tax.

¹ Due and Mikesell, *Sales Taxation - State and Local Structure and Administration*, The Urban Institute Press, 1995, pages 1 to 2.

² Source: Tax Foundation, *Facts & Figures On Government Finance*, 32nd Edition, 1998, page 10.

	State-level sales tax rate ³	% of state tax collections from general sales and use and gross receipts taxes (1996-1997 year) ⁴
All states	--	33.2
Arizona	5.0	41.8
California	6.0	32.4
Florida	6.0	57.3
Illinois	6.25	28.6
Massachusetts	5.0	21.6
New York	4.0	21.1
Oregon	No tax	0.0
Washington	6.5	58.7

Tax mix—State government tax collections for 1994 for all 50 states combined and selected states is provided below.⁵ In today's discussions of how income and sales taxes apply to transactions in electronic commerce, the varying mix of taxes among the states is an important element of the debate.

(In millions of dollars)

Type of tax	All 50 states ⁶	%	Calif.	%	New York	%	Texas	%
Property taxes	\$8,386	2.2	\$3,000	6.0	\$0	0	\$0	0
General sales tax	\$123,298	33.0	\$16,872	34.0	\$6,365	19.4	\$9,926	51.0
Selective sales tax ⁷	\$62,540	16.7	\$4,594	9.2	\$5,231	15.9	\$5,941	30.5
License taxes ⁸	\$24,203	6.5	\$2,471	5.0	\$941	2.9	\$2,526	13.0
Individual income tax	\$117,726	31.5	\$17,548	35.3	\$16,034	48.9	\$0	0
Corporate income tax	\$25,498	6.8	\$4,633	9.3	\$3,120	9.5	\$0	0
Death and gift	\$5,042	1.4	531	1.1	\$799	2.4	\$153	0.8
Documentary & Stock transfer	\$2,539	0.7	\$0	0	\$327	1.0	\$0	0
Severance	\$4,298	1.1	\$46	0.1	\$0	0	\$919	4.7
Other	\$279	0.1	\$0	0	\$0	0	\$0	0
Total	\$373,809	100	\$49,695	100	\$32,817	100	\$19,465	100

³ See http://www.taxadmin.org/fta/rate/sale_vdr.html. These tax rates do not include any additional sales tax that may be imposed by a city or county. For example, in the Silicon Valley in California, the sales tax rate with city and county rates included is 8.25%.

⁴ See <http://www.census.gov/govs/statetax/97tax.txt> and <http://www.taxadmin.org/fta/rate/97taxdis.html>.

⁵ Source: U.S. Census Bureau, <http://www.census.gov/>, under Government data. The chart does not reflect wage assessments for retirement and social insurance programs and unemployment compensation taxes.

⁶ Excludes the District of Columbia and local governments; thus, taxes that are collected at the local level, such as perhaps, property taxes, are not included in the chart.

⁷ Includes alcoholic beverage, amusement, insurance premium, motor fuels, pari-mutuel, public utilities and tobacco sales taxes.

⁸ Includes alcoholic beverage, amusement, corporation, hunting & fishing, motor vehicle, motor vehicle operators, public utility and occupation & business licenses.

Reliance on consumption taxes—U.S. versus other OECD countries—The U.S. does not rely on consumption taxes as much as other OECD countries. Also, with Australia's adoption of a goods and services tax in 2000, the U.S. will be mostly be itself at the low end of the following chart.

General Consumption Taxes as a Percentage of Total Tax Revenues—1994⁹

<u>Country</u>	<u>%</u>
Australia	8.5
Canada	15.5
France	17.2
Germany	18.1
Italy	15.4
Japan	5.3
Netherlands	14.7
United Kingdom	19.8
United States	7.9
Combined OECD countries	17.5

C. Brief History of U.S. Tax Systems

Rates—The current federal income tax came about soon after passage of the 16th Amendment to the U.S. Constitution in 1913. The federal tax system has been modified to some degree almost every year since the first income tax act in 1913. The highest marginal income tax rates for individuals have ranged tremendously over the past 86 years. In 1913, the tax rate for individuals was 1% on taxable income up to \$20,000, and 7% on taxable income over \$500,000. In 1952, the lowest individual tax bracket was 22.2% on taxable income up to \$4,000, and was 91% on taxable income over \$400,000. Following tax rates as high as 70% in 1980, the individual tax rates were lowered to just two rates starting in 1987—15% and 28%. In 1991, a 31% tax bracket was added, and in 1993, brackets for high-income individuals were added of 36% and 39.6%.

Capital gain income has typically been taxed at lower rates than ordinary income. Today, individuals generally face only a 20% tax rate on long-term (over one year) capital gains.

The income tax rates applicable to corporations have also varied since 1913 when they were 1%, to 52% in the early 1950s. Today, corporations face a four-rate graduated structure—15%, 25%, 34%, and 35%. Corporations pay tax on their capital gains at the same rates as for ordinary income.

Worldwide system—The U.S. income tax system is a worldwide system, rather than a territorial one. Thus, U.S. taxpayers and residents are taxed on their income earned throughout the world, rather only on income earned within the U.S. borders. Double taxation that arises when both the U.S. and another country subject a taxpayer's income to tax is relieved through a fairly complicated foreign tax credit (FTC) in the U.S. U.S. businesses using branches for their foreign operations will be taxed immediately on such foreign profits. On the other hand, U.S. corporations using foreign subsidiaries for their foreign operations will generally only be subject to U.S. taxation when profits are paid to the U.S. parent as a dividend. However, if an "anti-deferral" rule applies to the earnings of the foreign subsidiary, it will be subject to U.S. tax prior to being paid to the U.S. parent as a dividend. Generally, "subpart F" rules created in 1962, deny deferral of taxation on passive and other specified types of income of a foreign subsidiary.

⁹ Source: OECD, *Consumption Tax Trends*, 1997, page 10.

Total taxes as a percent of total income—Since 1913, taxes have increased as a percentage of total income, as illustrated in the following table.¹⁰

Year	Total Taxes as a % of Income
1913	8.2%
1940	18.3%
1955	26.8%
1970	31.7%
1980	33.3%
1990	33.2%
1997	35.2%

D. Mix of Taxes at the Federal Level

Over the past few decades, the individual and employment (Social Security) taxes have become the significant revenue sources for the U.S. government. The following table shows the mix of federal tax sources for 1977 and 1997.¹¹

Type of tax	1997		1977	
	(000,000,000)	%	(000,000,000)	%
Individual income tax	\$737	46.7	\$157.6	44.3
Corporate income tax	\$182	11.5	\$54.9	15.4
Employment taxes	\$539	34.2	\$106.5	30.0
Excise taxes	\$57	3.6	\$17.5	4.9
Customs, estate, gift, and miscellaneous taxes	\$63	4.0	\$19.0	5.4
Total	\$1,578	100.0	\$355.5	100.0

E. Basics of Business Taxation

Form of entity—The form of business entity matters for tax purposes. For example, a regular corporation (referred to as a "C" corporation because the tax rules governing it are in subchapter C of chapter 1 of subtitle A, Income Taxes, of the Internal Revenue Code) is taxed on its income and shareholders are also taxed on dividend income—a system of double taxation. Corporations have their own tax rate schedule. Partnerships, limited liability companies, and S Corporations (a corporation with 75 or fewer non-corporate shareholders that elects S status) are passthrough entities where income is only taxed to the owners. Thus, the tax rate depends on the type of owner (individual, C corporation or trust). A sole proprietor is also subject to only a single layer of tax computed using the individual tax rates and all income and deductions of the individual.

¹⁰ Source: Tax Foundation, Facts & Figures On Government Finance, 32nd Edition, 1998, page 13.

¹¹ Source: 1998 Form 1040 Instruction Booklet, and Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System under Present Law and Various Alternative Tax Systems*, JCS-1-96, 14 March 1996, page 5.

*Distribution of firms across organization types—1993*¹²

	# of firms	%	Assets (millions)	Gross receipts (millions)
C corporations	2,063,124	9.69	\$20,945,570	\$8,897,606
S corporations	1,901,505	8.94	\$870,299	\$1,967,936
Partnerships	1,467,567	6.90	\$2,155,112	\$567,790
Sole proprietorships	<u>15,848,883</u>	<u>74.47</u>	<u>not reported</u>	<u>\$752,751</u>
Totals	21,281,079	100.0	\$23,970,981	\$12,186,083

Additional tax rules relevant to businesses:

- a. Most fringe benefits paid by employers to employees, such as health insurance, are deductible by the business and usually are not taxable to the employee.
- b. Businesses must distinguish between employees earning wages who are subject to withholding taxes, and independent contractors.
- c. Most businesses must use the accrual method of accounting for income and expenses (others, typically small businesses without inventories, may use the cash method). In addition, expenditures for real property, equipment and other long-lived property must be capitalized and expensed over its useful life through depreciation and amortization deductions. Inventory may only be expensed when it is sold; various expenditures related to inventory must be added to inventory costs, rather than being currently expensed. Although these rules are similar to financial accounting rules, they are not exact. For example, the tax law generally requires more types of costs to be included in inventory than is required for financial reporting purposes. Also, depreciation on equipment for tax purposes is generally computed using the double-declining balance method, while straight-line depreciation is typically used for financial reporting purposes. Thus, a business must make adjustments to its financial reporting income to determine its taxable income and maintain multiple sets of records, such as for tracking inventory, depreciation and the basis of assets.

F. Basics of the U.S. Corporate Tax System

Rates—Unlike the tax rate schedule for individuals, the corporate tax rate structure is not adjusted annually for inflation).

<u>Taxable Income</u>	<u>Tax Rate</u>
\$0 to \$50,000	15%
\$50,000 - \$75,000	25%
over \$75,000	34%
over \$10,000,000	35%

Two surtaxes exist which cause the 15% and 25% brackets to be completely eliminated when income exceeds \$335,000, and the 34% bracket to be eliminated when taxable income exceeds \$18,333,333. Personal service corporations are taxed at a flat rate of 35%. For corporations, capital gains are taxed at the same rates as ordinary income.

Corporations that have utilized a significant mix of deductions and tax credits may find that their tax liability has been lowered to beyond the minimum amount Congress believes should be paid. In this

¹² Source: Joint Committee on Taxation, *Impact on Manufacturing, Energy, and Natural Resources of Replacing the Federal Income Tax* (JCS-7-96), 31 July 1996, pages 51 to 52; percentages added.

situation, the corporation will owe *alternative minimum tax* (AMT) that is computed at a 20% rate on a larger tax base.

Double taxation—Unlike the tax systems in many other countries, the U.S. corporate tax system is not integrated with the individual tax system. Thus, corporate earnings are taxed twice - first to the corporation, and secondly when paid as a dividend to the shareholders. While there have been studies and discussions in the past about different ways to integrate the tax systems, the cost to the federal fisc of doing so is the primary obstacle to removing this additional tax to capital.

G. Basics of the U.S. Individual Tax System

Through both personal and dependency deductions and a graduated rate structure, the individual income tax has always been progressive. The 1999 tax rates for married taxpayers filing jointly (tax brackets are adjusted annually for inflation):

<u>Taxable Income</u>	<u>Tax Rate</u>
\$0 to \$43,050	15%
\$43,050 - \$104,050	28%
\$104,050 - \$158,550	31%
\$158,550 - \$283,150	36%
over \$283,150	39.6%

High-income individuals must reduce the amount of their itemized deductions and personal exemptions, which in effect raises their tax rate. Thus, the highest tax rate actually exceeds the stated rate of 39.6%. Net long-term capital gains generally are not taxed any higher than 20%.

For most individuals, the tax rate structure only includes two brackets - 0% and 15%, as illustrated in the following table.¹³

Marginal tax bracket	Number of taxpayers (000)	Percentage
0%	41,616	31.7%
15%	61,579	47.0%
28%	23,946	18.3%
31%	2,346	1.8%
36%	1,012	0.8%
39.6%	516	0.4%
Total	131,015	100.0%

As indicated above, over 75% of individuals have an income tax rate of 15% or less. Employees and self-employed individuals face a payroll tax rate of 15.3% (employer and employee portions). Thus, many individuals have a payroll tax burden that exceeds their federal income tax burden.

Example: In 1999, a family with two dependent children taking the standard deduction owes no federal income tax if the family's taxable income is \$18,200 or less.¹⁴ This family would still owe Social Security and Medicare taxes on earned income (such as wages), at a combined employee-employer rate of 15.3%. The family would qualify for the refundable earned income tax credit (EITC).

¹³ Source: JCS-1-96, *supra*, page 44; percentages added. Amounts shown are projections for 1995.

Deductions and credits—Tax deductions available to individuals include medical expenses, charitable contributions, state income taxes, home mortgage interest, casualty and theft losses, alimony paid, and contributions to certain individually maintained retirement plans. Most of these deductions have a limitation applied to them such that the entire expenditure is not deductible. Individuals may also deduct personal and dependency exemptions. Tax credits available to individuals include child, child care, and higher education costs. Typically, these credits are not available to high-income individuals.

Alternative minimum tax—Individuals who have claimed a significant mix of deductions and tax credits may find that their tax liability has been lowered to beyond the minimum amount Congress believes should be paid. In this situation, the individual will owe *alternative minimum tax* (AMT) computed under a two-tier graduated rate structure of 26% and 28% on a larger tax base.

Distribution of the tax burden based on income—Recent data from the Joint Committee on Taxation and House Ways and Means Committee indicates the following for 1998:

<u>Income Class</u>	<u>% of Filers Who Pay No Income Taxes</u>	<u>Average Income Tax Liability (per tax return)</u>
Below \$10,000	93%	none
\$10,000 - \$20,000	66%	none
\$20,000 - \$30,000	39%	\$1,133
\$30,000 - \$40,000	21%	\$2,257
\$40,000 - \$50,000	9%	\$3,374
\$50,000 - \$75,000	2%	\$5,187
\$75,000 - \$100,000	.004%	\$9,479
\$100,000 - \$200,000	.002%	\$19,688
\$200,000 and over	.002%	\$128,128

In 1997, taxpayers with over \$100,000 of income paid 55.6% of the total income taxes paid, and in 1998 they paid 62.4%. This group includes 10.5 million taxpayers. In addition, 44.9 million taxpayers with less than \$20,000 of income paid no income taxes in either 1997 or 1998. This represents 35.7% of those eligible to pay in 1998.¹⁵

Statistics for 1993 show that the top 7% of individuals based on income (those with adjusted gross income (AGI) over \$75,000) paid 50% of all tax paid by individuals.¹⁶

Compliance—A 1999 Associated Press survey indicated that 56% of individuals hire someone to prepare their tax return.¹⁷

1999 Social Security and Medicare tax rates and limits (payroll taxes)—Social Security taxes are owed on the first \$72,600 at a rate of 6.2% by both the employee and the employer. Both the employee and the employer owe Medicare taxes on all earned income at a rate of 1.45%. Self-employed individuals are subject to the same Social Security and Medicare tax rates as an employee and employer combined are subject to. Total Social Security/Medicare taxes owed by individual with \$72,600 of wages in 1999 is \$5,554 (7.65% of wages). The employer would pay an amount equal to this as well. Wages and self-employment income greater than \$72,600 are still subject to Medicare taxes.

Other federal taxes applicable to individuals—Federal and state excise taxes also exist for various transactions and items, such as on tobacco and alcohol products, and telecommunications. Estate and gift

¹⁴ Represents a standard deduction of \$7,200 for married taxpayers filing jointly in 1999 and a personal and dependency exemption amount of \$2,750 for each spouse and child.

¹⁵ "Ways and Means Release on JCT Report," 98 TNT 241-20, 15 December 1998.

¹⁶ The Kiplinger Tax Letter, 21 April 1995.

¹⁷ Advisory from the Committee on Ways and Means, 18 May 1999.

taxes exist and generally apply to individuals with estates and/or gifts made exceeding \$625,000 for 1999 (this exemption amount is scheduled to increase to \$1,000,000 in 2006). Generally, gifts in excess of \$10,000 per donor are subject to gift tax by the donor. Beginning with gifts made in 1999, the \$10,000 exclusion is to be increased annually for inflation. The maximum estate and gift tax rate is 55%.

H. Administration of the Federal Tax Laws—The Internal Revenue Service (IRS)¹⁸

Organizational structure—The Internal Revenue Service (IRS) is the branch within the Department of the Treasury that administers the tax laws. The Treasury Department is part of the administrative branch of the U.S. federal government (the other two branches are the legislature (Congress) and the judiciary). The IRS oversees compliance with the laws through taxpayer assistance, audits, collection activities, and writing of regulations and rulings. A Commissioner appointed by the President for a 5-year term heads the IRS; the current Commissioner is Charles Rossotti. In the past, IRS Commissioners have been tax lawyers. Mr. Rossotti is not a tax attorney or tax accountant. Instead, he was selected for his management and systems experience.

Size and workload—In 1994, the IRS employed over 104,000 full-time equivalent employees. In fiscal year 1994, the IRS processed over 193,100,000 primary tax returns, 8,700,000 supplemental documents and over 1 billion information returns (such as Form 1099). In 1994, almost 123 million returns were filed and 1.3 million returns were audited (1.08% audit rate). The 1994 operating budget for the IRS exceeded \$7.3 billion. The IRS collects over \$1 trillion in revenue each year.

Cost to operate—In 1994, the operating costs of the IRS were \$7.4 billion and it collected \$1,276.5 billion. Thus, it cost the IRS roughly 58¢ to collect every \$100 it collected.¹⁹

Audit rate—In 1993, approximately 3% of corporate returns reporting less than \$10 million in assets were audited by the IRS. Less than 1% of individual income tax returns were audited.

Examples of recent technological improvements—Starting with the 1999 filing season, taxpayers were allowed to pay their taxes by credit card. The IRS does not see the credit card number and does not pay the transaction fee (the taxpayer pays it). Electronic filing has grown in popularity. In 1999, 19% more individual tax returns were filed electronically than in 1998. The IRS Web page has become quite popular as a source for obtaining tax forms and publications, as well as other information primarily of interest to tax practitioners. Between January 1, 1999 and March 21, 1999, the IRS Web page had over 531 million hits, representing a 155% increase over the same period for 1998.²⁰

New structure for 2001—In 1998, major legislation was enacted to restructure the IRS and change some of its audit and collection practices. Currently, the IRS examination and collection functions are split into four regional districts based on geography. Within each region are district offices where the auditors, collection agents, criminal investigation agents, and taxpayer service personnel are located. There are also ten service centers that process returns. The restructuring legislation calls for the IRS to be reorganized based on types of taxpayers and their needs, rather than on geographic regions. This restructuring is expected to be completed in 2001. The four operating units will be,

- 1) wage and investment income (about 90 million individual taxpayers);
- 2) small business (less than \$5 million of assets) + self employed (about 40 million taxpayers);
- 3) large businesses (about 80,000 mid-size and large case taxpayers, to be split among five industries:
 - i) manufacturing, construction and real estate; ii) food and retail; iii) energy, chemical and natural resources; iv) communication, technology and media; and
 - v) financial services); and

¹⁸ Unless otherwise noted, the information is from Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), 5 June 1995, page 78; hereinafter "JCS-18-95."

¹⁹ JCS-1-96, *supra*, page 76.

²⁰ Information release 1999-44, 29 April 1999.

4) tax-exempts (about 1.2 million taxpayers).

III. Brief History of Federal Tax Reform in the U.S.

A. What Tax "Reform" Has Meant in the U.S.

While tax legislation is enacted almost every year, the degree of change to the tax law varies. Changes in recent years have provided additional rights to taxpayers, added some tax breaks and educational incentives for low- to middle-income taxpayers, lowered the tax rates on capital gains, and closed some "loopholes." The last two pieces of tax legislation to use the term "reform" were, 1) the IRS Restructuring and Reform Act of 1998 that called for over 100 changes to the structure and operations of the IRS, and 2) the Tax Reform Act of 1986 that lowered tax rates for both individuals and corporations and eliminated various deductions and tax credits to broaden the tax base.

The term "reform" has more commonly been used today to refer to proposals to greatly change the federal tax law, such as to change from an income tax to a consumption tax or to make significant changes to the current income tax by broadening the base and lowering the rates in efforts to both simplify the law and to increase compliance. Section V of this article discusses these proposals and the opportunities and issues they raise.

B. Selected Tax and Fiscal System Changes and Issues of the Past 30 Years

Tax reforms in the U.S., have generally been "piecemeal" in that they focus on reforming a particular rule or problem. Some of the most significant changes are briefly described below. Many of these reforms are on-going ones that still receive attention from legislators and tax administrators today.

- 1. Mix of federal taxes**—The percentage of federal revenues derived from the individual income and payroll taxes have continued to increase while collections derived from the corporate income and various excise taxes have decreased. One possible reason for the decline in the corporate income tax and increase in the individual income tax as a revenue source is the increased ability of small businesses to operate either as a limited liability company (LLC) or an S corporation rather than as a corporation subject to corporate income taxes.
- 2. Federal spending**—A growing percentage of the federal budget is spent on entitlements (Social Security and Medicare primarily) and interest on the federal debt. For example, in 1963, about 30% of the federal budget was spent on entitlements and interest expense, while in 1993, 61.4% was spent on these items. It is projected that in 2003, entitlements and interest expense will represent 72% of federal spending.²¹
- 3. Tax rates and base**—Over the past 20 years, both the corporate and individual income tax rates have decreased. At the same time, the tax base has increased as certain credits and deductions have been eliminated or reduced.
- 4. Increasing problems with entitlement spending**—It is projected that Medicare will be insolvent within a few years. In addition, by the year 2032, more funds will be paid out to Social Security recipients than is collected from workers. For both political and social reasons, these problems are difficult ones to solve, yet most people would agree that the longer we wait for a solution, the more costly it will be.
- 5. Budget system**—To help prevent a growing national debt and help control deficit spending, a budget resolution was created in 1990 requiring that tax legislation be revenue neutral. Under this pay-as-you-go (PAYGO) system, any tax cut must be paid for with either a spending cut or revenue increase.

²¹ JCS-1-96, *supra*, page 3.

- 6. Focus on tax burden of low- and middle-income taxpayers**—Various tax credits, deductions, and exclusions added to the federal income tax law in the past several years are solely for the use of low- to middle-income taxpayers.
- 7. Elimination of tax shelters for individuals**—The Tax Reform Act of 1986 virtually eliminated the ability of individuals to reduce their tax liability by investing in passive activities that generated losses. While individuals can still invest in such activities (including rental activities), the losses that are generated may only be used against income from passive activities. Such passive losses may no longer be used to reduce wage and investment income.
- 8. International tax reforms to eliminate real and perceived abuses**—Concerns over whether multinational businesses were paying their "fair" share of taxes has led to tightening of transfer pricing rules, as well as anti-deferral rules (Subpart F) in the past 15 years. The Tax Reform Act of 1986 narrowed the exceptions to Subpart F income (thus making more types of foreign income subject to U.S. taxation when earned, rather than when repatriated). It also made more types of transactions that did not produce active income subject to U.S. taxation when earned (that is, deferral was eliminated). In addition, over the past 15 years, penalties for transfer pricing errors have been increased, additional recordkeeping is required, and extensive regulations were issued to explain pricing methodology. A few years ago, the IRS introduced an Advance Pricing Procedure (APA) which allows companies to get advance approval of their transfer pricing methodology by working with the IRS and the foreign taxing authority.
- 9. Complexity concerns**—For many years, members of Congress and tax practitioners have called for simplification of the income tax law. However, additional complexities, such as new tax credits, continue to be added to the law.

C. Periodic Discussions of Enacting a U.S. VAT

Recent history—For the past few decades, there has been much discussion of value-added tax in U.S. tax journals. For example, see 39 Tax Notes 244 (April 11, 1988) which lists 21 VAT articles previously published in *Tax Notes*. Many more have been written since then, as well as in other publications. In addition, various reports on VAT have been issued by the U.S. General Accounting Office (GAO) and U.S. Congressional Budget Office (CBO). In addition, Dr. Charles McLure of the Hoover Institution noted that in early 1972 it was rumored that President Nixon might propose a federal VAT.²² House Ways & Means Committee Chairman Al Ullman introduced VAT legislation in 1980.²³ A 1984 Treasury Department study on the VAT actually includes draft federal tax forms for reporting and collecting a credit invoice VAT.²⁴ In 1989, the Section of Taxation of the American Bar Association (ABA) issued a model statute for a credit invoice VAT.²⁵ In 1990, the American Institute of Certified Public Accountants (AICPA) released a report entitled *Design Issues in a Credit Method Value-Added Tax for the United States*. During tax reform debates in the 1990s, various proposals have been introduced for both a pure subtraction method VAT, as well as modified forms of a subtraction method VAT (discussed in Section V of this article).

²² Charles E. McLure, Jr., *The Tax On Value Added: Pros And Cons, in Value Added Tax: Two Views*, American Enterprise Institute for Public Policy Research, 1972, page 1.

²³ H.R. 7015, 96th Cong., 2d Sess., 126 Cong. Rec. 7481 (1980).

²⁴ Treasury Dept., *Tax Reform For Fairness, Simplicity, and Economic Growth, Value-Added Tax*, Vol. 3, Nov. 1984, at 125 to 127.

²⁵ American Bar Association, *Value Added Tax - A Model Statute and Commentary*, Alan Schenk, Reporter, 1989.

VAT evasiveness—The general view in the U.S. is that the public does not want a VAT. While 46 states impose a sales tax (which could just as well be a VAT), the concern is that a VAT at the federal level will just serve to increase total tax collections. While some of the tax reform proposals of recent years represent some type of either pure or modified VAT, they are not labeled as VATs by their sponsors. Congressman Arney has referred to the VAT as "possibly the most insidious tax scheme ever devised."²⁶ While Congressman Arney's flat tax is a modified form of subtraction VAT,²⁷ the impact of a subtraction VAT is generally the same as a European credit invoice type of VAT. A likely reason for "VAT evasiveness" is that the public does not understand how a VAT works. Thus, the VATs introduced in the current reform debate have been disguised by giving them another name, most likely in order to downplay the anti-VAT public sentiment that sponsors perceive may exist.

Author Comment: How likely is the prospect for major tax reform in the nature of replacing the federal income tax with a consumption tax if the promoters of this idea are not willing to honestly describe the particular proposal? Also, how can effective reform occur when the U.S. is primarily considering only some type of modified subtraction method VAT, and due to "VAT evasiveness," is not also considering the credit invoice VAT used by most of the world?

IV. Recent Reforms in the United States

A. Restructuring of the IRS and More Rights for Taxpayers

Overview—In late 1995, Congress included a provision in an appropriations bill to form a National Commission on Restructuring the IRS. The functions of this commission were to review the organizational structure of the IRS, its infrastructure, and the collection process. It was also to review requirements to improve paperless process, modernization efforts, collections, information accuracy levels, and changing the culture to make the IRS more efficient productive and customer-oriented. In addition, the commission was to review whether the IRS could be replaced with a quasi-governmental agency. Work was to be completed by October 1, 1997 (although the Commission's \$1 million budget was set to expire on July 1, 1997).

At the Commission's first hearing, it heard testimony from former IRS Commissioner Gibbs, and IRS Commissioner Richardson. At this hearing, co-chair Senator Kerrey asked the Commissioner whether she thought Congress and the president were conspiring to make it difficult for the IRS to meet its mission, particularly given the fact that the IRS had to adapt to over 9,500 IRC changes in the past ten years.²⁸ Senator Kerrey also stated that the Commission would focus on four areas: 1) increasing customer satisfaction, 2) tax systems modernization, 3) accounting, and 4) better internal management.²⁹

After the Commission issued its report to Congress in 1997, both the House and Senate held numerous hearings to consider the best organizational structure for the IRS and to investigate some alleged abuses by the IRS against taxpayers.

On July 22, 1998, Public Law 105-206, the IRS Restructuring and Reform Act of 1998 was signed into law.

²⁶ Richard Arney, *Caveat Emptor: The Case Against the National Sales Tax*, Policy Review, Summer 1995, at 31. Also, Anne Reilly Dowd, *Politics and Policy: Real Tax Reform Gathers Steam*, Fortune, 16 March 1995, at 14, quoting Congressman Arney as saying, "a VAT is an insidious hidden tax, which I will fight forever!"

²⁷ The main modification to a pure subtraction VAT that Congressman Arney makes is that businesses are allowed to subtract wages, but those wages are taxable to the employees and all taxpayers are subject to the same flat tax rate.

²⁸ "Restructuring Panel Looks At How IRS Can Get Things Right The First Time," 96 TNT 178-2 (11 September 1996).

²⁹ "Kerrey Statement At IRS Restructuring Commission Meeting," 96 TNT 178-31 (11 September 1996).

Structural changes to the IRS mandated by the Restructuring Act—Some of the provisions changing the operation of the IRS are briefly described below.

- New IRS Mission Statement (IR-98-59)—The mission of the IRS is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.
- The Act calls for a new Oversight Board to be part of the Treasury Department. It consists of the Treasury Secretary, IRS Commissioner, a full-time federal employee or a representative of employees, and six non-federal employees with qualifications in such areas as customer service, information technology, needs of taxpayers. Board members serve staggered 5-year terms and are paid. The Board oversees the administration functions and management of the IRS, but does not get involved with tax policy matters.
- The Commissioner is appointed by the President with the advice and consent of the Senate, for a 5-year term and can be reappointed. The Commissioner must have demonstrated ability in management and may be removed at the will of the President.
- A National Taxpayer Advocate (NTA) reports directly to the Commissioner. The NTA assists taxpayers in resolving problems with the IRS, identifies areas where taxpayers are having problems in dealing with the IRS, identifies potential legislative changes that might alleviate the problems, and proposes administrative changes to mitigate problems. The situations under which a Taxpayer Assistance Order can be issued to a taxpayer who is suffering from or about to suffer from a significant hardship were expanded.
- The national, regional, and district offices of the IRS are to be replaced with offices that focus on types of taxpayers and their needs. The four operating units will be 1) wage and investment income (about 90 million individual taxpayers); 2) small business (less than \$5 million of assets) + self employed (about 40 million taxpayers); 3) large businesses (about 80,000 mid-size and large case taxpayers, to be split among 5 industries: i) manufacturing, construction and real estate; ii) food and retail; iii) energy, chemical and natural resources; iv) communication, technology and media; and v) financial services); and 4) tax-exempts (about 1.2 million taxpayers). Expected to be completed in 2001.

New taxpayer rights and protections—Various changes were made to assist taxpayers in dealing with the IRS either in collection or audit activities. A few of these are listed below.

- Burden of Proof—The burden of proof shifts to the IRS in any court proceeding where the taxpayer introduces credible evidence with respect to a factual issue, if the taxpayer
 - 1) has complied with the Code requirements to substantiate any item,
 - 2) has maintained all records required under the tax law,
 - 3) has cooperated with reasonable requests of the IRS for witnesses, information, documents, meetings, and interviews, and
 - 4) is an individual, or if a partnership, corporation, or trust, has a net worth of \$7 million or less.
- Confidential communications—The attorney-client privilege of confidential communications was extended to also apply to clients of Certified Public Accountants and Enrolled Agents (tax practitioners "licensed" by the IRS).
- More information to taxpayers—The IRS is to provide more information to taxpayers regarding their rights during an audit, how tax returns are selected for audit, and how the appeals and collection process works.
- Right to civil damages—If an IRS employee acts negligently with respect to compliance of the law, a taxpayer may recover up to \$100,000 in civil damages.

- Liens and levies—A collection officer must obtain a higher level of approval within the IRS before he may seize certain taxpayer property.
- Complexity—The Act authorizes several studies on the complexity of the tax law.

Increased emphasis on electronic filing—The IRS is to have 80% of all returns filed electronically by 2007. The goal is to reduce errors in return processing. They must also work to accept electronic signatures. By 2007, the IRS is also to have procedures in place to allow taxpayers to review their own account electronically. In addition, the IRS is to study the feasibility of a return-free system for individuals for 2008 and later (something about 36 other countries already have).

Beyond the Restructuring Act—To improve its relationship with taxpayers, the IRS has engaged in various initiatives. For example, a few years ago, it started to form Volunteer Citizen Advocacy Panels that consist of private citizens who assist the IRS in identifying problems and making recommendations on how to improve its systems and procedures. In addition, the IRS has scheduled several "problem-solving" days where taxpayers can meet with IRS employees to get collection problems resolved. Finally, the IRS is continuing to expand the number of days and hours that it is reachable by phone to assist taxpayers.

In its efforts to improve service to customers, IRS Commissioner Rossotti has identified three strategic goals: 1) top quality service to each taxpayer; 2) top quality service to all taxpayers (such as by applying the law with integrity and fairness to all); and 3) productivity through a quality work environment.³⁰

B. Changes to the Tax Burden for Low- to Middle-Income Taxpayers

In the past few years, new tax credits and savings and educational incentives have been added to the law for the benefit of low- to middle-income taxpayers. Discussions in Congress continue to explore ways to reduce the tax burden, with a focus on middle income taxpayers. There is little support for tax cuts that also benefit higher income individuals.

C. Concerns over "Corporate Tax Shelters"

Overview—In the 1980s, use of tax shelters by middle- to high-income individuals was widespread. With tax rates as high as 70%, some individuals were eager to invest in real estate and other limited partnerships that produced interest expense and depreciation deductions. With the Tax Reform Act of 1986, Congress added a rule to only allow a deduction from a tax shelter (referred to in the law as a "passive activity") against income from a tax shelter. The result was that the shelter market for individuals ended. However, in recent years, there has been increased activity by some corporations to engage in financial transactions that appear to be done solely for tax purposes, rather than for business purposes. In 1997, Congress enacted a penalty provision for practitioners that market certain shelters. In 1999, President Clinton proposed 16 additional rules to further combat the spread of corporate tax shelters. In addition, an article in *Forbes* magazine ("The Hustling of X-Rated Shelters," *Forbes*, 14 December 1998) highlighted the types of transactions some corporations were engaging in that posed audit risks and appeared to have no business purpose.

1997 Legislation and Treasury Study—In 1997, Congress broadened the definition of a tax shelter and added a tax shelter registration requirement. Prior to this change, a tax shelter meant some type of entity or plan where the principal purpose was the avoidance or evasion of federal income taxes. The TRA'97 changed "the principal purpose" to "a significant purpose." As of 23 July 1999, no guidance has been issued under these changes. The registration requirements are not effective until regulations are issued. Apparently, the IRS is having difficulty separating "legitimate" tax shelters (such as corporate reorganizations and like-kind exchanges) from "bad" tax shelters. In July 1999, the Treasury Department released a report, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative*

³⁰ Charles O. Rossotti, "Modernizing America's Tax Agency," *Tax Notes*, 24 May 1999, page 1191.

*Proposals.*³¹ The Treasury Department would like to provide a "generic solution to curb the growth of corporate tax shelters" rather than just dealing with them after-the-fact. The report proposes the following definition of a "tax avoidance transaction" for which deductions, credits and exclusions could be denied.³²

"A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction are insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income.

A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the congressional purpose for such provision and the interaction of such provision with other provisions of the Code.)"

Also in July 1999, the Joint Committee on Taxation (which serves the congressional tax-writing committees) issued a legislatively-mandated report on penalty and interest provisions. This report also provides suggestions for using the penalty system to cut down on the proliferation of corporate tax shelters. Congress is expected to analyze the Treasury and Joint Committee on Taxation reports to determine what additional measures, if any, are warranted to address "abusive" corporate tax shelters.

Judicial approach—Courts have been able to, in effect, disallow a "tax shelter" using the economic substance and substance over form doctrines.³³

President Clinton's 1999 proposals—The 16 proposals include increasing penalties for substantial understatements of tax by corporations, increased disclosure of certain transactions, disallowance of a deduction for any fee paid to purchase a tax shelter, and imposition of a 25% excise tax on fees received for advising with respect to a corporate tax shelter.

Practitioner reactions—The Tax Section of the American Bar Association (ABA) presented testimony before the Senate Finance Committee on April 27, 1999 at a hearing on corporate tax shelters. The ABA expressed concern that in some tax shelter situations, taxpayers avoided penalties because they had favorable opinion letters from tax advisers. The ABA Tax Section has formed a task force to consider changes to its rules of conduct to address abusive situations. The Tax Section also expressed concern over the fact that typically the tax shelter transaction was treated differently for tax and financial reporting purposes, the sometimes secretive marketing of the shelters, and the fact that the Treasury tends to disallow the transaction prospectively only. The Tax Section also noted that problems in the tax law, such as its complexity, also needed to be addressed to reduce tax shelter activity.³⁴

The American Institute of Certified Public Accountants (AICPA) testified before the House Ways and Means Committee on 10 March 1999 and expressed similar concerns and observations. The AICPA noted that taxpayers have the right to arrange their affairs so as to minimize their tax liabilities. Thus, any tax shelter proposals that limited the ability of taxpayers to engage in proper transactions would be inappropriate. The AICPA expressed concern "that increased and multiple penalties, based on a loosely

³¹ Available at <http://www.ustreas.gov/taxpolicy/>.

³² U.S. Treasury Department, *The Problem of Corporate Tax Shelters*, July 1999, page 157.

³³ See *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999).

³⁴ "ABA Offers Comments on Corporate Tax Shelter Problem," *Tax Notes*, 10 May 1999, page 919.

defined standard and with no abatement for reasonable cause, should not apply in a subjective area where differences of opinion are the norm, not the exception."³⁵

D. International Tax Reforms

Overview—Changes and proposals in the international tax area over the past few years have varied from simplifying the law, to adding provisions intended to prevent deferral of foreign income, to updating the law to address transfers of software. Political debates have surrounded much of the international taxation area. Some politicians and taxpayers believe that current tax rules encourage (or don't discourage) U.S. companies from expanding their foreign operations, at the expense of U.S. jobs. Some also believe that foreign corporations with U.S. operations are not paying their proper amount of U.S. tax due to transfer pricing discrepancies. On the other hand, some politicians and taxpayers are concerned that the current U.S. international tax rules are out of sync with policies to expand trade and create adverse competitive disadvantages for U.S. multinational corporations that must be remedied. Listed and briefly described below are some recent examples of the variety of international tax law changes in recent years. Section VI explains some of the discussions that are currently taking place to improve international competitiveness for U.S. businesses and to modernize current international tax rules that were written in the 1960s when U.S. businesses faced a much different global economy.

Mixed message—One of the changes to accelerate taxation of foreign income added in recent years was "IRC §956A" enacted in 1993 and repealed in 1996 as a simplification measure. IRC §956A required 10% shareholders of a controlled foreign corporation (CFC) to currently include in income, their share of the CFC's earnings attributable to excess passive assets. Excess passive assets existed if the average of the amounts of the CFC's passive assets exceeded 25% of the average of the amounts of its total assets. U.S. corporations with foreign subsidiaries discovered that a way to avoid the impact of IRC §956 was to have their foreign subsidiaries invest in "active" foreign assets, which was the opposite effect that the 1993 legislation was intended to have.

Similarly, in each of the Administration's recent annual budgets, a proposal to change the export source rule from a 50/50 rule to an activity-based approach has been included (a significant revenue raiser). The result of this type of change would be a reduced ability of U.S. multinational companies to use their foreign tax credits which would increase the role of U.S. taxes in decisions about where to expand operations, with the U.S. being the ultimate loser in such decisions. The Republican-led Congresses of the past few years, have ignored the Administration's export source proposal.

Updates for software transactions—Two significant changes since 1997 have clarified how the tax law applies to transfers of software. For decades, federal and state tax laws (as well as other laws) have raised issues as to how they apply to software. These issues stem from the problems of determining if software should be classified as tangible or intangible, and whether the form (license generating royalty income) or the substance (off-the-shelf software treated as equivalent to a sale of goods) of a transfer should be respected. The first change was a legislative one in 1997 to provide that software licensed for reproduction abroad can be considered export property under the foreign sales corporation (FSC) provisions. The second change was made by the IRS through regulations that provide guidance on how transfers of software should be classified (as a transfer of a copyright producing royalty income, or as a sale of goods).³⁶

Transfer pricing—The U.S. has reduced transfer pricing issues by issuing regulations that provide extensive guidance on determination of an arm's-length charge for cross-border transactions. In addition, penalties for incorrect valuations in pricing have been increased in recent years. The IRS has attempted to reduce the audit time spent on transfer pricing by allowing taxpayers to apply for an "Advance Pricing

³⁵ "AICPA Comments on Administration's Corporate Tax Shelter Proposals," *The Tax Adviser*, May 1999, page 346.

³⁶ Treasury regulation §1.861-18.

Agreement" to be negotiated by the taxpayer, U.S., and foreign tax authority. The APA establishes an approved transfer pricing methodology that generally alleviates audit issues.

E. Tax Gap Measures

To reduce the tax gap (currently, about 17% of federal taxes go uncollected), various legislative and administrative remedies have been created in the past several years. These remedies include increased reporting obligations by payors of income, increased penalties, more specific focus by examiners on understanding the nature of the business being audited and how to detect unreported income, and simpler filing procedures for some individuals.

V. Proposals for Major Federal Tax Reform in the United States

A. Overview

What is being said about making major changes to the U.S. income tax system—Recent quotes from members of Congress and the Administration provide a concise summary of the politics and uncertainties of even suggesting that the federal income tax (and perhaps Social Security and excise taxes) be replaced with a consumption tax. Some of these quotes are provided below.

In my opinion, our challenge will do no less than pull the current Income Tax Code out by its roots and throw it away so that it can never grow back. When we abolish the income tax from the books as an insurance policy I would not at all mind seeing a repeal of the 16th Amendment. To make doubly sure that the Income Tax won't rise from the dead, and won't ever again haunt the American people.

House Ways & Means Chairman Archer (R-Texas) at a tax reform hearing on June 6, 1995

Our tax system needs more than a Band-Aid. It needs a transplant. If we are serious about our Nation's future, we must scrap the current tax system and put in its place a system that works.

(former) Senator Nunn (D-Georgia), April 25, 1995, upon introduction of the USA tax system

Our current tax system is broken and needs to be scrapped and replaced with a system that is fair, simple and honest. The current tax code is complex; unfair; inhibits savings, investment and job creation; imposes a heavy burden on families; and undermines the integrity of the democratic process. It must go.

Congressman Arme, testimony before the House Ways & Means Committee, April 15, 1997

I strongly believe that Congress should abolish the income tax system in its entirety and begin anew. A single-rate consumption tax on goods and services is the fundamental change needed to spur economic growth and increase wages, saving and investment. Our intrusive tax system should be transformed to one that is fair, transparent and friendly to savings and investment. A sales tax would achieve these goals and allow us to abolish the IRS. Every dollar the American people earn would be theirs to save, spend or invest. They would not have to account for it or face intrusive audits. They could pass it along to loved ones without strings attached.

Senator Lugar, January 20, 1999 press release

It's time for America to cut through the jungle of federal tax laws. The tax code is one million words and 5000 pages. America needs a tax code that is simpler and fairer. One that spurs economic growth and creates jobs.

Congressman English's Web page June 1999

Replacing the entire income tax with a consumption tax would be a grand experiment of applying theory to a practical application that no other country in the world has chosen to undertake. Proponents of these plans must,

therefore, overcome a significant hurdle - they must show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

(former) Assistant Secretary for Tax Policy, Les Samuels, June 7, 1995 testimony

Major—"Major" federal tax reform typically refers to replacing the federal income tax system (and perhaps also estate and gifts and payroll taxes) with a consumption tax. However, for some people, major tax reform means making drastic changes to the current income tax system such as by broadening the base, simplifying it by removing various credits and deductions, and lowering the rates. Still others would like to see changes made to encourage certain types of significant activities, such as hiring and training of workers, U.S. research and development work, or discouraging activities that cause greenhouse emissions.

Subnational tax reform—Today, reforms of subnational tax systems generally are suggested for all or some of the following reasons, and tend to vary from state to state. While the focus of this article is on federal tax reform, two types of reform being discussed at the subnational level are mentioned below to provide a better perspective of the concerns of taxpayers and governments.

- a. Increase the collection of use tax (the complement to sales tax that applies when a purchase is made out of state). Current law only allows a state to make a vendor collect this tax from customers if the vendor has a physical presence in the state. Increasing use of mail order and e-commerce activities results in a decline in state use tax collections.
- b. Modernizing and improving tax systems to address shifts in consumption patterns from taxable goods to non-taxable services (sales tax issue), utility and excise tax systems that may no longer make sense given today's merger of industries, increased competition among the states for businesses to locate in the state, reduction of the tax burden on the poor, and improved use of technology to simplify compliance and decrease the tax gap.³⁷

B. Why Major Federal Tax Reform Is Being Discussed

An imperfect system—The current U.S. tax system is commonly viewed as having the following imperfections:

- a. Taxing of savings that represent previously taxed income.
- b. Double taxing corporate income.
- c. Encouraging corporate debt over corporate equity.
- d. Hindering capital formation (for example, preference for debt over equity, limits on capital losses, limited incentives for capital investments).
- e. Inflationary gains are taxed.
- f. Certain types of income are given preferential treatment, such as fringe benefits, tax-exempt bond interest, and capital gains; such preferences can lead to distorted decision-making.
- g. Lack of basic conformity with accounting principles, such as disregard for the matching principle.
- h. Sometimes, the recipient must report income before the payor is allowed to deduct the related payment.
- i. Many married taxpayers are subject to higher tax rates as married taxpayers than if they each filed as single (the *marriage penalty*).
- j. Many dollars of taxes go uncollected every year (tax gap).

³⁷ For an excellent summary of tax and fiscal issues facing state and local governments in the U.S. see National League of Cities' *Is the New Global Economy Leaving State-Local Tax Structures Behind?*, by Bonnett, 1998; (888) 571-2939.

Complexity as a major problem of the federal income tax—Taxpayers at all income levels tend to have complaints regarding the complexity of the federal income tax rules. The instructions to the simplest individual tax form (Form 1040 EZ) is typically over 30 pages long. This complexity leads more and more individuals to seek professional assistance in preparing their income tax returns. In 1993, 7 of every 10 individual income tax returns claimed the standard deduction (which is viewed as a simple return) and about 50% of all individual returns were prepared by a paid preparer.³⁸ Congressman Armev has noted that "Americans spend 5.4 billion man-hours each year calculating their taxes - more man-hours than it takes to build every car, truck and van produced in the United States. The tax code puts a drag on our economy worth an estimated \$232 billion a year in compliance costs, an amount equal to \$900 for every man, woman, and child in the country."³⁹ In addition, some of the most complex provisions apply to those least able to afford professional tax preparation (for example, earned income tax credit, definition of a dependent).

Much of the complexity is brought about by constant changes to the tax law and the addition of new exclusions and tax credits for individuals over the past few years. As (former) IRS Commissioner Margaret Richardson stated, "We cannot lose sight of the fact that complexity is the result of our struggle for fairness."

Lack of neutrality—The current U.S. tax system is frequently used to create incentives to either encourage a particular activity or discourage a particular activity (that is, it is not neutral). The cost of preferential rules to the tax system is rarely weighed against alternatives for reaching the same goal, either when they are added, or in future years. For example, does the cost to the government of the preference, which allows interest income on state and local bond interest to be exempt from tax, cost the federal government more than the benefit derived by the state and local governments? Does anyone know? If the cost to the federal government is higher, a direct subsidy from the federal government to the state and local governments would be "cheaper" than having a tax preference for bond interest.

Some preferences have evolved to the point that people have lost sight of their underlying purpose. For example, a home mortgage deduction is allowed to encourage home ownership. However, the current tax rule allows for deduction of mortgage interest on two homes, rather than just one, and on debt up to \$1.1 million dollars, far larger than the average home cost in the U.S. Additional problems created by a non-neutral system that has various "preferential" rules is increased complexity of the law and lack of respect for the system that appears to provide favors to selected taxpayers. Professors Hall and Rabushka, designers of the "flat tax" state: "The federal income tax encourages lawyers and lobbyists to seek tax favors from Congress instead of earning an honest living."⁴⁰ Such views tend to harm compliance rates and lead to lack of faith in the tax system.

C. Commonly Listed Goals for Major Federal Tax Reform

Listed below are various goals that have been suggested as reasons to undertake major reform at the federal level in the U.S. Background information is also provided here to better understand why each of the goals has likely been offered as a reason for reform. The following goals are not listed in any particular order.

1. To simplify the current tax system.

³⁸ "Tax Report," *Wall Street Journal*, 21 June 1995, page A1.

³⁹ Cong. Rec., 19 July 1995, E1461.

⁴⁰ Hall and Rabushka, *The Flat Tax*, second edition, page 3.

A 1993 study by the Tax Foundation found that on average, a Fortune 500 company spends \$2,110,000 annually to comply with income taxes. For small business, the federal income tax compliance cost for 1990 was 390% of the tax owed.⁴¹

At tax reform hearings before the House Ways & Means Committee in June 1995, the senior tax counsel for Mobil Corporation brought with him his 9 volume, 6,300 page, 76-pound federal tax return. He stated that Mobil spent \$10 million, 57 man-years and workpapers consisting of about 146,000 documents to produce the return for which Mobil owed \$2 billion in taxes.⁴²

2. To improve compliance to reduce the tax gap.

The *tax gap* is the difference between taxes that are owed and taxes that are voluntarily paid. Currently, the federal tax gap exceeds \$110 billion per year.⁴³ About 75% of the tax gap is caused by individuals, and the rest by corporate taxpayers.

3. To improve the ability of companies to compete globally.

The U.S. tax system has differences from those of trading partners: the U.S. has a worldwide tax system where all income is taxed no matter where it is earned (rather than a territorial system which only taxes income earned within the borders); U.S. income taxes are not border adjustable (for example, GATT⁴⁴ and the WTO⁴⁵ favor indirect taxes, such as a value-added tax, which can be imposed on imported goods and refunded for exports). The United States and Australia are the only OECD⁴⁶ countries without a value-added tax.⁴⁷ However, Australia will start to use a goods and services tax (GST) in 2000.

4. To eliminate the IRS from every citizen's life.

House Ways & Means Chairman Bill Archer includes eliminating the IRS from the lives of individuals as one of his five key objectives for federal tax reform: "I mean completely and totally out of our individual lives."⁴⁸

5. To serve as part of a plan to shrink government.

If the public wants a smaller government, a simpler tax system would likely be needed in order to shrink the size of the IRS and Treasury Department. Also, if smaller government means that less revenue is needed, than perhaps the current system should be reviewed to determine what spending will be reduced and whether it ties into specific tax rules that could be eliminated. Such a review should also consider where complications and inefficiencies of our current tax system could be eliminated.

⁴¹ "The Income Tax Compliance Cost of Big Business," the Tax Foundation, Nov. 1993; "Accounting Costs, Another Tax," by Hall, Wall Street Journal, 9 December 1993, page A18.

⁴² "Hearings open on tax overhaul," San Jose Mercury News, 7 June 1995.

⁴³ The IRS estimates that the amount of taxes not voluntarily paid is about 17% of total federal income taxes each year (83% compliance rate). IRS enforcement efforts eventually raise the compliance rate to about 87% each tax year. GAO, *Reducing The Tax Gap - Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June 1995, pages 2 to 3.

⁴⁴ General Agreement on Tariffs and Trade.

⁴⁵ World Trade Organization.

⁴⁶ Organization for Economic Cooperation and Development.

⁴⁷ OECD, *Consumption Tax Trends*, 1995, page 11; hereinafter, *Consumption Tax Trends*.

⁴⁸ Congressman Archer, "Goals of Fundamental Tax Reform," in *Frontiers of Tax Reform*, The Hoover Institute, 1996, page 4.

6. To serve as part of a plan to change government spending.

Government spending has changed greatly in the past 30 years such that today, entitlement spending and payment of interest on the federal debt dominate, relative to prior years.⁴⁹

Major Spending	1994	1962
Percentage of outlays for:		
Discretionary spending	37.3%	70.1%
Entitlements and other mandatory spending	54.0%	30.2%
Deposit insurance	(0.5%)	(0.4%)
Net interest	13.9%	6.5%
Offsetting receipts	<u>(4.7%)</u>	<u>(6.4%)</u>
Total	100.0%	100.0%

Problems exist with Social Security and Medicare funding in that funds are not expected to be sufficient to meet the needs of the "baby boom" generation. In 1995, the Bipartisan Commission on Entitlement and Tax Reform reported that if no policy changes are made, spending on entitlements and interest on the debt will consume almost all federal revenue by the year 2010. By the year 2030, federal revenue will not be sufficient to pay for entitlement spending.⁵⁰ Medicare Part A is currently projected to be insolvent by the year 2003.

7. To enable individuals to better see how much money they are giving to the government.

Congressman Arney's first flat tax bill introduced in 1994, H.R. 4585, proposed to eliminate withholding and replace it with monthly payments to better enable citizens to see what they were spending on government. This proposal was eliminated from Arney's current flat tax proposal, H.R. 1040. However, this goal also underlies the proposal to replace the U.S. income tax system with a national retail sales tax. Proponents of a national retail sales tax suggest that it will be a more transparent system than the current wage withholding technique used for the individual income tax, and will enable individuals to better control how much they pay, by controlling how much they spend.

8. To improve savings.

The current U.S. tax system is viewed as not encouraging savings because it taxes earnings from savings. The U.S. savings rate is lower than that of Germany and Japan. OECD statistics show that between 1983 and 1992, Japan's national savings rate was over five times higher than the U.S. savings rate while Germany's rate was three times higher and than the U.S. and the European Union rate was over twice as much.

Net national savings in the U.S. as a percentage of GDP is low relative to other countries. For example, in 1989, the OECD reported that the net national savings as a percentage of GDP was as follows for these countries:⁵¹

⁴⁹ "The Economic And Budget Outlook: Fiscal Years 1996-2000," CBO Director Robert Reischauer, January 1995, Tables E-4 and E-6.

⁵⁰ Final Report To The President from the Bipartisan Commission on Entitlement and Tax Reform, January 1995, pages 9 and 17.

⁵¹ JCS-1-96, *supra*, page 86.

<u>Country</u>	<u>Net national savings as a % of GDP</u>
Canada	8.6
France	8.8
Germany	14.1
Italy	8.5
Japan	20.0
Netherlands	13.4
United Kingdom	4.5
United States	3.2

9. To improve capital formation.

The current system favors debt over equity because corporations can deduct interest payments, but cannot deduct dividend payments. Also, some view our current tax system as taxing capital gains at too high of a rate and not adjusting for inflationary gains (that is, the cost of a capital asset is not adjusted upward to reflect the effects of inflation, thus, when that asset is sold at a gain, some (or perhaps all) of that gain represents inflation, rather than a true increase in value). In addition, some view IRC §1202, added in 1993 to allow non-corporate shareholders a 50% exclusion for gains from small business stock held over five years, as too restrictive to be useful. In addition, some view the estate tax system as another hindrance to capital formation. Finally, double taxation of corporate income that exists under current federal income tax rules is viewed as increasing the cost of capital.

10. To reduce the tax burden for individuals.

The strong U.S. economy has led to a budget surplus (if the Social Security fund surplus is included) after a few decades of deficits. Many politicians would like to return some of this surplus back to individuals now. However, many would also like to wait until the Social Security system is strengthened.

Arguably, the American public will only give up favored deductions and tax credits if tax reform results in a lower tax liability for them now and in the future.

Author Comment: Before Congress engages in major tax reform, it should clearly indicate what the objectives are and rank the goals in order of importance so that proposals can be properly evaluated. Each of the current reform proposals does not meet each of the goals listed above.

D. Is Major Federal Tax Reform Likely?

Overview—While most taxpayers and politicians would agree with the ten goals of tax reform listed above, how to achieve them is a matter of great debate. Current proposals call for a complete replacement of the federal income tax with a consumption tax. This would be a significant economic event such that it would be difficult to ensure revenue neutrality as well as distributional neutrality (that is, different income categories of taxpayers could see changes in their tax liability, as could different industries). Also, the difficulties of transitioning from one system to another raises a number of challenges that could be significant enough to prevent major reform from occurring. For example, what should happen to loss and credit carryovers that businesses have at the date the U.S. switches from an income tax to a consumption tax? Also, if the U.S. switched to a national retail sales tax, would senior citizens who saved their earnings on which they paid income tax, now also have to pay sales tax when they spend their previously taxed income?

Additional issues and hindrances to major reform—

- a. *The "politics" of tax reform.* It will be difficult to campaign for a tax plan that calls for elimination of favored deductions, such as the home mortgage deduction. However, does such a deduction

make sense under the particular proposal, politics aside? Also, sound bites can't tell the whole story. Tax reform is a complicated topic involving many technical points and economic theories.

b. *Failure to clearly state the purpose of reform and to determine whether it is what taxpayers desire.* As noted earlier, many different goals for tax reform have been identified. Many, if not all, of these goals can also be achieved by keeping and reforming the income tax system, rather than replacing it with a consumption tax. Thus, good reasons are needed to justify enactment of a consumption tax. Also, failure to clearly identify the concerns of taxpayers today may lead them not to accept reforms that do not address their concerns.

c. *Lack of objective information.* Press releases from sponsors of proposals tend to have more good news than bad news. For example, the Nunn-Domenici press release does not state that fringe benefits would be included in income under the USA tax proposal. However, the legislative proposal is clear that fringe benefits are included in gross income (proposed §3(a)(2)). Similarly, press releases from Congressman Gephardt have stressed a "10% tax" plan. However, the plan actually involves a graduated 5-tax rate structure ranging from 10% to 34%.

Also, surveys of taxpayers used to indicate a desire for reform usually do not adequately explain what the reform would mean to the respondent and the economy. Also, few people understand our current tax system well enough to compare it to anything. During flat tax discussions in 1982, a Harris poll indicated that 62% of individuals favored a 14% flat rate. However, the survey also indicated that well over 50% favored keeping deductions that would have to be eliminated to get the tax rate reduced to 14%.⁵²

d. *Definitions.* The term "flat" tax is often used in the tax debate with different meanings. In general, a flat tax means a single tax rate. However, when used in the tax debate today, it generally means a proposal, such as the Arney flat tax, which represents significant changes to our current tax base.

e. *Subjective terminology.* What does it mean to say that a proposal is one for a "fair" tax system? This word has different meanings to different people. For example, Congressman Arney interprets "fair" as meaning that every taxpayer is subject to the same tax rate. On the other hand, Congressman Gephardt interprets "fair" to mean that more types of income are subject to tax so that some individuals and businesses do not get benefit of preferences that currently exist in the tax law.

f. *Taxes as the source of all that is wrong with the country.* Taxes are a topic on which many people have some opinion and it is not a popular topic. Thus, taxes are an easy target for distributing blame for such things as unemployment, scarce capital, and burdens on families, to name a few. Evaluators of tax reform should ask themselves what problems can and cannot realistically be solved through the tax law before believing that the tax law is the source of most problems in the U.S.

g. *Key missing information.* A lot of key information is missing from most of the current proposals, making it difficult, if not impossible, to effectively evaluate them. For example, most proposals are silent as to what happens to estate and gift taxes, basis of assets transferred by death or gift, corporate reorganization rules, basis rules for ownership interests in businesses, and transitional rules (such as what happens to existing business asset basis and loss and credit carryforwards upon enactment of the new tax system). Also, a key piece of information missing from each plan is its revenue estimate. For example, most plans are offered as being revenue neutral; that is, they will raise as much revenue as our current tax system. However, without revenue estimates, the currently proposed rates and tax base may not present the true picture (that is, rates might have to be changed).

⁵² *Business Week*, 6 September 1982, page 15.

E. Consumption Tax Background

Not an entirely new idea for the U.S.—Leading up to the ratification of the U.S. Constitution in 1789, a series of papers was published referred to as *The Federalist Papers*. It is interesting to note that Paper Number 21, allegedly written by Alexander Hamilton, talks about the benefits of a consumption tax.

"It is a signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. They prescribe their own limit, which cannot be exceeded without defeating the end proposed—that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty that, "in political arithmetic, two and two do not always make four." If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them."

The operation of a consumption tax—A consumption tax is a tax on spending rather than on income; income is taxed when spent (consumed), not when it is saved. Following is the formula for a consumption tax:

$$\text{Income} = \text{Consumption} + \text{Savings}$$

$$\text{Thus,} \quad \text{Consumption} = \text{Income} - \text{Savings}$$

Considering the above formulas and the current U.S. tax system, a few observations can be made:

- 1) If income is taxed, that means that both consumption and savings are taxed. However, the U.S. tax system does not tax all income. Some types of income, such as most types of fringe benefits are excluded from income, and various deductions, such as for home mortgage interest, limited medical expenses, and charitable contributions are allowed. In addition, the U.S. income tax system has various provisions to encourage savings, such as reduced taxation of capital gain income, exclusion of up to \$250,000 gain from sale of a principal residence (\$500,000 if married), and personal retirement savings deductions.
- 2) Ignoring possible deductions and exclusions, a tax base consisting of consumption is smaller than a tax base consisting of income. Thus, for a U.S. consumption tax to raise as much revenue as the current income tax, it would appear that the consumption tax rate would have to be higher than the current income tax rates.
- 3) If consumption is taxed, it can either be done at the point of consumption, such as with a sales tax, or directly (by taxing Income less Savings). There are two ways to measure consumption as Income less Savings: a) all income less savings ("cash-flow approach"), or b) earned income only ("tax prepayment approach"). Following are some simple examples using a 20% tax rate to illustrate the equality of the cash flow and tax prepayment approaches to taxing consumption.⁵³

Cash flow approach: Individual earns \$25,000 and saves \$1,000 in an account earning 5%. The \$1,000 savings deduction produces a tax benefit of \$200 (\$1,000 x 20% tax rate). One year later, Individual withdraws the \$1,000 + the \$50 interest, and includes \$1,050 in his tax base producing an additional tax of \$210 (\$1,050 x 20%). The net proceeds of the transaction is \$1,050 - \$210 = \$840. This approach is used in the USA tax proposal discussed later.

Tax prepayment approach: Same facts as above. Individual pays \$200 tax on the \$1,000 saved, and thus saves only \$800. One year later, he withdraws \$840 (\$800 + 5% interest) and pays no tax on any of this amount, thus netting \$840 as in the earlier example. This approach is used in the Arney flat tax proposal discussed later.

Indications that a tax is a consumption tax—An indication that a tax is a consumption tax is that it exempts savings, and for businesses, it allows investment in capital (such as land, building, and

⁵³ From example at JCS-18-95, *supra*, pages 52 - 54.

equipment) to be deducted when acquired, rather than depreciated over a period of years. Such expensing removes the expected future income from that investment from taxation (under an assumption that the cost of the asset reflects the net present value of its expected future income).

Key benefits of a consumption tax—A commonly cited economic benefit of a consumption tax over an income tax is that a consumption tax does not penalize a taxpayer who earns and saves in early years and then consumes in later years, relative to a taxpayer who does not postpone consumption. A consumption tax would treat taxpayers with either consumption pattern similarly. The unequal treatment of these taxpayers under an income tax stems from the fact that the early saver will pay tax on earnings from savings. Stated another way, the early consumer will have less income over his lifetime (less earnings from savings), which would impact lifetime income taxes, but not lifetime consumption taxes.⁵⁴ Thus, the perceived benefit of a consumption tax relative to an income tax is that it will increase savings and investment.

Common questions under a consumption tax system—Who is the taxpayer or consumer? For example, who is the consumer of a college education or child care? Is education a non-taxable investment or taxable consumption? Should any types of consumption be exempt? For example, should employer-provided health insurance be exempt as it is under the current income tax system - don't the same reasons for exempting it under the income tax justify exemption under a consumption tax?⁵⁵ Should rates be progressive or flat? How should regressivity concerns be addressed?⁵⁶

VAT as a consumption tax—There are three main forms of VAT:

- a. Credit invoice VAT—This type of VAT is computed by charging VAT on all taxable purchases by businesses and consumers. A company's recordkeeping is fairly straightforward because it must just institute a procedure whereby it keeps track of sales invoices showing VAT collected and purchase invoices from other businesses showing VAT paid. At the end of the reporting period, a company merely totals each set of invoices and submits to the government, the excess of VAT collected over VAT paid. Or, if VAT paid exceeds VAT collected, the company would request a refund of the difference from the government. From the government's perspective, the audit trail is also straightforward because it consists of two types of records: sales invoices and purchase invoices. Under credit invoice systems, sellers are generally required to state the VAT charged on the face of the invoice.
- b. Subtraction method VAT—Instead of tracking VAT paid and collected on a sale-by-sale and purchase-by-purchase basis, all sales are aggregated and reduced by the aggregate of taxable purchases for the period. The result is the amount of value added by the business on which is pays VAT. A subtraction VAT form looks very much like an income tax return except that no wage deduction is allowed (wages are value added). Also, interest income and expense are not reported and most taxes are not deducted.
- c. Addition method VAT—This VAT adds up the value added by a business, such as wages paid and certain taxes paid, plus owner profit and multiplies this by the VAT rate. It is the reverse of the subtraction method VAT in that instead of taxable sales less taxable purchases equals VAT base, the elements of the VAT base are added together.

⁵⁴ This simplistic explanation is not intended to completely summarize all of the economic theory underlying income and consumption taxes. For a complete discussion comparing income taxes to consumption taxes, see Blueprints 1977, *supra*, page 39 to 42, and JCS-18-95, *supra*, pages 51 to 56 (also discusses the impact of existing wealth), as well as various economic reports cited in these reports.

⁵⁵ Under the Arney flat tax, discussed later, businesses may not deduct the costs of fringe benefits. Thus, such benefits are subject to tax.

⁵⁶ Consumption taxes are typically viewed as regressive meaning that they represent a larger percentage of a lower income taxpayer's income relative to a higher income taxpayer.

Retail sales tax (RST)—If a retail sales tax were used instead of a VAT, the tax would just be collected by the retailer (most prior purchases would be exempt under a resale exception). When a VAT has no special rates or exemptions, it can raise the same amount of tax as a retail sales tax that is just imposed on the final retail sale.

Commonly cited benefits of a VAT over an RST—

- An improved chance of collection because the VAT is collected at each stage of production and distribution, rather than just at the final sale to the retail consumer. Also, under a credit invoice VAT, each purchaser is likely to demand an invoice from a seller in order to claim a credit for the VAT paid. This mechanism can be a self-regulating feature of a credit invoice VAT that is not present with an RST.
- Elimination of the cascading effect of an RST caused by businesses paying the RST on items, such as manufacturing equipment, that are not held for resale.⁵⁷ Tax authorities and businesses would no longer need to deal with sales tax exemptions that only apply to specific types of items.
- Elimination of the seller's burden to determine and document whether a buyer is exempt from sales tax. Under a VAT, unless the item transferred is zero-rated or the seller is exempt, VAT is charged on the sale of the good or service; it is up to the buyer to obtain a credit if they are entitled to one. Thus, a VAT can be an easier system for removing the tax on producer goods.
- The above advantages of a VAT may make it a better vehicle than the RST for taxing services.

Advantages of the credit invoice VAT over a subtraction VAT—

- It is easier to use multiple rates and exemptions.
- It is known to be GATT compatible (not clear for a subtraction VAT).⁵⁸
- It is not a hidden tax, particularly if the tax is separately stated on invoices provided to the final consumer.
- It provides for separate recordkeeping and an audit trail of sales and purchases invoices all showing the VAT collected or paid.
- It is a simpler mechanism for implementing a destination principle because it is easier to identify export transactions (invoices) and to rebate the tax on them.⁵⁹
- Many examples exist of this tax in practice.
- Because it is more widely used today than the subtraction VAT, arguably, it would be the more appropriate VAT to adopt when considering what is appropriate for businesses operating in a global economy.
- The tax can more easily be collected closer in time to the transaction.
- For people most familiar with an income tax, the credit invoice method may be easier to understand than the subtraction method because they are less likely to raise the objections that typical income tax deductions, such as wages and interest expense, are eliminated.⁶⁰

⁵⁷ While many states provide sales tax exemption for items used in manufacturing, not all states do so. In addition, non-manufacturing businesses usually have no exemptions available to them for sales taxes on their purchases, unless they are for resale.

⁵⁸ See Joint Committee on Taxation, *Factors Affecting The International competitiveness of the United States* (JCS-6-91) at 304 ("there is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT.") The concern is that a subtraction VAT may not be viewed as an indirect tax in that it more closely resembles a corporate income tax than a sales tax.

⁵⁹ Gary Hufbauer and Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*, Institute for International Economics, 1996, pages 19 to 20.

⁶⁰ Because the subtraction VAT calculation looks so much like the taxable income formula, except that certain deductions are missing, commentators tend to focus on the subtraction VAT as unfavorable because it taxes labor

Advantages of a subtraction VAT over a credit invoice VAT—

- It uses records already maintained for income tax and financial reporting purposes.
- It would be more compatible with existing income tax recordkeeping, forms and filing procedures.
- It is less likely to cause direct interference with a state's RST because of how this VAT is calculated and assessed.
- It would enable states to increase the RST collected because purchases would likely include the subtraction VAT (while this is also possible with the credit invoice VAT, it is more obvious and may be difficult for the states to implement)⁶¹ (would likely be viewed as a disadvantage of this VAT by taxpayers).
- It likely involves lower compliance and administrative costs because there is no need for collection of VAT that will ultimately be refunded, as under the credit invoice VAT.
- It is typically viewed as less susceptible to the addition of special rates and exemptions.⁶²

*Not all consumption taxes operate in the same manner—*The following chart shows how various factors affect a business's tax liability under both the Armeiy flat tax and the USA tax (these two consumption tax proposals are explained in the next section). Notice the differences.

Factor	Increases (+) or decreases (-) tax liability under:	
	Armeiy	USA
Wages	-	+
Fringe benefits	+	+
Pension plan	-	+
Payroll taxes	+	-
Non-cash compensation	+	+
Independent contractor costs	-	-
Interest expense	+	+
State income taxes and property taxes	+	+
Imports	-	+
Exports	+	-
Foreign income and expenses	*	*
Inventory at transition date	**	-
Undepreciated property at transition date	**	-
Sale of assets	+	+
Purchase of business assets and inventory	-	-

* Neither the Armeiy flat tax or USA tax includes foreign source income or expenses in the tax base (they are territorial systems). Rules will likely be needed to distinguish between U.S. source, foreign source, exports and imports. For example, if a company provides a service to a foreign customer which also benefits the customer's U.S. location, where should the receipts from the service be taxed?

and interest expense. However, this is the purpose of a VAT - to tax value-added, such as wages and interest expense and owner profit. Such criticisms are rarely heard with respect to the credit invoice method because the form of the calculation looks more like a non-cascading sales tax rather than an income tax.

⁶¹ Alan Schenk, *Choosing the Form of a Federal Value-Added Tax: Implications For State and Local Retail Sales Taxes*, 22 *Cap. Univ. Law Rev.* 291 (1993) at 311-12. Professor Schenk notes that it may be "politically difficult" to impose the RST on VAT-inclusive prices under a credit invoice VAT.

⁶² A subtraction VAT is capable, though, of allowing for exempt businesses. In fact, the business activities tax (BAT), a subtraction VAT introduced by Senators Boren and Danforth in 1994, specifically exempts small businesses (those with \$100,000 or less of gross receipts). S. 2160, 103d Cong., 2d Sess.

** The Arney flat tax (H.R. 1040) provides no transitional rules. Unless such rules are added, ending inventory and the adjusted bases of fixed assets at the transition date from the income tax to the Arney flat tax would disappear. Similarly, when a business sells inventory or a fixed asset with basis from the income tax system, it is not clear whether they will be allowed to reduce the gross receipts from the sale by the basis in the asset. Under the USA tax proposal, ending inventory and asset bases leftover from the income tax system is to be expensed over 3 to 40 years.

F. Flat Tax Proposals

Hall-Rabushka Flat Tax—Most of the flat tax proposals are based on the proposal of Robert E. Hall and Alvin Rabushka of the Hoover Institute at Stanford University in Palo Alto. Their proposal and rationale is explained in the 2nd edition of their book, *The Flat Tax*. They propose a two-part tax system—one on businesses and one on individuals, both at a 19% rate. All income would be taxed at the source. For example, businesses would pay tax on their income, but when that income is paid to the owners, a second tax would not be owed. The two-part system allows for some progressivity through a wage deduction for businesses that then requires wage income to be reported by individuals, thus allowing for an exemption. However, fringe benefits are not deductible by businesses. To prevent distortions among employees, governments and non-profit organizations would report fringe benefits (apparently including the employer's share of FICA) paid to employees as income. Some of the points made by Hall and Rabushka in *The Flat Tax*: include:

- Rationale for not taxing capital gains—"Capital gains are taxed under the flat tax." Proceeds from the sale of business property are included in business taxable income. Gains from sales of stocks are created from "capitalization of after-tax income." Such gains derive from growth in business earnings which are fully taxed. "Another tax on the appreciation of shares would amount to a second tax on a single stream of income." Gains from the sale of owner-occupied housing "arise from capitalization of rental values, which are heavily taxed by state and local governments." Such gains also represent the effects of inflation.
- The flat tax would encourage foreign investment and raise the value of the U.S. dollar in foreign exchange markets.
- The flat tax would promote growth in the economy that by the year 2002 would increase each citizen's income by about \$1,900, in 1995 dollars.

*Arney Flat Tax (H.R. 1040 - The Freedom and Fairness Restoration Act (106th Cong. 1999))*⁶³—In June 1994, Congressman Arney first introduced legislation providing for replacement of the current federal income tax system with a 17% flat tax (20% for the first two years) [H.R. 4584 (103d Cong. 1994)]. In July 1995, H.R. 2060 was introduced which was a modified version of the earlier legislation. Congressman Arney introduced H.R. 1040 in 1997 and 1999. The 1999 Arney flat tax proposal, based on the Hall-Rabushka flat tax, is summarized below.

- a. Individual tax system: Taxable income for individuals includes wages, salary and pension income earned for services performed in the U.S., unemployment compensation, and taxable income of each dependent child under age 14 (such child would have no filing obligation). Investment income and social security benefits would not be taxable. This tax base is reduced by a standard deduction based on filing status and an additional standard deduction of \$5,200 for each dependent; both deductions would be indexed for inflation. Unlike current law, no additional deduction is provided for the elderly and the blind. All tax credits, including the earned income tax credit, child care credit, and child credit are eliminated. The alternative minimum tax (AMT) would be repealed. For the first two

⁶³ Information obtained from H.R. 1040 (106th Congress) and Congressman Arney's flat tax Web page at <http://flattax.house.gov/>.

years of the tax, the rate would be 19%, and then it would drop to 17%. Estate and gift taxes would be repealed in conformity with the flat tax theory that income is to be taxed only once.

- b. Business tax system: All forms of businesses (corporations, partnerships, etc.) would be taxed in the same manner. The tax base is equal to gross active income less deductions for cash wages for services performed in the U.S., retirement plan contributions, amounts paid for property sold or used in the business, amounts paid for non-employee services, and excise, sales, customs taxes imposed on deductible purchases. "Gross active income" refers to gross receipts from the sale or exchange of property or services in the U.S. plus gross receipts from the export of property or services from the U.S. Thus, the Arney flat tax is an origin-based tax (goods and services are taxed where the value is produced). While the legislation is not specific on this point, because the flat tax is intended to be a territorial system, allowable deductions should include only business inputs purchased in the U.S. or imported into the U.S. This is consistent with statements of Hall-Rabushka who provide an example in their book⁶⁴ where a U.S. company sends parts to Mexico for assembly and brings the completed product back to the U.S. for sale. In this example, the value of the goods is part of gross receipts upon export to Mexico and the value of the import is deductible when returned to the U.S. for sale. Costs incurred in Mexico would not be deductible. As for individuals, investment income of a business is not taxable. No deductions are allowed for fringe benefits, interest expense, state and local taxes or payments made to owners. Sales proceeds of previously expensed assets would be included in gross active income. As with individuals, the tax rate is 19% for the first two years, dropping to 17% thereafter. All tax credits, such as the research tax credit, are eliminated. The alternative minimum tax (AMT) would be repealed. A business with a loss would convert it into the equivalent of a credit to be used in future tax years. The excess loss is increased by an interest factor before being converted to a tax credit. Changes and simplifications would be made to qualified retirement plan rules.
- c. Other changes: Tax-exempt entities, such as governments, would be subject to tax at 17% (19% for the first two years) on the excludable compensation (such as fringe benefits and compensation paid outside of the U.S.) paid to employees. A 60% supermajority of Congress would be necessary to increase any federal income tax rate, create any additional income tax rate, reduce the standard deduction, or provide any exclusion, deduction or credit that results in reduced federal revenues.
- d. Benefits as seen by Congressman Arney: Listed below are some of the advantages of the flat tax system, as seen by Congressman Arney.
- Simplifies the tax law.
 - Restores fairness by "treating everyone the same" (same tax rate applies to every taxpayer).
 - Eliminates abuse by lobbyists.
 - Eliminates the current double taxation of savings.
 - Promotes investment and job creation.
 - Eliminates the marriage penalty.
 - Increases the standard of living for citizens by:⁶⁵
 - 1) reducing compliance costs such as by eliminating the need for Form 1099s (for reporting interest and other types of income);
 - 2) allowing for more efficient use of resources by eliminating preferences;
 - 3) ending the bias in the current system against savings and investment by freeing up more funds for investment;
 - 4) encouraging work by lowering the marginal tax rates; and

⁶⁴ Hall and Rabushka, *The Flat Tax*, Hoover Institution, page 76.

⁶⁵ From Congressman Arney's testimony before House Ways & Means Committee, 27 March 1996, 96 TNT 63-68 (29 March 1996), Doc. 96-9502.

5) cutting taxes and federal spending which will "raise the level of economic growth."

e. Analysis: Following are some observations—both favorable and unfavorable, that are offered to help in better understanding the flat tax and some of the issues that must be addressed before this proposal can be seriously considered.

- The Arney flat tax is a type of subtraction VAT except for the business deduction for wages which are instead taxed to employees (less an exemption). However, Congressman Arney refers to it as an income tax and the tax form looks like an income tax form. This "masking" of the flat tax as an income tax prevents a thorough discussion of the economics of the tax, and comparable alternatives, such as a credit invoice VAT used in most countries that utilize a VAT.
- Some information is missing information. For example, will businesses be allowed any deduction under the flat tax for the amount of ending inventory they have at the transition date from the income tax to the flat tax? Similarly, will businesses be allowed a deduction for the undepreciated basis of assets, including land? What happens to loss and credit carryovers at the transition date? What about unrealized gains and losses that exist in investment assets of individuals? If transitional rules are added, what will be the effect to the proposed tax rate? Additional missing information includes guidance on how to distinguish taxable business income from non-taxable investment income. For example, how many paintings must an art collector sell to constitute a business, rather than just an investment? Also, H.R. 1040 provides no guidance on accounting method and period rules. Similarly, the proposal is silent with respect to the treatment and sourcing of royalties and rents (assuming they are taxable).

Guidance is also needed as to how an owner's basis in partnership and corporate entities is to be tracked. What happens to an owner's loss and credit carryovers related to passthrough entities at the transition date? Also, are deferral rules, such as the like-kind exchange rules, intended to remain under the flat tax?

- New problem areas will arise. For example, the current issues of distinguishing between an employee and a contractor will likely be more important since not all payments made to employees are deductible by the business, while all payments to a contractor are deductible. Also, imputed interest rules will have heightened importance to be sure that businesses do not attempt to obtain a deduction for interest expense through financing of assets.
- There is no evidence that the flat tax will be either revenue neutral or distributionally neutral, relative to the current U.S. income tax. The Treasury Department has stated that the rate is too low to maintain revenue neutrality and suggests that to prevent a \$138.3 billion reduction in tax revenues per year, the tax rate would either have to be 20.8% or the exemption amount would have to be reduced by over 50% (or some combination of these two techniques). This analysis assumes that no transition rules for existing business assets would be included in the tax plan. The Treasury Department study also concluded that at a 20.8% rate, the Arney proposal would reduce taxes for families with \$200,000 or more of income by 28.1%, while increasing federal taxes for families with income under \$200,000 by between 5% and 70.7%. At income levels currently entitled to the earned income tax credit, the large tax increase found by Treasury under the Arney flat tax is primarily due to the repeal of the earned income tax credit under the Arney proposal. The calculations of the tax impact to individuals include taxes paid by businesses, but borne by individuals. For example, because FICA taxes and fringe benefits would no longer be deductible by businesses, they in effect, would be taxed at the flat tax rate. The Treasury analysis assumes that these taxes should be considered directly borne by individuals in their analysis. The analysis also includes a portion of business income (as investment income) in the calculations for higher income individuals (\$100,000 or more of wage income), even though paid directly by the business.⁶⁶

⁶⁶ The 20 December 1995 Treasury Dept. report can be obtained from the Treasury Dept. or at 70 Tax Notes 451 (22 January 1996).

- **Regressivity observations:** Taxing of earned income and allowing payors a deduction for the payments enables the system to have a mechanism to remove the tax burden from low-income individuals. However, for many low-income taxpayers, the exemption alone is not the equivalent of today's benefit from the earned income tax credit which is a refundable credit designed to offset the impact of non-income taxes on the poor (such as Social Security and excise taxes). In addition, removal of the business deduction for fringe benefits may result in elimination of such employer-provided benefits which would have the greatest impact on low-income workers. The large personal exemption (relative to the current tax system) adds some progressivity to the system.
- **Selected economic observations:** (1) A system which continues a wage deduction for businesses may ease the potential adverse transitional impact of switching from an income tax to a consumption tax relative to other proposals that remove a deduction for wages. For example, the Arme y flat tax is less likely to lead to a one-time increase in price levels that would likely occur under a national sales tax or pure VAT.⁶⁷
 - (2) Not allowing a deduction for fringe benefits, in effect taxes them. This treatment also shifts the tax on fringes from the business to the worker, and makes the payment subject to Social Security and Medicare taxes. Also, assuming higher level employees (for example upper management) have more control over salary negotiations, they may be likely to get more benefits converted to wages than lower level employees. Also, what is the potential impact on the health care reform debate? If employees eliminate health insurance deductions, will all employees get their own coverage or will the government have to provide a mechanism to subsidize or otherwise encourage purchase of individual health coverage?
 - (3) The Arme y flat tax is not border adjustable per WTO guidelines because it is not an indirect tax. Congressman Arme y is aware of this, but believes it poses no problem because a border-adjustable tax is not an effective tool in reducing the trade deficit. Instead, he says that improving the U.S. savings rate will reduce the need for foreign cash and the trade deficit will drop because we will invest more in the U.S. Is this true?
 - (4) Subjecting employees to tax on their wages and taxing governments and tax-exempt organizations on noncash compensation provided to employees broadens the tax base than might otherwise be possible with some forms of VAT. For example, if a VAT instead exempted governments and tax-exempt organizations, no tax would be paid on the value they add in the form of wages.
- **Potential adverse impact on state and local governments:** The impact of federal tax reform usually overlooks the positive and negative impacts to state and local governments. Some of the adverse effects to subnational governments posed by the Arme y flat tax are also present with other reform proposals. One significant impact is that governments (and tax-exempt entities) would be subject to tax at 17% (19% for the first two years) on fringe benefits provided to employees. A report by the California Franchise Tax Board concluded that the annual cost of this tax could be about \$375 million for the State of California and about \$2.2 billion for local governments in California.⁶⁸ Also, the National League of Cities (NLC) estimates that the removal of the exemption for interest on municipal bonds could cause an increase in capital improvement and borrowing costs of up to 30%.⁶⁹ The California Franchise Tax Board estimates that if the interest rate on municipal bonds increased by one-half of a percentage point due to removal of the federal

⁶⁷ For a further discussion of possible changes in prices under tax reform proposals, see CBO, *Comparing Income and Consumption Tax Bases*, July 1997, page 35.

⁶⁸ California Franchise Tax Board - Economics and Statistical Research Bureau, *The Impact of the Flat Tax on California*, December 1995, pages 63-64; based on an assumed 22.9% tax rate.

⁶⁹ NLC, *Nation's Cities Weekly*, 22 January 1996.

exclusion for interest income on municipal bonds, the increased first-year debt service cost to California state and local governments would be about \$100 million.⁷⁰

Other flat tax proposals—Other proposals for a flat rate structure and changed tax base have been proposed. Most are based on the Hall-Rabushka-Armev model with minor changes. For example, some allow individuals to also deduct interest on a home mortgage, as well as limited charitable contributions.

G. Other Forms of VAT under Discussion

Tax reform proposals discussed in this section include the USA tax which imposes a subtraction method VAT on businesses and a consumed income tax on individuals. Another highly promoted proposal calls for a national retail sales tax. In addition, a few years ago (former) Congressman Gibbons introduced H.R. 4050 (104th Congress) for a pure subtraction method VAT on businesses with an income tax remaining on high-income individuals to ensure that the distribution of the tax burden among income classes remains similar to what it is under the current income tax system.

Nunn-Domenici Plan - S. 722, 104th Congress - the USA Tax Act of 1995—Senators Nunn, Domenici and Kerrey introduced this proposal in April 1995. Senator Nunn has since retired from Congress. This proposal received a lot of attention because it was the first to provide complete legislation. While the sponsors have not reintroduced this legislation, Congressman English has introduced H.R. 134 (106th Congress) which is a simplified USA tax. Because so much attention has been given to the original USA tax proposal in the tax reform debate, it is briefly described in this article.

"USA" stands for Unlimited Savings Allowance, and represents a deduction for savings that is part of the individual tax component of the USA proposal. The USA tax is a two-part system consisting of a consumed income tax for individuals (following the cash flow approach) and a subtraction method VAT for businesses.

- a. Individual tax system: The individual tax component of the USA system is quite complex, primarily due to the USA deduction for net savings and the recordkeeping that it requires. The basis formula applicable to the tax base for individuals begins with gross income, defined as all income from whatever source derived including compensation for services, fringe benefits, distributions from business entities, interest, rents, royalties, alimony, child support, pensions, includible social security benefits, income from discharge of debt, and gains from sale of assets (other than savings assets). Items excluded from gross income include tax-exempt bond interest, some social security benefits, amounts received under accident or health benefit plans, gifts, inheritances. The tax base is increased for deferred income defined as income attributable to withdrawals of previously saved (deferred) gross income. Deductions are allowed for alimony and child support payments, the USA, personal and dependency deductions, a family living allowance, a home mortgage deduction on acquisition debt, a higher education deduction, a philanthropic transfer deduction, and an optional transition basis deduction.

Unlike the flat tax form of consumption tax, the USA tax includes a graduated tax structure for individuals with the lowest rate at 8% and the highest at 40%; the 40% rate begins at \$24,000 of taxable income for married taxpayers filing jointly and at \$14,400 for single taxpayers (these rates are higher than under the current income tax system).

Individuals are allowed a refundable tax credit for the employment taxes withheld from their wages, limited to the Social Security wage base; Medicare taxes paid beyond that wage base are not creditable. For self-employed individuals, refundable payroll tax credit equals one-half of the basic self-employment tax payable for the tax year. The refundable earned income tax credit would continue with modifications. Individuals would also be entitled to foreign tax credit (similar to current law) with respect to foreign taxes paid on amounts included in individual's gross income.

⁷⁰ FTB Report, *supra*, page 63.

- b. Business tax system: Under the USA tax proposal, businesses of all types would be subject to an 11% subtraction method VAT. They would also be subject to an 11% import tax on the customs value of goods and services brought into the U.S. for consumption, use or warehousing. The import tax is due and payable at the time of the import.

The tax base for the VAT equals the amount received from sales of goods and services less the amount paid to other businesses for goods and services. Interest income and other financial receipts are excluded from the tax base, as is interest expense. Wages paid to employees are not deductible. Plant and equipment would not be depreciated, but would be deducted in full in the year acquired, as would inventory items. A 15-year carryforward would be allowed for business losses.

Special rules are provided for insurance and financial products, financial institutions and tax-exempt organizations. "Financial intermediation businesses" are to include financial receipts, such as interest, in their taxable receipts, and may include the cost of financial instruments and payments for the use of money as business purchases. A financial intermediation business includes one providing lending or insurance services.

The USA VAT is a territorial tax. It excludes exports from the business tax, but taxes imports (Example: a foreign business manufacturing outside the U.S., but selling its products in the U.S. will pay the import tax). Sourcing rules with respect to services state that a business would be treated as exporting a service if the benefit of the service will be realized outside of the U.S. and the "benefit will be realized solely in connection with the activities of the purchaser occurring outside" the U.S. A service is imported if its benefit will be realized in the U.S. and will be realized solely in connection with the entity's U.S. business activities.

Businesses receive a non-refundable tax credit for their share of employment taxes, but this credit is not usable against the import tax. No loss or credit carryovers from current law would be allowed; special amortization transition rules are provided for the undepreciated basis of existing property and inventory which allow for write-offs over 3 to 40 years depending on the type of property.

- c. Analysis: Listed and explained below are selected evaluation points to help in analyzing the USA tax and its likelihood of serious consideration.

- While the legislative text of the USA proposals is quite complete, a few important items are not specified. For example, it is not clear whether any changes to excise, estate and gift taxes are intended. Also, sourcing rules for rents and royalties are absent.
- As with the Army flat tax, for businesses, interest income is excluded and interest expense is not deductible, thus, rules on imputed interest would still be needed to be sure, for example, that the cost of equipment, for example, does not include an interest expense element.
- The USA tax may lead to new abuses and problem areas, such as the following:
 - Problems might arise under a system where individuals may deduct charitable contributions, but businesses may not. For example, businesses might try to channel contributions through employees.
 - With businesses and individuals taxed at different rates, is a potential that taxpayers will attempt to shift income between the two types of taxpayers where possible.
 - Lack of transitional rules for loss and credit carryovers will penalize some taxpayers and lead to planning techniques to try to utilize such attributes prior to enactment of the new tax system, such as engaging in sales-leaseback transactions that will generate sufficient gains to utilize net operating loss carryovers.
- Regressivity observations: Continuance of the earned income tax credit provides some tax relief for low-income wage earners. Also, the employment tax credit will provide some relief to lower income taxpayers. The USA proposal appears to be less progressive than the current system because the top tax rate begins at much lower income levels. As opposed to a sales tax or VAT type of consumption tax, the USA system allows for graduated tax rates.

- It is not clear whether the USA tax would be GATT compatible. The USA business tax has some features of an income tax, such as the carryover of net operating losses and the ability to transfer such a loss to an acquirer of the loss business. Also, the computation is similar to an income tax calculation with fewer deductions.⁷¹

National Retail Sales Tax Act of 1996 - H.R. 1467 (106th Congress, April 1999)—

- a. Basics: The national retail sales tax would replace the federal income tax with a 15% federal sales tax (effective rate is at least 17.6% though) which can be administered by the states provided they first conform their sales tax system to the federal one. H.R. 1467 also recommends repeal of the 16th amendment. The RST would repeal excise taxes on alcohol, tobacco, gasoline, diesel fuel, luxury cars, and some other items, but keep other excise taxes that would be administered by a new "Excise Tax Bureau." Social Security taxes would continue and be administered by the existing Social Security Administration. Estate and gift taxes would be repealed. The RST proposal also calls for phase-out of the IRS and creation of a Sales Tax Bureau within the Treasury Department.

The RST would be imposed on *gross payments* for the use, consumption or enjoyment in the U.S. of any *taxable property or service*, whether produced or rendered within or without the U.S. This definition of gross payments leads to an effective rate greater than 15% and the definition of taxable property and services is quite broad, including real property. The sales tax is to be charged separately from the purchase price and the vendor is to provide each buyer with a receipt.

"Gross payments" means the product of the *pre-tax factor* and payments for the taxable property or service exclusive of state and federal taxes imposed by the RST and state taxes in conformity with the federal RST. The pre-tax factor is equal to $1 \div [1 - 15\% - \text{the state tax rate imposed in conformity with the federal tax}]$. Oddly enough, although the sponsors of the RST proposal want states to adopt the same federal rules and then administer the federal tax along with the state's RST, this would cause the residents to pay a higher RST under the "pre-tax factor" formula.

"Taxable property or service" is defined as any property (including leaseholds and rents) other than intangible property, and any service (including financial intermediation services). Services generally do not include wages unless paid by an employer who is not engaged in an active trade or business. "Tangible personal property" is to be defined based on common law; the Treasury Secretary is to write regulations establishing uniform rules as to this definition.

Exemptions include (no tax owed): 1) purchases for resale, 2) purchases to produce taxable property or services (such as manufacturing machinery), 3) purchases in furtherance of a bona fide business purpose, 4) exports from the U.S., and 5) certain *de minimis* transfers by individuals not engaged in a trade or business. Purchases to produce taxable property or services includes taxable property or services used in an active trade or business for research, experimentation or development purposes. Education and job-related training (tuition, but not room and board) are treated as purchased to produce taxable property or services. Generally, there are no special exemptions for federal, state or local governments. A special rule generally requires government employers and certain tax-exempt organizations to pay sales tax on wages by Federal, State and local government employees.

Generally, the seller is liable to collect and remit the tax with two key exceptions: 1) the buyer must remit tax for taxpayer property or services purchased outside the U.S., but brought into the U.S. (unless "*de minimis*"), and 2) if the buyer of principal residence elects to pay sales tax (plus interest) in installments over 30 years. Individuals not engaged in a trade or business must collect tax on casual or isolated sale if the sale exceeds \$2,500 per year. Individuals must also report use tax on imports exceeding \$400 per year.

⁷¹ In "GATT Treatment of Subtraction Method VAT," ABA Section of Taxation Newsletter, Fall 1994, page 28, Stanley Simon raises the question of whether a subtraction method VAT is border adjustable under GATT. The issue is whether a subtraction method VAT looks more like a corporate income tax than a VAT. See earlier discussion under "Terminology" ("Advantages of the credit invoice VAT").

Allowable credits include: 1) used property credit - for previous sales tax paid on the resale of taxable property or services; 2) business use conversion credit (when taxable property is converted to business use); 3) administration credit which is available to taxpayers filing timely monthly reports and is equal to the greater of \$200, or .5% of the tax remitted (but not to exceed 20% of the tax due); 4) compliance equipment cost credit equal to 50% of the cost of equipment required to be purchased by vendors to enable them to comply with the requirement to report tax and purchase price separately on invoices; and 5) transitional inventory credit equal to 15% of the cost of qualified inventory held prior to the effective date of the sales tax.

To address the regressivity of the tax, a "family consumption refund" (rebate) is allowed for individuals. The rebate is equal to 15% of the lesser of, 1) 117.6% of the poverty level for their family size, or 2) the wage income for the family unit. The family rebate is administered by a family member's employer (or split among wage earners in the family) by additions to each paycheck. Family members include spouses, children, grandchildren, parents and grandparents who have a bona fide social security number (if over age two) and are a lawful resident of the U.S. The relevance of whether a person is a family member is in determining the poverty level for that family to determine the family rebate amount (particularly where the family's wages exceeds the poverty level amounts). For non-wage earners, such as retired individuals receiving Social Security benefits, a "compensating payment" equal to the product of their qualified fixed income payment amount and the excess inflation rate, may be obtained. Such individuals are required to apply for these payments and they are added to their monthly Social Security benefit. Also, Social Security benefits are to be indexed on a sales tax inclusive basis.

Monthly reporting is required with tax to be paid by the 20th day of the succeeding month; interest and penalties for late payments and late filing are provided for. Persons liable to collect and remit taxes who are engaged in an active trade or business must register with the federal or state taxing authorities. Penalties are provided for failure to register.

States that conform their state's sales tax to the RST and then administer the federal RST for the U.S., have no less than 15 days after receipt to remit the federal tax to the U.S. and may keep a fee equal to 1% of the federal tax required to be remitted. If a state is not an administering state, the Secretary of the Treasury will administer the federal tax in that state; the Secretary will also administer the tax if an administering state fails to properly collect and remit the federal tax. A conforming state may contract with another conforming state to administer its sales tax for an agreed fee. The federal government will administer a program to allow for information sharing among the States.

Vendors with retail establishments in five or more conforming states may elect to have their sales tax obligations administered (including audits) by the federal government under the *multistate vendor program*. Under this program, the federal government will collect the federal and state sales taxes and remit the state tax to the states within 10 days of receipt. The U.S. Tax Court would have jurisdiction over federal tax disputes. A new federal "Office of Revenue Allocation" would be created to arbitrate disputes among administering states as to which state is entitled to the tax collected in certain instances. Apparently the purpose of these rules is to enable administering states to adopt rules in conformance with other administering states. Guidance is provided as follows to determine the destination state:

Tangible personal property - where first delivered to buyer;

Real property - location of property;

Other property - residence of buyer;

Services - generally, the state in which the use, consumption or enjoyment of the services occurred; may be allocated to more than one state based on time;

Telecommunications services (including cable television, and computer on-line or network services) - residence of purchaser;

Domestic transportation services - final trip destination;

International transportation services - deemed that 50% of the service is attributable to the U.S. destination or origin;

Financial intermediation services - residence of the purchaser;

Rents and royalties for the lease of tangible property - location of the property;

Vehicle rentals of one month or less - where vehicle was originally delivered; and

Vehicle rentals exceeding one month - residence of lessee.

b. Other changes: A two-thirds majority vote in the House and Senate is required to raise the federal sales tax rate, or to provide any exemption, deduction, credit or other benefit resulting in reduced federal revenues.

c. Analysis: Following are some observations—both favorable and unfavorable, to assist in understanding the issues that might arise in enacted an RST.

- While the sponsors of H.R. 1467 are correct that most consumers are familiar with a sales tax, they are not familiar with one that would tax services and real property along with tangible personal property.
- Transition: H.R. 1467 is silent as to whether any business would obtain any transition relief for loss and credit carryovers existing at the transition date of switching from the income tax to the RST. Another transition issue that would affect the revenue neutrality of the RST is whether individuals might borrow as much as they can prior to the effective date to make purchases, particularly large ticket items, so as to avoid paying the sales tax. Another transition issue, of particular concern to older individuals, is whether any transition relief will be provided when they buy taxable property and services using funds previously taxed under the income tax (leading, in effect, to double taxation).
- Additional costs for governments would be created because they would be required to pay tax on its consumption, including wages paid to employees.
- While compliance burdens for individuals not engaged in a business are generally eliminated, some new compliance burdens are created, such as the family consumption rebate that individuals will need to monitor, particularly if they change employers during the year; payment of use tax on imports (unless de minimis); collection of sales tax on casual or isolated sale (unless de minimis); dealing with the used property credit when they resell property; and the principal residence installment election to pay the sales tax (and interest) over 30 years.
- The high tax rate may lead to evasion.
- Because the IRS really cannot be phased out and H.R. 1467 would create new agencies, it is misleading to the public to tout elimination of the IRS. It would be more appropriate to state that most individuals would no longer have a yearly filing obligation.
- Taxpayers must still deal with state income and franchise tax rules, which, if based on federal income tax rules, will continue to be complex, will require each state to adopt (because the federal income tax rules will no longer exist for reference), will require states that rely on federal audit results to expand their audit workforce, and will unlikely reduce compliance burdens of taxpayers (records must still be kept and filing obligations met).
- Excise taxes on alcohol, tobacco and gasoline currently serve more than just a revenue generating purpose. Should these taxes remain in addition to the sales tax? This is an important policy issue that needs to be addressed. Keeping the excise taxes on these items does not cause any compliance burden to individuals.

Other proposals for a national retail sales tax—Senator Lugar has repeatedly introduced a sense-of-the-Senate resolution calling for replacement of the income tax and estate and gift taxes be replaced with a sales tax that will raise as much revenue as the income tax (S. Res. 24, 106th Congress). Americans for Fair Taxation are calling for a 23% national sales tax on goods and services, which they refer to as the

"fair tax." This tax would replace income taxes, payroll taxes, estate and gift taxes. It also calls for repeal of the 16th Amendment.⁷²

H. Policy Proposals (suggestions with no specific plans)

The National Commission on Economic Growth and Tax Reform ("Kemp Commission")—This commission was formed in 1995 by (former) Senator Dole and House Speaker Gingrich. One of their goals was to better ensure that tax reform would be a major issue, if not the major issue of the 1996 presidential campaign.⁷³ The Commission heard testimony from various persons at meetings held throughout the country in 1995. In January 1996 they issued their report, "Unleashing America's Potential." Instead of offering a specific tax plan, the report outlines principles that "establish the foundation upon which a new system can be raised." The report recommends that the Internal Revenue Code be repealed in its entirety. The Commission also urged President Clinton to appoint a commission to "bring the recommendations offered by this congressionally appointed commission to the next level of public debate." The final report lists six "points of principle:"

- 1) "Economic growth through incentives to work, save, and invest
- 2) Fairness for all taxpayers (by this, the Commission means a single tax rate for all taxpayers).
- 3) Simplicity so that anyone can figure it out.
- 4) Neutrality that lets people and not government make choices.
- 5) Visibility to let people know the cost of government.
- 6) Stability so people can plan for the future."

The final report also lists six "points of policy:"

- 1) "A single tax rate.
- 2) A generous personal exemption to remove the burden on those least able to pay.
- 3) Lower tax rates for America's families.
- 4) Payroll tax deductibility for workers.
- 5) Ending biases against work, savings, and investment.
- 6) Making the new tax system hard to change."

The Commission proposed to make the new system hard to change by requiring a two-thirds majority vote in Congress to raise the tax rate. Additional suggestions of the Commission include abolishing separate taxation of capital gains; consideration of a territorial tax system; ending double taxation of savings; and use of dynamic scoring in determining the revenue effects of any proposal. The report also suggests, but does not specifically recommend elimination of estate taxes, a reduction in the amount of power given to the IRS; and continuation of policies to encourage home ownership and contributions to charity.

Congressman Archer's View—Since becoming chairman of the House Ways & Means Committee after the November 1994 Republican victory in Congress, Mr. Archer has been discussing major federal tax reform. At a June 1995 House Ways and Means Committee hearings on tax reform and subsequent presentations, Mr. Archer has outlined his five "bottom-line" objectives to guide tax reform:

- 1) Individuals should no longer have to deal with the IRS.
- 2) Savings should be encouraged.
- 3) The underground economy should be reached.
- 4) The tax should be border-adjustable.

⁷² See www.fairtax.org/home.html.

⁷³ Per Grace-Marie Arnett, Executive Director of the Commission, ABA Tax Section meeting, Chicago, 4 August 1995.

5) The system should be fair and not create undue burdens on low-income individuals.

I. Proposals to Make Modifications to the Existing Federal Income Tax

Overhaul/Revision of Current Tax System—Each year, several bills are introduced in Congress to make significant changes to the U.S. income tax. These proposals include such changes as:

- Adding more savings incentives to the income tax, such as allowing larger contributions to Individual Retirement Accounts (IRAs), excluding some specified dollar amount of interest and dividend income, or lowering the capital gains tax rate.
- Reducing the tax burden by an across-the-board tax cut, or allowing more income to be taxable at 15% (rather than at the higher rates of 28%, 31%, 36%, and 39.6%).
- Elimination of the marriage penalty that many two-earner married couples face due to fact that the tax rate brackets for married individuals are not double those for singles and other deductions and credits are not adjusted for marriage. The cost to the government to eliminate the marriage penalty is quite high.
- Elimination of the alternative minimum tax (AMT) due to its complexity and the fact that it does not solely just affect high income taxpayers.
- Repeal of estate and gift taxes.

Congressman Gephardt's 10% Tax Act of 1998 (H.R. 3620, 105th Congress, April 1998)—H.R. 3620 maintains the income tax, but makes significant changes to the tax base and lowers tax rates for individuals. Mr. Gephardt claims that his proposal is "fair" because it will treat (tax) more types of income the same.

- a. **Individuals:** The tax base for individuals would be expanded to include tax-exempt interest, fringe benefits (other than health benefits), and employer pension contributions. All itemized deductions would be eliminated except for mortgage interest. Investment interest and job-related expenses (with a limit) would remain and be treated as deductions for adjusted gross income (AGI). The AMT would remain, but with lower rates. The earned income tax credit and foreign tax credits would also remain, while the child care and elderly credits would be eliminated. The foreign earned-income exclusion would be removed. A progressive rate structure for individuals would include five rates: 10%, 20%, 26%, 32% and 34%. Congressman Gephardt claims that for 75% of taxpayers, the tax rate would be 10% or less and a majority of taxpayers would not have to file, and that a postcard size tax return could be used.
- b. **Businesses:** H.R. 3620 proposed to cut "corporate welfare" in order to provide tax cuts for small businesses. A commission would be established to identify the items to change. If revenues from elimination of corporate welfare provisions is less than \$10 billion per year, the corporate tax rates will be increased,
- c. **Analysis:** A critique of the 10% tax plan should include the following items.
 - While the proposal is referred to as the "10% tax," not all taxpayers would be in a 10% tax bracket; graduated brackets actually exist and corporations apparently keep the existing tax rates.
 - Inclusion of certain employer-provided benefits in the tax base may not be viewed as simplification.
 - Because gains and losses from sale of assets would be taxable, along with interest and dividend income, capital gains and losses, and rental income, the postcard-size tax return would likely need schedules to support the calculation of taxable income.

Proposals to Change the Income Tax to Incentivize Certain Activities—The category of "major" federal tax reform should also include suggestions for changes designed to change taxpayer behavior for specific purposes, as illustrated by the following two proposals.

- a. Corporate behavior: Some tax reform proposals call for using the federal income tax system to encourage certain type of behavior by individuals and/or businesses. Some of these proposals would lower the tax rate for corporations that provide retirement and health care benefits, as well as training to its workers. In addition, corporations would typically have to engage in R&D activity in the U.S. One proposals also called for a new securities excise transfer tax for stock held less than two years to help to encourage a longer term focus on corporate results.⁷⁴ These types of behavior changing proposals do not receive much discussion because it does not seem to be a majority view in Congress that the tax law should try to do this much. Many people would view these types of proposals as too much government involvement in business decision-making that will not benefit the economy as a whole.
- b. Environmental protection: Some reform proposals that have received some attention, particularly in discussions of global warming, focus on how to use the tax law to encourage individuals and businesses to reduce their consumption of energy that produces high levels of carbon emissions. For example, in its principles of tax reform, the National Wildlife Federation included a "polluter pays" principle.⁷⁵ Also, Congressman Stark has proposed a series of bills to discourage pollution. He has stated that the tax reform debate should also include "lowering the tax on labor and job skills and increasing it on pollutants."⁷⁶ Congressman Stark's proposals include the removal of tax subsidies for extracting fuels and minerals that pollute. He proposes that the money raised from such proposals be used to fund lower taxes on wages. Similar "tax shift" proposals have been suggested by environmental groups as well.⁷⁷ In addition, Minnesota has introduced a tax shift proposal - The Economic Efficiency and Pollution Reduction Act of 1997.⁷⁸

J. Evaluating and Understanding the Various Proposals—Some Considerations

There are numerous issues to consider in evaluating and comparing tax reform proposals (and in comparing them to the current federal income tax). Several of these types of issues and considerations are explained below (in no particular order).

- *"Buy-in."* How will policymakers get buy-in from the public? Most individuals do not understand the current tax system; thus, it will be difficult to explain why the new system would be better and why it would better encourage economic growth than under the current tax system. Also, the public is used to the current tax system and it is hard to change perceptions of what a proper tax system should include. Also, many individuals already file a single page tax return - how can simplification be sold to them? Won't most people want a tax cut in order to buy-in to the new system?
- *How to predict levels of economic growth?* Several economists and sponsors of reform proposals state that a consumption tax will increase levels of economic growth, job creation and increase in wages. Given the complexity and significance of the prospect of replacing the federal income tax with a consumption tax, how can all the effects be predicted? What if savings increases in the short run, but results in a decline in consumer spending? While economic models may suggest economic growth in the long run, what happens in the short run?

⁷⁴ See the March 1996 proposal by Senators Bingaman and Daschle for "A" Corps—corporations "allied with America's working families." In April 1996, Senator Kennedy introduced S. 1668, the American Workers Economic Security Act.

⁷⁵ See 95 TNT 243-28 (December 14, 1995).

⁷⁶ Cong. Record, January 22, 1996, pg. E46 and September 12, 1995, pg. E1761. Also see Cong. Rec., 21 October 1997 page E2024.

⁷⁷ For example, Redefining Progress (http://www.rprogress.org/progsum/ecc_progsum.html), "Tax Waste, Not Work," and the Worldwatch Institute (<http://www.worldwatch.org/worldwatch/pubs/paper/134.html>), Paper #134: "Getting the Signals Right: Tax Reform to Protect the Environment and the Economy."

⁷⁸ For further information, see <http://www.me3.org/projects/greentax/taxwork.html>.

- *Employment tax reform.* Can federal income tax reform realistically occur without reform of employment taxes. For example, if federal income taxes are reformed first and later employment taxes are reformed by raising the tax rate for Social Security and Medicare taxes, would public outcry follow?
- *Concerns of low-income taxpayers.* How will the tax system deal with low-income taxpayers? The current system provides for an earned income tax credit received through filing of an income tax return. How could relief be provided under a value-added tax or a national sales tax? Would new bureaucracies be needed to address such an issue? Under a system where only businesses directly pay taxes, would some type of individual income reporting mechanism still be required in order to determine which taxpayers should be given some type of relief under a regressive tax, such as a sales tax? How will regressivity be addressed if revenue neutrality is obtained for any of the current proposals by reducing the personal exemption amount rather than increasing the tax rate? Also, for many low-income wage earners, their significant tax liability is the payroll tax of 15.3% of wages. How will income tax reform help these individuals?
- *Taxation of fringe benefits.* What will be the impact of taxing fringe benefits? Will employers stop providing them? Will they be converted into taxable wages? Will current rules aimed at preventing favoritism in benefit plans towards highly-compensated employees, in effect by nullified if fringes are converted to wages? Can the subjective reasonable compensation rules replace anti-discriminatory rules that currently apply to some fringe benefits?
- *The tax gap.* How will the new tax affect the tax gap? Can the tax effectively reach the underground economy? Can any tax reach the underground economy? What new evasion techniques might arise under a particular proposal? What enforcement rules would be appropriate under the proposed tax system?
- *Simplification.* Will the new system be simpler than the present system?⁷⁹ Perhaps some complexities, such as international issues and those involving innovative financing cannot easily be removed. In addition, some current complexities might become more problematic; for example, under a system where wages are not deductible, but cost of other services are deductible, the distinction between employee and independent contractor becomes a bigger issue than under our current system.

Are the touted simplifications of each proposal legitimate? For example, a single tax rate does not necessarily make a tax system simple because taxpayers use tax tables and computers. Also, removal of the mortgage interest deduction is not simplification because little recordkeeping is involved.

- *Improved savings.* What factors truly affect savings rates? Per the OECD information presented earlier, consumption taxes in Japan represented just 4.8% of their tax revenues, the lowest percentage of all OECD countries. Yet, as also noted earlier, Japan has a much larger savings rate than the U.S. The current income tax system does include several savings incentives, such as for corporate sponsored pension plans and individual retirement accounts (IRAs). In addition, the tax-favored treatment of a taxpayer-owned principal residence can be a significant savings vehicle for many taxpayers.⁸⁰ Would savings rates improve if these incentives were expanded? Would replacement of

⁷⁹ The complexity of the tax law is not a new issue. It was a major reason to support tax reform discussions in 1982. The problem even predates 1982. In an article, "Suggestions for Simplification of Federal Income Taxation" by Paton in *The National Income Tax Magazine* dated August 1923, when the tax laws were only ten years old, the author stated:

It may fairly be urged that our present system of Federal income taxation is unduly complex. At any rate, little in the way of simplification has thus far been accomplished by revision. Each successive act has been more elaborate than its predecessor; and the maze of administrative and judicial technicalities surrounding the taxpayer has been steadily thickening.

⁸⁰ Tax incentives available to homeowners include the deduction of mortgage interest on up to \$1.1 million of debt, the deduction for real estate taxes, deferral of gain upon sale if the proceeds are timely invested in another

the income tax with some type of consumption tax discourage individuals from buying homes and investing in retirement assets?

- *Global competitiveness.* How would the new system affect the ability of businesses to compete globally? How does the system compare to that of other countries? Would a territorial system encourage businesses to locate to lower tax countries? Would low tax rates in the U.S., such as under the Armeey flat tax, cause the U.S. to become a tax haven?
- *GATT compatibility.* Consensus does not exist as to how important it is for a tax to be GATT-compatible. Some commentators view it as unimportant under the theory that a border adjustable tax is not an effective tool in reducing the trade deficit. In a 1992 report, the Congressional Budget Office stated that border adjustments do not improve the balance of trade because of resulting changes in exchange rates.⁸¹ However, others view GATT-compatibility as an important goal for tax reform.⁸² The importance of GATT-compatibility, must be further analyzed and openly debated prior to instituting a tax that is not GATT-compatible, such as the Armeey flat tax, or making an effort to ensure that a new tax is GATT-compatible if it makes no difference. This debate should consider, 1) the effect of GATT-compatibility under various trade balance scenarios, 2) the effect in the long-term versus the short-term, 3) the impact of transitioning to a GATT-compatible tax, 4) possible differences of impacts among industries, and 5) trading partner acceptance of the taxing system as GATT-compatible.

If it is determined that GATT-compatibility is important, careful attention must be paid to the new tax to be enacted to be sure that it is truly GATT-compatible. Most of the world using a VAT uses the credit invoice VAT which is more obviously an indirect tax, relative to the subtraction VAT. As noted by former Treasury Assistant Secretary, Les Samuels, "Whether a subtraction method VAT would survive a GATT challenge is an untested issue."⁸³ Also, per a 1991 Joint Committee on Taxation report: "there is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT. The distinction may be made that a subtraction-method VAT, unlike a credit-invoice VAT, is not imposed on particular transactions but directly on a business, where the tax base is equal to the business's value added. In this technical respect, a subtraction-method VAT may more closely resemble a corporate income tax than a sales tax."⁸⁴ On the other hand, others believe that a subtraction VAT is likely to be GATT compatible.⁸⁵

principal residence, and the \$125,000 gain exclusion upon sale of a principal residence by a taxpayer age 55 or older (once in a lifetime exclusion).

⁸¹ CBO, *Effects of Adopting a Value-Added Tax*, February 1992, pg. 63. Also see Esenwein, Congressional Research Service, "Consumption Taxes and the Trade Balance: The Role of Border Tax Adjustments," 95-893E, Aug. 14, 1995. This report notes that the balance of trade is affected by international capital flows, not by the flow of traded goods and services and border tax adjustments. "[A]ny changes in the product prices of traded goods and services brought about by border tax adjustments would be immediately offset by exchange rate adjustments. ... That is not to say that changes in the tax structure could not influence trade patterns. Tax policy can and does affect the composition of trade. In addition, changes in tax policy which might affect the underlying macroeconomic variables that govern capital flows (for instance, by increasing either public or private savings which in turn would lower interest rates) could affect the balance of trade. But, by themselves, border tax adjustments will not change a nation's balance of trade."

⁸² Congressman Archer, "Goals of Fundamental Tax Reform," in *Frontiers of Tax Reform*, The Hoover Institute, 1996, page 5. Also, per Congressman Gibbons, a "border-adjustable tax system would promote the competitiveness of American companies and invigorate American exports." Gibbons, "A Revenue System for America's Future," outline to his subtraction method VAT proposal, March 27, 1996, page 3.

⁸³ From June 7, 1995 record testimony (pg. 28) before the House Committee on Ways and Means by then Assistant Treasury Secretary (Tax Policy), Les Samuels.

⁸⁴ JCS-6-91, *supra*, page 304.

⁸⁵ For example, see Hufbauer and Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*, Institute for International Economics, 1996, pages 67 to 70. Hufbauer posits that the subtraction VAT can be attributed to

In the GATT-compatibility debate, it is important to note that the current proposals call for a *variation* on a subtraction VAT. While a pure subtraction VAT might be shown to be GATT compatible, the USA subtraction VAT is not a pure subtraction VAT because of its net operating loss (NOL) carryforward and Social Security tax credit provisions. These provisions may indicate that it is not an indirect tax. However, if this is true, these are fixable aspects of the proposal; the key will be to fix such problems prior to enactment, rather than upon a later GATT challenge.

- *Tax treaties.* Current tax treaties deal with income taxes, not consumption taxes. Thus, the treaties will need to be renegotiated if the income tax is replaced. The time frame needed for this task, as well whether other countries would be willing and interested in renegotiating treaties with the U.S., must be considered in the tax reform debate.
- *Adequacy of information for the public.* How can the public effectively evaluate proposals? Most proposals are not complete in that they do not specify what happens to other parts of the tax law, and definitions and transition rules are lacking. Also, it will be easier to evaluate short-term effects than long-term effects, but without the long-term evaluation, the public may not give a complete look at tax reform. Also, it is difficult to evaluate proposals due to uncertainties about prices, interest rates, Federal Reserve actions, impact on the economy, short-term versus long-term impacts, etc. How can the government effectively provide enough information to the public to allow for an appropriate discussion of the issues?
- *The Changing U.S. Economy*—The current U.S. tax system is based on the industrial age where most transactions were easy to identify and crossing borders of states and countries was obvious. The tax laws were designed to deal with tangible goods and easy to identify transactions. In today's economy, services are becoming more important. Also, intangibles, such as software and information, are commonly transferred between taxpayers and easily transferred across borders. For example, the Department of Commerce reports that by the 21st century, telecommunications and information-based industries will represent about 20% of the U.S. economy.
- *Politics versus economics.* Will the debate be driven by politics or economics? For example, will certain preferences be put in a system (such as a home mortgage deduction), even though it does not make economic sense under the new type of tax (such as a consumption-based flat tax)?
- *Relevance of business form.* How will removal of the relevance of the type of business entity affect current businesses and new businesses?
- *Existing debt.* How will removal of the current tax system's preference for debt over equity affect companies that are currently heavily debt laden? How will it affect the capital formation markets?
- *Owing tax in downturns.* In a system where assets are not depreciated over several years and inventory get expensed prior to its sale, businesses may be surprised when during a downturn in their business or the economy, they still owe federal tax. During a downturn, key business deductions will not exist or will be reduced, such as equipment and inventory purchases, and there will be no depreciation and cost of goods sold to reduce the tax base. And, if the new tax system is one where employee wages are not deductible, the business is even more likely to owe tax during a downturn.
- *Recordkeeping changes.* How will recordkeeping change? For example, businesses have many records which are only kept for tax purposes, such as those to track inventory figures for tax

individual products unlike the corporate income tax which is dependent on the business cycle and other factors. Hufbauer also suggests that the associated legislation should be drafted to indicate that the liability for the tax attaches when the goods or services are sold. The Hufbauer text contains an excellent and very complete discussion of border adjustments. Also, the sponsors of the USA proposal appear to have taken the position that it is a GATT-compatible tax.

purposes. What new records will be needed? Will current recordkeeping systems be capable of tracking or producing any new data or reports?⁸⁶

- *State conformity.* How likely is it that states would or should conform to any new federal tax system? Would they need additional time to determine how to adapt and to set a tax rate? Will its citizens demand conformity to the federal system to achieve simplification?
- *Reliance on federal tax mechanism.* If the federal income tax system were eliminated, could states realistically keep their income tax systems in place? Many state income tax systems are based on the federal tax system, including terminology and rules. In addition, many states rely on federal tax audits for identifying adjustments to state tax returns. How much time would states need to reform their tax systems to any federal changes? Will Congress factor this time into the transitional period for federal reform?
- *Potential double consumption tax for states.* If a state were to abolish its income/franchise system in response to repeal of the federal income tax and adopt a version of the federal consumption tax in its place, most states would then have two consumption tax systems in place - the new one and the sales tax. As noted earlier, most federal proposals call for some type of a VAT which is just a mechanism for collecting a sales and use tax. If a state were to have a subtraction VAT and a sales tax, it would have increased the regressivity of its overall tax system and eliminated one possible form of relief, namely, exemptions and credits available through the income tax system (which also helps to identify who is a "low-income" taxpayer).
- *New costs for the states.* Under the Armev flat tax, governments (and tax-exempt entities) would be subject to tax at 17% (19% for the first two years) on fringe benefits provided to workers. The goal of this provision is to equalize the costs to both the private and public sector of hiring employees. How will states and cities bear the burden of this tax?
- *Subnational e-commerce concerns:* Today, state and local governments have concerns over further erosion of their sales tax base as e-commerce grows. Today, a state may only impose sales tax collection obligations on a vendor if that vendor has a physical presence in the state. Using e-commerce, it is very easy for a company to only have a physical presence in a single state, yet have customers in all states. For example, Amazon.com only has physical presence in three states (one of which does not impose sales tax (Delaware)), yet sells to customers in all 50 states. Can federal tax reform assist the states with their sales taxation concerns? For example, would a national sales tax better enable states to unify and simplify their sales tax such that they would be able to impose collection obligations on all vendors without impeding interstate commerce?
- *What type of transitional relief, if any, will be provided?* For example, if we change from an income tax to a consumption tax, will individuals with savings consisting of previously taxed income be able to exempt that savings from the consumption tax on the theory that it has already been taxed once? What happens to carryovers such as net operating losses, capital losses and foreign tax credits? What types of complexities will transitional rules present?
- *Changed behavior during the transition period.* In the period preceding the effective date of a new tax system, what will be the impact of changed behavior on the new system? For example, if consumption will be taxed, how will revenue projections be affected by individuals buying cars, prepaying college tuition, etc., immediately prior to the effective date of the new system?

⁸⁶ For example, there have occasionally been suggestions that compliance among independent contractors could be improved by requiring service-recipients to withhold taxes on payments made to contractors. Businesses have typically responded to such proposals by noting that their current accounts payable systems cannot accommodate such withholding.

VI. Current Tax Issues in the United States

A. Dealing with a Budget Surplus

After decades of deficit spending, a 1997 budget act and a strong economy have created a budget surplus. This has led some politicians to push for tax cuts to "return" the surplus to taxpayers. However, others do not want to enact any tax cuts due to the significant debt that has piled up over the past several decades and impending funding problems with Social Security and Medicare. Some are calling for further budget reform, such as removing the current Social Security surplus from the general budget so that it is clear that without the Social Security surplus, there continues to be a small deficit (which is likely to disappear in 1999 or 2000).⁸⁷

B. Social Security and Retirement Savings Concerns

While the Social Security system has not short term problems, it faces serious funding problems in the long term unless changes are made now. Since 1998, President Clinton has been calling upon Congress to use any budget surplus to "Save Social Security First." However, while most politicians agree that problems exist, solutions are very political, pit generation against generation, and require some level of education of taxpayers to best understand the purpose of Social Security (which many erroneously view solely as a retirement system, rather than as a welfare system).

At present, the Social Security trust funds are expected to be solvent until 2032. At the current rate, only about 72% of benefits can be paid to beneficiaries in 2032. Possible solutions for dealing with the expected shortfall of funds to pay beneficiaries 100% of what they expect include:

- Deal with it later. The problem though is that the solution costs more later.
- Reduce outlays by reducing benefits, decreasing cost-of-living adjustments, raising the retirement age, and/or instituting means testing.
- Increase revenues by increasing payroll taxes⁸⁸ and/or the removing or raising the wage base ceiling, expanding the number of workers covered by Social Security, increase the earnings on the trust fund (such as by investing some of the funds in the stock market), and/or increase income taxes on Social Security benefits.
- Privatize the system by creating personal investment accounts for participants, but leave some portion for social insurance/welfare. These types of plans differ with respect to how much of current contributions should go into such plans, who should manage them (the government or each individual), and how to transition to such a system.

Some additional factors to consider in the Social Security debate:

- Medicare funding poses a more immediate problem than Social Security funding.
- In 2032, the system won't be bankrupt, there will just no longer be a surplus, and the worker to retiree ratio will be lower than today. In addition, life expectancy will be higher than today.
- Changes have occurred in the original assumptions that existed in 1935 when Social Security was created. For example, in 1935, life expectancy was 61 but it is 76 today; family composition and earnings patterns have changed, and there are fewer poor elderly (in 1960, 34% were in poverty, in 1995, only 12%).

⁸⁷ For further information: the Congressional Budget Office at <http://www.cbo.gov/> and the Concord Coalition at <http://www.concordcoalition.org/>.

⁸⁸ The AICPA report notes that an immediate and permanent increase in the FICA tax rate from 12.4% to 14.6% would eliminate the shortfall expected to hit in 2032. AICPA, *Understanding Social Security: The Issues and Alternatives*, November 1998, page 1.

Poverty rates for single women and minorities is greater than for white males. For example, for 1996, the poverty rate for men over age 65 was 6.8%, while it was 13.6% for women. The poverty rate for 1996 for married females was 4.3% compared to 23.1% for single females.⁸⁹

- About 30% of beneficiaries depend on Social Security for 90% or more of their income. For about 66% of beneficiaries, Social Security represents over one-half of their income.⁹⁰
- Social Security is more than a retirement savings plan, it was also built on a system of income redistribution and as an anti-poverty program.

C. Simplifying the Tax Law

The complexity of the U.S. tax system has been a complaint almost since 1913 when today's income tax system was created. While Congress and Treasury continue to talk about simplifying the law, new laws and regulations are created that add to the complexity. Both politicians and tax practitioners are well aware that complexity undermines the voluntary compliance system by reducing respect for the law. The IRS Restructuring and Reform Act of 1998 included the following statements and provisions:

- a. "The Restructuring Commission found a clear connection between the complexity of the Internal Revenue Code and the difficulty of tax law administration and taxpayer frustration. The Committee shares the concern that complexity is a serious problem with the Federal tax system. Complexity and frequent changes in the tax laws create burdens for both the IRS and taxpayers. Failure to address complexity may ultimately reduce voluntary compliance."
- b. By March 1 of each year (beginning in 1999), the IRS is to issue a report to the tax-writing committees that addresses such factors as:
 - questions frequently asked by taxpayers
 - common errors on tax returns
 - areas of the law that often result in taxpayer-IRS disputes
 - major areas for which there is no or incomplete guidance or for which the law is uncertain
 - areas where revenue agents make frequent errors in interpreting or applying the law
 - the impact of recent legislation on complexity
 - how long it takes taxpayers to complete and review forms, how many taxpayers use each form, and how the time may have changed due to recent legislation
 - recommendations to reduce complexity in administering the tax law
- c. Tax Complexity Analysis—The Joint Committee on Taxation (JCT) is to provide a complexity analysis to be included in committee reports of the tax-writing committees (or conference committee) or provided to committee members as soon as practicable once the committee report is filed. An Analysis is required for tax provisions of widespread applicability to individual or small business taxpayers. The JCT should seek consultation from IRS and Treasury in completing the Analysis. The Analysis should include:
 - estimated number and types of taxpayer affected by the proposal
 - the income level of affected individual taxpayers
 - the extent to which tax forms will have to be revised and whether new forms will be needed
 - whether taxpayers will be required to keep new records
 - estimated cost of compliance for taxpayers
 - the extent to which the proposal will require the IRS to develop or modify regulations
 - whether and to what extent the proposal will lead to taxpayer-IRS disputes

⁸⁹ Poverty information is from U.S. Bureau of the Census data, as reported in the AICPA report, *supra*, page 18.

⁹⁰ From Social Security Administration data, as reported in the 1998 AICPA report, *supra*, page 19.

- the impact to the IRS, such as whether internal training will be needed, whether the Internal Revenue Manual will need revision, whether programming will be needed, and whether the IRS would need to divert or redirect resources to deal with the new provision.

Several congressional hearings were held in 1999 to develop a list of simplification measures. Some members of Congress acknowledge that calls for major federal tax reform stem from complexity, but prior to replacing the current law, interim measures to reduce complexity are needed. In its testimony before the tax-writing committees in Congress, the American Institute of Certified Public Accountants (AICPA) noted that complexity leads to erosion of voluntary compliance. Problems identified by the AICPA that stem from complexity include: 1) more taxpayers perceive the tax law to be unfair, 2) it is increasingly difficult for the IRS to administer the tax law; 3) the cost of compliance for taxpayers increases; and 4) complexity interferes with economic decision making (testimony before the Senate Finance Committee on 15 April 1999).

D. Equity and Fairness Issues

Concerns over perceived inequities and unfairness of the federal income tax system typically involve the following issues:

- Lowering the tax burden on middle-income taxpayers.
- Eliminating the marriage penalty that two-earner couples often face where they pay more taxes than they would if each spouse could file as a single person.
- Reduction of the tax burden on individuals and businesses by considering proposals to "enhance retirement and health security, including strengthening retirement plans, improving availability and affordability of health care, and increasing personal savings by reducing the tax burden on savings."⁹¹
- Eliminating "corporate welfare." Corporate welfare is a term used to describe certain tax breaks and grants made available to businesses. Most of the concern is with subsidies provided outside of the tax law.
- Consideration of replacing the income tax (and perhaps estate and gift taxes) with a consumption tax that will reward savings and not penalize earning income.

E. Reducing the Tax Gap

The *tax gap* is the term for the revenue the government loses because taxpayers do not fully comply with the tax laws. The tax gap is estimated at about \$120 billion per year, which represents about 17% of taxes that are owed, but not voluntarily paid. The gap stems from taxpayers who do not report all of their income, or do not remit all of their reported taxes, or who claim excess deductions, or do not file a tax return.

In the past several years, Congress has made changes to the law to reduce the tax gap. For example, more information returns are required and some penalties have been increased. In addition, Congress has included funding for specific compliance initiatives in the budget for the IRS in past years, such as programs to improve the collection of delinquent taxes.⁹²

The IRS has instituted a program called Compliance 2000. The goal of this program is to increase taxpayer compliance from 83% to 90% by the year 2000. Compliance 2000 focuses on the problems that lead to a tax gap so that the IRS can eliminate problems before they arise and better devote their resources to areas which are most likely to improve voluntary compliance. For example, the IRS has

⁹¹ From hearing announcement from House Ways and Means Committee of June 2, 1999.

⁹² *Tax Gap - Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, May 1994, page 24.

developed a Market Segment Specialization Program (MSSP) in which they study market segments or professions to find out where areas of noncompliance exist. Efforts are then made to educate examiners about these industries and professions and the potential areas of noncompliance. The IRS has written detailed audit guides for examiners to use in auditing taxpayers in these industries and professions and identifying the problem issues which may lead the examiner to find areas of noncompliance. MSSP audit guides exist for numerous industries and professions including, attorneys, barbers, pizza restaurants, mobile food vendors, gas retailers and architects.

It is not realistic to consider that 100% compliance will be achieved. As noted in a 1995 report by the General Accounting Office (GAO):

"[T]he bottom-line decision on whether to extend the reach of the tax system to recover additional revenues due the government under current law involves determining the right mix between (1) the acceptable level of compliance for each type of taxpayer and (2) the acceptable level of tax system intrusiveness to promote compliance within each category of taxpayer."⁹³

New problems—While Congress and the IRS have made efforts to reduce the tax gap over the past several years, recent events may be acting to maintain or increase the tax gap. These events include:

- Fewer audits by the IRS—In 1981, about 1.6% of individual income tax returns were audited, while in 1998, only .46% were audited.⁹⁴
- Continued "bashing" of the IRS—The hearings that led up to enactment of the IRS Restructuring and Reform Act of 1998 did not portray the IRS in a positive light because only stories of how the IRS abused taxpayers were presented. In addition, some members of Congress, as well as presidential candidates continue to portray the IRS as the source of all complexity and problems with the tax law and as an inefficient agency that needs to be replaced. These comments likely lead to disrespect for the tax law among some taxpayers and reduced voluntary compliance.
- Adjusting to new administrative rules—Changes in collection and audit procedures by the 1998 IRS Reform Act have led to reduced collection activity by the IRS as they revise procedures to comply with the law.

F. International Tax Reform Considerations

Overview—Proposals to change the international tax rules of the U.S. income tax system range from considerations of modernizing the rules to improve the competitiveness position of U.S. multinationals to tightening the rules due to concerns that the current rules encourage companies to manufacture offshore. Most likely, no significant reform will occur until more politicians understand the reasons behind the location and financing decisions made by U.S. multinationals. In 1999, the congressional tax-writing committees held hearings on various aspects of international tax reform, including simplification and consideration of how current tax rules impact the international competitiveness of U.S. businesses. Additional hearings will be needed before any significant reform will occur regarding the U.S. international tax regime. Future hearings will likely need to consider e-commerce issues, simplification, tax reforms in other countries, convergence of tax rates around the world, and attention to better ensuring that U.S. tax and trade policies are coordinated.

Calls to reduce or eliminate deferral—An example of differences in understanding the impact of international tax rules and global competition on U.S. multinationals is the ongoing debate among politicians as to whether current deferral rules should be eliminated. Some people who believe that U.S. companies have a foreign presence solely to take advantage of lower labor costs or lower tax rates, have periodically called for eliminating or reducing deferral of the active income earned by foreign subsidiaries. Businesses and some politicians have countered such positions by pointing out that deferral of active business income of foreign subsidiaries is necessary in order for U.S. companies to compete in a

⁹³ GAO/GGD-95-157, *supra*, pages 2 and 17.

⁹⁴ See <http://trac.syr.edu/>.

foreign market without a serious tax impediment. They also note that elimination of deferral would not equate to removal of a privilege in the tax law, but would constitute the imposition of a penalty. Companies argue that they don't locate offshore solely for tax reasons, but for business reasons, such as the need to have a presence in the market in order to sell in it. U.S. companies also note that for continued economic growth, they must be an active player in foreign markets. Elimination of deferral would most likely decrease U.S. company investment in other countries (including developing countries) which would provide an advantage to foreign companies that are not subject to such strict rules - thus, U.S. jobs and the economy would be hurt. Companies argue that the current rules help to level the playing field when U.S. companies compete with companies in a foreign country that has a territorial system, less restrictive foreign tax credit rules, that allows for tax sparing treaties, or has less strict anti-deferral rules. Finally, companies argue that deferral does not constitute a permanent exclusion and that the current rules are already more strict than in most other countries. This debate will likely continue until the understanding of business decisions and the current global economy improves among members of the public and Congress.

Preliminary discussions on updating the tax law to address the current global economy—In 1998, Senator Roth, Chair of the Senate Finance Committee, announced that he wants to review the international tax provisions in light of the current state of global markets. "We need to fundamentally rethink the tax code with a view to enhancing American competitiveness in the new global economy and helping the American workforce. In order to ensure that we enact policies that will lead the United States into the 21st Century at the forefront of competition, as Chairman of the Finance Committee, I intend to hold hearings over the coming year to explore the ramifications of the changing world economy and the needed reforms in both the international tax and trade areas. The cornerstones of these hearings will be ensuring economic growth in our domestic economy and competitiveness overseas. We must determine how our existing international tax regime, which was designed to address the needs of a totally different age, can be reengineered to complement the changing international marketplace and changing business profiles. We must also strive to encourage the creation of more jobs that draw on these new opportunities."⁹⁵

In remarks made at the George Washington University/IRS Annual Institute on Current Issues in International Taxation in December 1998, Treasury Assistant Secretary for Tax Policy Donald Lubick announced a study on Subpart F to be performed by Treasury.⁹⁶ Treasury will reexamine the deferral rules in order to provide information to the tax-writing committee of the 106th Congress as they deliberate international tax issues. Lubick stated that the study would not be constrained by the policies that have been followed for the past 30 years. The report is expected to be released in the summer of 1999.

General tax reform discussions would fit well with the discussions on improving the international tax rules. Some of the rules that place U.S. companies in a less than competitive position in the global economy are not just the international tax rules. Domestic provisions that hurt competitiveness include depreciation lives that are too long, double taxation of corporate income, the alternative minimum tax, and temporary R&D incentives.

Worldwide versus territorial—Probably the most significant international tax reform that warrants discussion is whether the U.S. tax systems should be changed from a worldwide-based one to a territorial one. The proposals for major federal tax reform discussed earlier all call for a territorial tax system. However, this aspect of reform has not received much attention in the "flat tax" debate. Instead, the matter has been discussed in the tax press and raised at hearing held by Senator Roth. As the U.S. share of world GDP continues to decrease and the U.S. government works to reduce trade barriers, some find it

⁹⁵ Senator Roth, "U.S. Finance Committee Chair Roth's Address at Forum on Taxation of Multinationals," 98 TNI 192-24, 1 October 1998.

⁹⁶ "Treasury's Lubick Remarks on Subpart F Reexamination," 98 TNT 239-48 (12/11/98); Treasury RR-2855 (11 December 1998).

more and more difficult to justify a worldwide tax system that serves to achieve a goal that U.S. companies not favor foreign investment solely for possible tax advantages (such as lower tax rates). At the Senate Finance Committee hearing on international tax reform held on 11 March 1999, the Chief Tax Counsel for DaimlerChrysler noted that because Chrysler is now a subsidiary of a German company, its international taxes have decreased because of certain anti-deferral rules and foreign tax credit limitation rules that exist in the U.S. and the fact that Germany has a territorial tax system.⁹⁷

E-Commerce—In November 1996, the U.S. Treasury Department issued a report⁹⁸ that raised and analyzed various issues regarding the application of tax rules to electronic commerce, as well as tax administrative issues that might arise. Some of the international taxation considerations raised in this report are summarized below.

- *Neutrality*: New technologies should not be impeded by taxes or tax policies that treat them differently than existing technologies and transactions. "Our overall tax policy goal ... should emulate policy in other areas - maintain neutrality, fairness and simplicity - a policy which serves to encourage all desirable economic activity new and old."
- *Application of current concepts to new transactions/technologies*: The paper points out that consideration should be given to determine how existing tax rules and concepts may apply to new technologies, as opposed to creating new rules. For example, the paper notes that a business that sells information may be analogized to a seller of goods in that the computer server where information is stored may be equivalent to the warehouse where tangible goods are stored, with permanent establishment rules applying similarly to each situation.
- *Increased importance of residence-based taxation*: "Transactions in cyberspace will likely accelerate the current trend to de-emphasize traditional concepts of source-based taxation, increasing the importance of residence-based taxation."

For example, a software development company can easily sell its product worldwide via the Internet, with no permanent establishment (PE) outside of the U.S. If a server from which the software can be downloaded were treated as a PE, it would be too easy to relocate the server to a different location with more favorable tax rules. Also, supporters of a residence-based approach note that the income-producing activity of the company is in the U.S.

- *Cooperation in rule development*: Treasury seeks comments from and wants to work with taxpayers, tax advisors, tax law specialists, computer technology specialists, academics, foreign tax policy makers and administrators (such as the OECD and U.S. treaty partners) and Congress to develop "clear and rational principles" to make sure that the tax law does not impede the growth of new technologies.
- *Cross-border administrative concern*. How should reporting systems be developed and implemented to deal with "disintermediated micro-transactions," such as where unsophisticated taxpayers are engaged in cross-border investments and transactions (which are easier to do on one's own with today's technology, as opposed to having to use a large, sophisticated intermediary). What types of information reporting systems should be used for these types of transactions?

The Internet Tax Freedom Act enacted in October 1998 created an Advisory Commission on Electronic Commerce with a very broad mission to study the "Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate or international sales activities." Some of the international issues to be examined by the Commission include "(i) barriers imposed in foreign markets on United States providers of property, goods, services, or information engaged in electronic commerce and on United States providers of

⁹⁷ "DaimlerChrysler Testimony at Finance Hearing on International Taxation," 98 TNT 48-46.

⁹⁸ *Selected Tax Policy Implications of Global Electronic Commerce*, available on the Internet at <http://www.ustreas.gov/taxpolicy/internet.html>.

telecommunications services; and (ii) how the imposition of such barriers will affect United States consumers, the competitiveness of United States citizens providing property, goods, services, or information in foreign markets, and the growth and maturing of the Internet."

Additional international taxation issues under discussion—

- a. Simplification—This topic continues to be discussed with respect to international tax rules, but progress is slow on implementing broad simplification measures.
- b. Hybrid entities—"Check-the-box" regulations issued in 1996 simplified the classification process for partnerships and other non-corporate entities by, in essence, allowing the taxpayer to state its own classification via a binding election. These rules apply for both domestic and foreign entities. In early 1998, the IRS issued Notice 98-11 stating that regulations would be issued to prevent the use of certain "hybrid branches" under subpart F. A hybrid branch is treated as a branch for U.S. tax purposes, but as a separate entity (such as a corporation) for foreign tax purposes. The regulations met with much controversy and the IRS repealed them along with Notice 98-11. In Notice 98-35, the IRS indicated that instead of issuing regulations on hybrid branches, it would issue regulations on hybrid transactions, some of which will result in current taxation (that is, no deferral of the foreign income of the foreign corporation). In February 1999, H.R. 672 was introduced to prohibit the IRS from issuing regulations on hybrid transactions. In July 1999, proposed regulations were issued on using hybrid entities to avoid subpart F income. These regulations are not effective though until five years after the regulations become final. Thus, sufficient time is being provided to allow for discussion of the concerns that caused the regulations to be issued, as well as the possible adverse impact on international competitiveness.
- c. Foreign sales corporations (FSCs)—The World Trade Organization (WTO) continues to review the complaint filed by the European Union that the FSC provisions of U.S. law violate international trade rules.
- d. Tax treaties—Efforts continue to update tax treaties as needed and expand the U.S. treaty network which does not include some countries in Asia or Latin America.
- e. Do multinational corporations pay their "fair" share—Senator Dorgan continues to argue that some foreign-owned multinationals and some U.S. controlled corporations do not pay U.S. tax even though they have billions of dollars of U.S. sales. He cites to studies indicating transfer pricing abuses are a major reason for paying no U.S. tax. A press release of 11 May 1999 from Senator Dorgan's office states that the "IRS lacks the resources to properly enforce tax laws on such transactions. As a member of the Senate Appropriates Committee, Dorgan said he would push for additional resources to help the IRS stop such massive tax avoidance schemes. He said he will also push for a new system of enforcing those tax laws, switching from the outdated "arm's length" pricing method to determine whether or not pricing in transactions between related companies is appropriate to a formulary apportionment method which states have used for years to apportion taxable income to various states." Not all politicians, taxpayers, and practitioners agree with Senator Dorgan's conclusions.

G. Improved Use of Technology in Tax Administration and Compliance

The existence of software programs, at relatively small costs, for preparation of individual tax returns has made it somewhat easier for many individuals to prepare their own tax returns.

The IRS has continued to increase the use of technology to improve compliance and administration. The number of returns filed electronically continues to increase. The IRS Restructuring Act of 1998 mandates further technological improvements by the IRS, such as paperless electronic filing. In addition, the Treasury Department is to develop procedures to implement a return-free tax system such that appropriate individuals may satisfy their filing and payment obligations without filing a return. Such a system is to be operational by 2008. In the meantime, the IRS is to issue a report on the resources needed to implement such a system, tax law changes that would enhance use of such a system, and the number and types of taxpayers who would be able to use such a system.

H. Electronic Commerce Issues and Activities

Overview: New ways of doing business created by the Internet have created various issues and concerns of federal and subnational governments and businesses. In the U.S. the discussion of tax issues are focused on subnational and international tax systems. At the federal domestic level, concerns related to taxation of e-commerce focus predominantly on administrative concerns of being able to adequately identify the parties to transactions that occur via the Internet and the ability to transfer large amounts of money with, perhaps, no documentation. The Treasury Department issued an issues paper on taxation of electronic commerce in November 1996, which seems to have then encouraged other countries, such as Canada, the EU, and Australia to do the same. This has heightened discussion of issues at the international level, which are being coordinated, primarily by the OECD.

Tax issues related to changed business model—The Internet has changed sales and operations of many businesses, and created new business models, such as for Amazon.com. Internet technology—

- Makes borders unimportant (although businesses must still often consider laws and customs in the countries in which their products and services are available).
- Enables businesses of all sizes to more easily and cost-efficiently reach a global marketplace.
- Allows for new types of deliveries for services, as well as for products that can be digitized, such as books and videos. As technology advances to provide greater bandwidth at low cost, digitized products will likely become more of a reality.
- Changes business practices and decisions. Many businesses provide customer support via the Internet. Some businesses have also created intranets to allow for improved internal communications and data-sharing. Some decisions have been quite significant, such as Egghead's decision to eliminate its physical stores and just sell software via the Internet. The ability to reach large markets from a single location can lead businesses, particularly new ones, to consider tax rules in their location decisions. For example, it was recently reported in a story about Amazon.com that one of the reasons for not locating the company in California was that there are too many customers there and they would have to pay sales tax when buying books from an in-state company.⁹⁹
- The following chart illustrates some of the concerns of subnational governments that have arisen due to e-commerce.

E-Commerce Trait	Tax & Fiscal Issues for Governments	Example
Fewer physical distribution facilities are needed.	Land use decisions.	Amazon.com and Egghead.com
More custom inventory, so less storage needs.	Land use decisions. Distinguishing between goods and services.	Purchase of cars via the Internet
Reduced need to be close to customers.	Greater likelihood that residents purchase from foreign (out-of-state) vendors—use tax collection issue; dealing with a global economy..	Amazon.com
Digitized products, rather than physical products.	Less tangible personal property - thus, smaller sales tax base..	Music, books, videos, and software

⁹⁹ David Streitfeld, "Booking the Future; Does Amazon.com Show That Publishing Clicks on the Internet?," *The Washington Post*, July 10, 1998, page A1. Also see Chip Bayers, "The Inner Bezos," *Wired*, March 1999, page 115, 174. The *Wired* article notes that Amazon.com also has a warehouse in Delaware which has no state sales tax, and will open a third in Nevada to help serve its large California customer base (without having a presence in California).

Sale of information	Intangible assets and services typically are not subject to sales tax.	Availability of data bases, software that can analyze data, etc.
Remote workforce that may be scattered throughout a state or country, rather than working in a single work location together. ¹⁰⁰	Reduced infrastructure costs as more people work closer to their homes. Business license taxes applied to home workers.	Customer support provided via the Internet with workers working out of their homes, rather than the company's location.

Summary of issues facing subnational governments and multistate businesses—

"There are approximately 30,000 separate taxing jurisdictions in the United States, thus presenting the potential for an enormous variety of taxes and tax rates on Internet activity. The unique character of the Internet transcends physical and political boundaries and permits commercial and intellectual communications to move from city to city, State to State, and nation to nation without any set path in a manner that is virtually unparalleled in history." [S. 1888 (105th Congress) (predecessor to the Internet Tax Freedom Act)]

The Clinton Administration: The Clinton Administration has been very active in discussing various aspects of Internet use and e-commerce. For example, in July 1997, the White House "Framework" on Electronic Commerce was released covering various legal and operational aspects of global electronic commerce.¹⁰¹ The five principles discussed—

1. The private sector should lead.
2. Governments should avoid undue restrictions on electronic commerce.
3. Where governmental involvement is needed, its should support and enforce a predictable, minimalist and simple legal environment.
4. Government should recognize the unique qualities of the Internet.
5. Electronic commerce over the Internet should be facilitated on a global basis.

With respect to taxation and customs issues, the framework provides:

- The U.S. will advocate that the Internet be declared a tariff-free zone when used to deliver products or services.
- No new taxes should be imposed on Internet commerce.
- Taxation of e-commerce should follow current principles of international taxation, should avoid double taxation, and be simple to administer and easy to understand.
- Taxation of e-commerce should not hinder commerce and consist of a system that can accommodate both U.S. tax systems and those of other countries.
- Guidance should be based on existing tax concepts and principles, wherever possible.
- Any tax system applicable to e-commerce must address its special characteristics—possible anonymity of the parties, small transactions, and difficulties of trying to identify non-physical transactions with a physical location.
- The U.S. should work with the OECD to help achieve global consensus on taxation of e-commerce.

¹⁰⁰ The GartnerGroup predicts that by 2003, one-third of the U.S. workforce will be working remotely at least one day per week. Jack Lessinger, author of *Penturbia*, predicts that more of the workforce will move from urban and suburban settings to telecommute from remote areas including resort areas and farms. "For Better or Worse, IT's Influence Over Our Daily Lives Will Only Grow," *Executive Edge*, June/July 1999, page 15.

¹⁰¹ Available on the Internet at <http://www.whitehouse.gov/WH/New/Commerce/>.

- The above principles should be applied not only in the international context, but also at the subnational levels.
- "Before any further action is taken, states and local governments should cooperate to develop a uniform, simple approach to the taxation of electronic commerce, based on existing principles of taxation where feasible."

In November 1998, the Administration issued the *First Annual Report of the U.S. Government Working Group on Electronic Commerce*, noting the progress that had been made on the framework and introducing some new initiatives, such as ensuring adequate bandwidth and access, and assisting small businesses in effectively using the Internet.¹⁰²

The Administration has also been involved in WTO and OECD activities to promote the growth of e-commerce and an understanding of the tax issues it raises. In December 1998, Donald C. Lubick, Treasury Assistant Secretary of Tax Policy, noted that the Administration's push for "reasonable and non-discriminatory tax policy" in the e-commerce arena did not mean that there would be no taxation of e-commerce. He stated that one of the principles Treasury endorsed at the October 1998 Ottawa OECD conference was that "our taxation systems must impose and collect with respect to electronic commerce the right amount of tax at the right time. We must not allow the Internet to become a tax haven that erodes the tax base and deprives governments—federal, state and local—of the revenue they need to invest in education and infrastructure and to provide essential services."¹⁰³

Administrative and compliance concerns identified by the U.S. Treasury—Some of the areas that the Treasury Department identified in its November 1996 report as warranting discussion and guidance include:

- The tax evasion potential of electronic money, how to prevent the potential, whether techniques in use to combat evasion using paper money are adaptable, types of new audit techniques that will be needed, and information reporting requirements that can and should be imposed on those who issue electronic money.
- How records kept under an "accounted system" (where the money issuer tracks the flow of the funds through the economy) can be "integrated into the system of tax administration and the standards that should be applied to determine whether the records maintained by an accounted system are acceptable for tax purposes."
- How digital identification systems (such as digital signatures and certificates) can be used for tax purposes, including their use for electronically filed documents. In addition, what role should the IRS play in certifying parties that issue digital identifications?
- How technologies (such as digital notarization systems) can be used to verify the authenticity of electronic transaction. Also, what role should the IRS play in developing these types of authentication systems?

ITFA: The Federal Internet Tax Freedom Act (ITFA) enacted on 21 October 1998 imposes a three-year moratorium (from 1 October 1998 through 21 October 2001) on state and local taxes on Internet access, unless such tax was already in existence before 1 October 1998. The moratorium also applies to multiple or discriminatory taxes on e-commerce. Exceptions: (1) persons or entities who knowingly communicate via the Web in interstate or foreign commerce for commercial purposes, materials that is harmful to minors (with some exceptions), (2) Internet access provider who doesn't offer screening software to limit access to material that is harmful to minors.

¹⁰² Available at <http://www.ecommerce.gov/>.

¹⁰³ "Treasury's Lubick Remarks on Subpart F Reexamination," 98 TNT 239-48 (11 December 1998); Treasury RR-2855.

The ITFA also calls for formation of a 19-member Advisory Commission on Electronic Commerce. The members include the Commerce and Treasury secretaries, the U.S. Trade Representative, 8 people representing state and local governments (including one from a state with no sales tax), and 8 from e-commerce industries (including one small business representative). This group is to conduct a thorough study of all levels of tax with respect to e-commerce, including considerations of all types of remote commerce. The Commission is directed to "ensure that its work does not undermine the efforts of the National Tax Association Communications and Electronic Commerce Tax Project" which began studying similar issues in late 1996.¹⁰⁴ The Commission ends and their report is due 21 April 2000.

The ITFA also includes sense-of-congress declarations that the Internet should be free of foreign tariffs, trade barriers, and other restrictions, and that no new federal taxes should be imposed during the moratorium.

VII. Conclusion

Major federal level tax reform in the U.S. is moving at a very slow pace. Proposals to replace the income tax with a consumption tax, such as either the Armeey flat tax or a national retail sales tax, have been introduced as many as four times over the past six years. Some might argue that these proposals are decoys to prevent discussions on fixing the problems with the income and Social Security taxes. However, the talk of major reform has helped to identify problem areas and improved the understanding among many tax advisers, economists, and politicians as to the enormity of the task of major reform.

Meanwhile, specific areas of the federal tax law have been reformed, most notably, reform of the tax administration process by the IRS Restructuring and Reform Act of 1998. Discussions currently underway are focused on international tax reform, fueled by the emergence of electronic commerce and recognition that U.S. multinational companies face a far greater competitive global environment than they did when the current rules were written.

Significant areas of the U.S. tax system that appear to most be in need of attention include complexity, tax issues raised by electronic commerce, international tax rules that are not coordinated with trade policy, and long-term funding of the Social Security system. These are all difficult problems from both the economic and political perspectives and will likely dominate the tax reform discussions in the U.S. for the next several years.

¹⁰⁴ This industry-government group was formed in late 1996 to address state and local tax issues of applying subnational taxes to e-commerce, and to reach consensus, possibly in the form of model legislation for states to adopt. The group consists of 16 people from industry, 16 from government and 7 "other" from universities, the ABA, and the AICPA. The work of this NTA group is being carried out through the following subcommittees: project scope, tax rates, tax base, sourcing transactions, filing simplifications, and other simplifications. Draft papers and background information on the project are available on the Internet at <http://www.taxadmin.org/nta/> and <http://www.nhdd.com/nta/ntaintro.htm>.