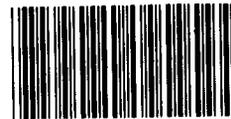


February 1992

TAX POLICY AND ADMINISTRATION

Luxury Excise Tax Issues and Estimated Effects



146244



**RESTRICTED--Not to be released outside the
General Accounting Office unless specifically
approved by the Office of Congressional
Relations.**

RELEASED

553821

General Government Division

B-246285

February 26, 1992

The Honorable Bill Bradley
The Honorable Frank R. Lautenberg
The Honorable Bob Graham
United States Senate

The Honorable William J. Hughes
The Honorable Frank J. Guarini
The Honorable Jim Saxton
House of Representatives

This report responds to your requests that we provide information about the luxury excise tax. As requested, this report examines the effect of the tax on the luxury boat, car, aircraft, jewelry, and fur markets. It provides information on the anticipated tax revenues, the Internal Revenue Service's (IRS) actual collections, and the costs and issues associated with administering this tax. This report also discusses other products that have been taxed as luxury items in the United States or that are taxed as luxuries by other countries.

Background

The Omnibus Budget Reconciliation Act of 1990 enacted a new excise tax imposed on the first retail sale of certain products classified as luxuries. The tax, which became effective on January 1, 1991, is equal to 10 percent of the amount by which the sales price exceeds specified threshold amounts. The luxury excise tax requires businesses to keep appropriate records and to collect and remit the taxes. In addition, individuals who import and use items which would have been subject to the tax if sold in the United States are responsible for paying luxury excise tax on these items. Sales taxes and rebates are excluded from the taxable price, but trade-ins of used products, the gas guzzler tax on certain cars, and fishing equipment excise taxes are not. In addition, the installation of certain parts or accessories within 6 months of the date the product is placed in service may be subject to the tax. The luxury tax is imposed on the following categories of items:

1. Private boats costing over \$100,000: boats used exclusively in a trade or business are exempt from the tax. Business use would include charter vessels with a licensed captain, for example, but would not include a corporate yacht purchased to entertain clients.

2. Cars costing over \$30,000:¹ generally, any passenger car with an unloaded gross vehicle weight of 6,000 pounds or less could be subject to the tax depending on its cost. Vehicles used by a business to transport persons or property for hire (such as a taxi) are exempt.

3. Aircraft costing over \$250,000: the tax does not apply if at least 80 percent of the aircraft's use is for business purposes.

4. Jewelry costing over \$10,000: the tax applies to items designed to be worn on the person or apparel for adornment. This includes custom-made jewelry and jewelry made from gems and other material supplied by the customer. Watches are included as jewelry.

5. Furs costing over \$10,000: items that are made from fur, or of which fur is a major component, are subject to the tax. The tax does not apply to leather or artificial fur.

The luxury tax has been controversial since its enactment, and several bills have been introduced in Congress to repeal the tax on some or all of the items.

Results in Brief

Diverse factors have interacted to affect both demand for and supply of the five luxury products. We could not disentangle the effects of these factors from the effects of the tax and therefore could not quantify the tax effects. Boat, jewelry, and fur sales began declining before the luxury excise tax took effect. Sales of all five products were probably depressed by the 1990-1991 recession. Luxury car sales were also affected by an increase in the gas guzzler tax, and airplane sales decreased in the 1980s due to product liability costs. Therefore, although some portion of the decline in sales during 1991 may have resulted from the price effect of the luxury excise tax, it is likely that other factors also significantly affected these markets. (See apps. I through V.)

As part of its deliberations on the Omnibus Budget Reconciliation Act of 1990, Congress determined which products to tax as luxuries. Both the products selected and the threshold levels that were established reflect subjective decisions about which products are luxuries. Other products that the United States has taxed as luxuries in the past include perfumes,

¹The tax is imposed on passenger vehicles, defined to include (1) cars having an unloaded weight of 6,000 pounds or less, (2) trucks and vans having a loaded gross vehicle weight of 6,000 pounds or less, and (3) limousines without regard to weight. Throughout this report, we refer to passenger vehicles as "cars."

cosmetics, clothing costing over certain amounts, and luggage. Examples of products taxed by other countries as luxuries include home appliances, electronics, sporting goods, and cameras. Generally, there is no consistency in what is regarded as a luxury.

IRS collected \$168,404,000 in luxury excise taxes during fiscal year 1991. IRS estimated its administrative costs to collect these taxes were about \$500,000. Thus, IRS' administrative costs were about 0.3 percent of the revenues collected in fiscal year 1991. IRS expected its administrative costs to decrease to about \$200,000 annually in future years, and the Joint Committee on Taxation estimated that luxury excise tax revenues will increase. (See app. VI.)

IRS' initial information indicated that taxpayers had been informed about the luxury excise tax and were complying with it. IRS does not have an estimate of the cost to taxpayers to comply with the luxury excise tax. (See app. VI.)

The difficulty of ensuring compliance with the proposed luxury excise tax regulations will vary, depending on factors such as the number of firms and transactions involved and the level of complexity in applying the rules. For example, provisions regarding the installation of parts or accessories on boats, cars, and aircraft place responsibility for paying the tax on a large number of firms. Many small businesses install accessories such as electronics and communications equipment on vehicles previously purchased from dealers. The large number of firms may make it more difficult for IRS to determine whether all taxes due are paid. According to an IRS official, auditing for accessories added on after purchase is the most expensive area for IRS to audit.

Another problem area involves the rules governing the modification of a customer's jewelry. Jewelers have expressed some concerns, raising questions about the difference between a repair and a modification and how to determine the fair market value of customers' jewelry. (See app. VI.)

Data Inadequate to Estimate Luxury Tax Effect

We collected and analyzed data on each of the five products affected by the tax (i.e., boats, cars, planes, jewelry, and furs). We did not find, with the possible exception of cars, any data that were adequate to use in reliably estimating the effect the luxury tax may have had on sales of the taxed products.

Measuring the responsiveness of sales to tax-induced price increases requires data on the number of units sold and their prices. If such data existed for each of a series of years, then past responsiveness of sales to price changes could be used to estimate the effect of luxury tax-induced price changes. Because the luxury tax applies only to units over a price threshold, data are needed on the number of units sold over the threshold price and the prices of those units.

These basic data were not readily available for boats, planes, jewelry, and furs. We sought data from industry associations, government agencies, and academic sources.

For boats, we found sales data for inboard cruisers, a category in which sales prices were most likely to exceed the price threshold. However, price data on individual models within this category were not available. The average price for the whole class was available, but unsuitable because the average price fluctuated as the mix of models sold changed, i.e., as the proportion of more or less expensive models sold changed. Without adequate price data, the responsiveness of sales to price changes cannot be accurately measured.

For aircraft, like boats, industry representatives were able to furnish information by types of aircraft—single- and multi-engine piston aircraft, turboprops, and turbojets. Again, however, these data were not adequate primarily because the average prices fluctuated due to changes in the mix of expensive versus less expensive aircraft sold each year. Because several manufacturers went out of business during the last 20 years, it is unlikely that we could have obtained the needed data directly from manufacturers.

An additional data problem was especially relevant to aircraft—the number of aircraft that would escape taxation due to business use. Some information was available on the portion of each type of aircraft that met the business use test for depreciation. However, an aircraft qualifies for accelerated depreciation for tax purposes if it is used more than 50 percent for business; the aircraft must be used 80 percent for business to escape

the luxury excise tax. No information was available to estimate the portion of aircraft that could meet this stricter standard.

We found that jewelry and fur data were only available in industrywide aggregates—luxury sales were not separated from industry totals.

While much research and data on the market for cars exist, research in the economics literature shows that sophisticated, data-intensive models are needed to distinguish price effects from other influences. The one published study we found that examined the impact of a tax on different categories of cars, including luxury cars, was published in 1979 and was too old to use for purposes of this study.²

Although we were unable to find adequate data to quantitatively estimate how much the luxury tax affected sales of the five products, economic theory and an evaluation of factors affecting the market for each product provide some insight into the probable luxury excise tax effects. Our conclusions are based on sales trends in the taxed industries, economic theory, and the results of studies of similar taxes.

Effects of the Luxury Excise Tax

According to economic theory, the luxury excise tax is likely to increase prices of the taxed products (including the tax) and should decrease the quantity of new taxed products sold. The tax should also increase sales of substitute products, for example nonluxury boats, cars, planes, jewelry, and furs (see app. I). However, the magnitude of these effects is difficult to determine because other factors besides the tax have also been important influences in the markets for luxury boats, cars, airplanes, jewelry, and furs. (See apps. II through V.)

Economic models suggest that while prices are increasing any tax-induced decrease in consumer demand for new products sold will likely be disproportionately larger in the short run than in the long run. For example, any increase in price due to the tax will reduce the number of luxury boats consumers want. Until the total number of boats decreases to the level desired by consumers, fewer older boats will be replaced by new purchases. Once the market has adjusted, however, new boats will again be

²After we had completed our work and were preparing to issue this report, we learned that a model containing updated information was commercially available. Our preliminary discussions with the proprietor indicated that modifications to the model would be needed to estimate the tax effects on luxury cars, that modifying the model and validating the reliability of the results would require several weeks, and that the effort would be costly. Due to time and budgetary constraints, we decided it was not practical to use the model at this time.

needed to replace older boats. Consequently, the tax may decrease replacement sales in the short run more than in the long run.

Although prices of the taxed products are likely to have increased when the tax took effect, they are not likely to have increased initially by the full amount of the tax. In the short run, producers³ may be forced to absorb part of the tax by accepting a lower return on their business resources if these resources, such as plant and equipment, cannot be shifted quickly to other profitable uses. If necessary, in the long run, producers can probably find alternative uses for their resources and will be less likely to absorb the tax. Therefore, in the long run, consumers are more likely to pay a greater portion of the tax. The effect of such a price increase on unit sales of the taxed goods depends, in part, on the willingness of consumers to purchase untaxed substitutes.

The revenue realized from the luxury excise tax depends on how much the tax decreases unit sales and increases prices. The impact on labor depends on the decrease in unit sales and on how quickly, and at what wages, workers can find alternative employment.

Any attempt to measure the impact of the tax by comparing sales before and after the tax was imposed must control for other factors that may have affected sales. One such factor is the 1990-1991 recession, which is likely to have decreased sales of all five products. For example, both luxury boat and nonluxury boat sales have been steadily declining since 1988, well before the luxury excise tax took effect. Boat sales have been cyclical, increasing during economic expansions and decreasing during recessions like the one experienced in 1990 and 1991. Therefore, it is very likely that the tax alone is not responsible for the sales decline in 1991. (See app. II.)

Car sales data also illustrate that factors other than the luxury excise tax influenced this market. Cars have provided the majority of revenues from the luxury excise taxes (\$152 million of \$168 million collected in fiscal year 1991). Luxury car sales declined by about 15 percent in 1991. While some decrease in sales may be due to the tax, we believe the tax alone cannot account for the full decrease in sales in 1991. Sales of nonluxury cars were also down in 1991. Other factors that affected demand for luxury cars in 1991 included the recession and the gas guzzler tax increase. (See app. III.)

³In this report, "producers" refers to both manufacturers and sellers of the taxed products.

Few aircraft are likely to be affected by the tax because planes costing over the threshold level of \$250,000 are generally for business or other exempt uses. Five tax returns, representing \$53,000 in revenues, were submitted during the first two quarters of fiscal year 1991. It is likely that the recession contributed to a decline in 1991 aircraft sales. (See app. IV.)

Jewelry and fur sales also began declining before the luxury excise tax took effect. Therefore, other factors, in addition to the tax, may have contributed to the sales decline in 1991. We expect jewelry and fur sales were affected by the recession in 1990 and 1991. (See app. V.)

Objectives, Scope, and Methodology

Our objectives were to analyze the effect of the tax on the five industries, to provide information on tax revenues and IRS' administrative costs, and to discuss other items that have been taxed as luxuries. We analyzed relevant data and interviewed appropriate government and industry officials. We discussed the draft report with IRS officials. They agreed that the information we presented regarding the IRS is accurate, and we included their comments when appropriate. We did our work from May 1991 through December 1991 in accordance with generally accepted government auditing standards. (See appendix VII.)

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will provide copies of this report to appropriate congressional committees, Members of Congress, and other interested parties.

The major contributors to this report are listed in appendix VIII. If you have any questions, please contact me at (202) 275-6407.



Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Contents

Letter		1
<hr/>		
Appendix I		12
The Economics of the Luxury Excise Tax on Durable Goods	The Effect of an Excise Tax Depends on Several Factors	12
	Tax Effects Differ Between the Short and Long Run	13
	Estimating the Tax Effect	14
<hr/>		
Appendix II		15
Luxury Boat Sales Are Cyclical	Boat Sales Have Been Cyclical	15
	Factors Other Than the Tax May Also Have Affected Luxury Boat Sales	17
	The Effects of the Tax	18
	Conclusions	19
<hr/>		
Appendix III		20
Several Factors Influenced Luxury Car Sales	Luxury Car Sales	20
	Effects of the Tax	22
	Other Factors Explaining the Decline in Luxury Car Sales	22
	Conclusions	23
<hr/>		
Appendix IV		24
The Tax May Affect Few Aircraft Manufacturers	The Aircraft Market	24
	Other Factors Affected General Aviation Aircraft Sales	26
	Effect of the Tax	26
	Conclusions	27
<hr/>		
Appendix V		28
Several Factors Affected the Jewelry and Fur Markets	The Jewelry Market	28
	The Fur Market	29
	Conclusions	30

<hr/>		
Appendix VI		31
Luxury Excise Tax	Estimated Revenues From Luxury Excise Taxes	32
Revenues and	Most Revenues Were From Luxury Car Sales	32
Administrative Issues	Administrative Costs Have Not Been Great and Should Decrease	33
	Taxpayers' Compliance Costs Vary	35
	Taxpayers May Need Additional Information	37
	States' Interest in Administering Federal Excise Taxes	39
<hr/>		
Appendix VII		40
Objectives, Scope, and		
Methodology		
<hr/>		
Appendix VIII		41
Major Contributors to		
This Report		
<hr/>		
Tables	Table VI.1: Estimated Revenues From Luxury Excise Taxes	32
	Table VI.2: Fiscal Year 1991 Luxury Excise Tax Collections	33
	Table VI.3: IRS' Administrative Costs	34
<hr/>		
Figures	Figure II.1: Total Dollar Value of Luxury and Nonluxury Boat Sales	16
	Figure II.2: Percentage Change in Number of Luxury Boats Sold and GNP	18
	Figure III.1: Number of Luxury Cars Sold in the U.S. During 1986-1991	21
	Figure IV.1: Shipments of General Aviation Aircraft by Type	25
	Figure V.1: Consumer Spending on Jewelry, Watches, Precious Metals, and Costume Jewelry	29
	Figure V.2: U.S. Retail Sales of Furs	30

Contents

Abbreviations

CRS	Congressional Research Service
GNP	gross national product
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
VAT	value-added tax

The Economics of the Luxury Excise Tax on Durable Goods

The effect of an excise tax on the prices and quantities sold of new durable goods—such as new luxury boats—depends upon the responsiveness of buyers to a higher price (including the tax) and the responsiveness of producers to a lower price (excluding the tax). The responses of consumers and producers to the tax may differ between the short run and the long run. Economic theory suggests that in the long run the prices of the taxed products will likely increase by the full amount, or almost the full amount, of the tax and fewer units will be sold. In the short run, prices probably will not rise immediately by the full amount of the tax—producers are more likely to have to bear some or all of the tax. While we can qualitatively describe the effects of the tax, we could not estimate the size of these effects because we could not find the necessary data.

The Effect of an Excise Tax Depends on Several Factors

The effect of an excise tax on market price and quantities sold depends on the relative price elasticities of demand and supply. The price elasticity of demand measures the degree to which consumers change the quantity of a good they wish to buy when its price changes. For example, if consumers wish to substantially reduce the quantity purchased when the price increases by a small amount, demand is said to be elastic. If consumers wish to buy only slightly less of a good despite a substantial price increase, demand is said to be inelastic. The greater the availability of substitute goods, the more sensitive consumers will be to price changes (demand is more elastic).

The price elasticity of supply measures the degree to which producers change the quantity of a good they offer to sell when the price of the good changes. Like consumers, producers can substitute away from the taxed good. They can produce less of the good or leave the industry altogether and produce an untaxed good. The easier that plant, equipment, and labor can be adapted to other profitable uses, the more sensitive producers will be to changes in price (supply is more elastic).

An excise tax will normally increase market price (including the tax) and decrease units sold. The sizes of these changes depend on the relative elasticities of demand and supply. If buyers have many close substitutes (demand is relatively elastic) and producers have large investments in fixed plant and equipment (supply is relatively inelastic), then little of the tax would be passed on to buyers in the form of higher prices. On the other hand, if producers can easily exit an industry (supply is elastic), then buyers either must pay the tax or forgo new purchases. Thus, in general, the luxury tax is likely to decrease sales of luxury goods and increase sales

of substitute nontaxed goods, including boats, cars, aircraft, jewelry, and furs priced below the tax threshold.

The revenue realized from a tax and the impact on labor also depend on the elasticities of demand and supply. If demand is elastic and producers are able to adjust their plant and equipment to other uses, then the decrease in quantities sold will be relatively large and the tax revenue relatively small. The impact on labor depends on how much sales of the taxed good decline and how quickly and at what wages workers can find alternative employment.

Tax Effects Differ Between the Short and Long Run

The short-run effects of a tax can differ from the long-run effects. First, producers are more likely to have to absorb some or all of a tax in the short run, because plant, equipment, and skilled labor are more likely to be fixed (i.e., not easily adapted to profitably produce untaxed goods). Thus, in the first year after a tax is imposed, the price paid by buyers (including the tax) will probably not increase by the full amount of the tax, and new units sold will probably not decrease by as much as they would if the entire tax was passed on to buyers.

In the long run, however, producers have more opportunity to adjust to the tax by putting their resources to other uses. The remaining producers would not be willing to accept lower profits than they could earn by producing other goods, and workers would not be willing to earn lower wages than they could receive in other industries. As a result, the total price (including tax) would probably rise close to the amount of the tax. The decrease in the number of units sold would depend on the substitutes available to buyers.

Second, if the taxed product is a durable good, the existing stock of these goods can substitute for new purchases.¹ This substitution can magnify the short-run effect on product sales. For example, suppose the existing stock of a durable good owned by consumers is 100 units and the total stock consumers want is also 100 units. If 20 percent of the stock needs to be replaced annually (because of depreciation), then sales of newly produced goods would equal 20 units per year. If a tax-induced price increase reduced the total stock consumers want to 80, then sales of new units would fall to zero during the first year of the tax. After the first year, sales of new units eventually would rebound, but only to 16 units (20 percent of

¹Durable goods are long-lived products that yield benefits over their lifetime to their owners.

80). The long-run decrease in sales is four units per year, but the short-run decrease is 20 units.

The goods subject to the luxury tax are durable, and therefore the tax-induced decrease in demand for new units sold likely will be larger while prices are increasing in the short run than in the long run.

Thus, we expect that the price of the taxed luxury good will probably increase initially by less than the tax, but will likely increase over time until the full amount, or nearly the full amount, of the tax is borne by the consumer. We do not know how long that will take. While prices are going up, the decrease in new units is expected to be larger than after the market has completely adjusted to the higher prices. Similarly, the tax revenues generated and the effects on labor will differ in the short and long run, with the size of the effect depending on the extent of any decrease in quantities sold.

Estimating the Tax Effect

To predict the impact of the tax, data on quantities, prices, and other relevant factors are needed. The price data must be specific (such as data on each model of boat that exceeds the luxury tax threshold) and adjusted for quality changes over time. Such specific information was not available.

Information that was available regarding the tax effect on the individual products is presented in appendixes II through V.

Luxury Boat Sales Are Cyclical

Luxury boat sales exhibited large annual fluctuations between 1970 and 1991. The cyclical nature of the luxury boat market indicates that any sales decline since the tax was imposed must be interpreted with caution. Although tax-induced price changes are likely to have depressed sales after January 1, 1991, other factors also affected luxury boat sales. For example, economic growth, as measured by changes in gross national product (GNP), has been strongly correlated to luxury boat sales. We could not estimate the size of the tax impact, separate from the effects of other factors, on luxury boat sales because we were not able to obtain sufficient price data on luxury boats.

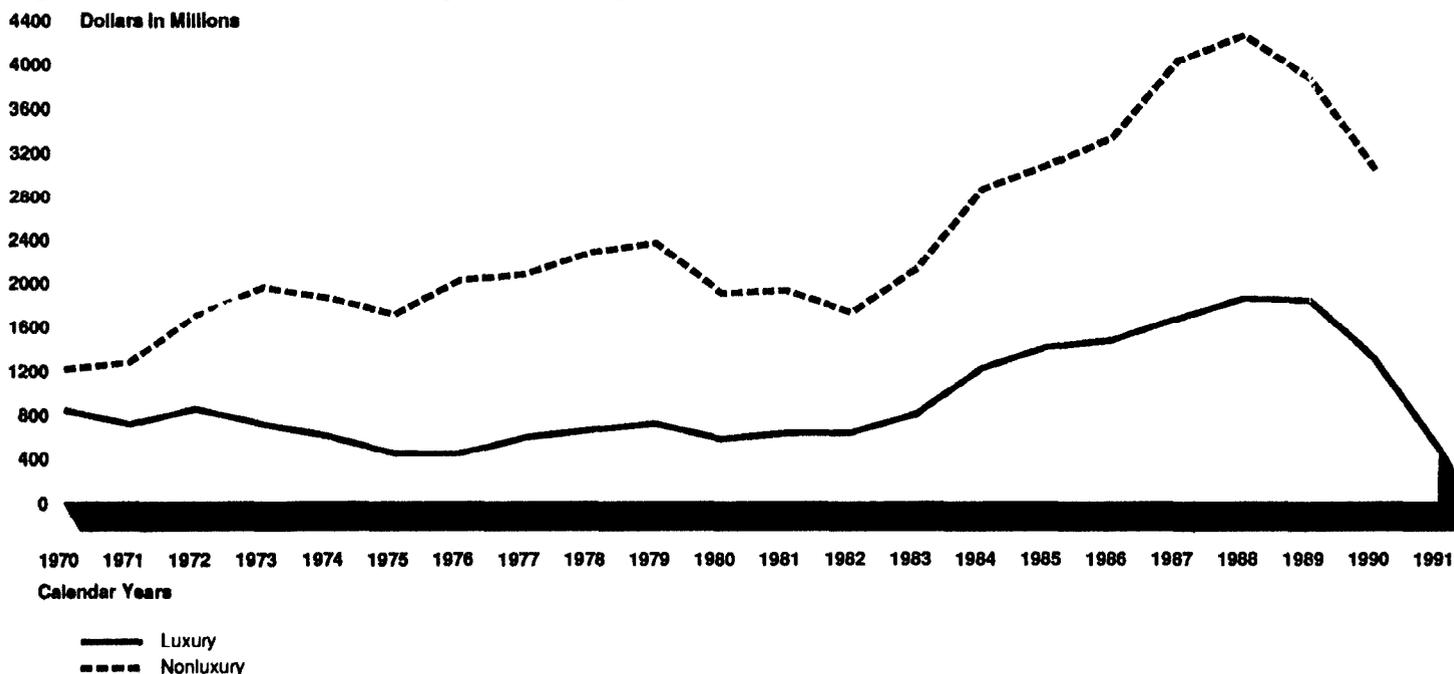
Boat Sales Have Been Cyclical

Historically, luxury boat sales have followed a cyclical pattern, rising and falling along with overall economic activity, and have been highly variable.¹ For example, between 1972 and 1975, sales declined by about 49 percent. Between 1982 and 1988, sales increased by about 195 percent. As shown in figure II.1, the current decline in luxury sales began in 1989, two years before the luxury tax took effect. These data do not include imported or exported boats.

¹We used data for inboard cruisers to estimate luxury boat sales because many boats in this category exceeded the \$100,000 threshold for luxury boats. In 1991 the average price of inboard cruisers was \$186,582. During each of the years 1970 through 1990, the average price of inboard cruisers exceeded the luxury excise tax threshold (as adjusted for inflation). According to industry sources, these data were the most representative data on luxury boats available.

**Appendix II
Luxury Boat Sales Are Cyclical**

Figure II.1: Total Dollar Value of Luxury and Nonluxury Boat Sales



Note 1: Luxury boats are inboard cruisers.

Note 2: Datum was not available for 1991 nonluxury boats.

Note 3: Data are in 1987 dollars.

Note 4: Sales shown for luxury boats are total dollar amounts. As such, changes in reported sales can be caused by changes in price, units sold, and product mix.

Source: National Marine Manufacturers Association

Nonluxury boat sales have also been cyclical.² During the 1980s, nonluxury boat sales trends paralleled luxury sales. For example, the percentage change in nonluxury boat sales decreased by 20 percent in 1980 and increased by 35 percent in 1984. Luxury boat sales also declined 20 percent in 1980, and sales increased by 53 percent in 1984. Sales of both

²We included data on sailboats over 30 feet in length as nonluxury boats, although some of these boats are luxury boats costing over \$100,000. The average price of these sailboats was below the taxable threshold, at \$84,673 in 1991, and a smaller proportion of sailboats are luxury boats than was the case for inboard cruisers. If the data on sailboats over 30 feet in length had been included as luxury boats, the appearance of Figure II.1 would have changed only slightly.

luxury and nonluxury boats declined by about one-third from 1988 through 1990.³

The cyclical nature of luxury boat sales, the current sales decline which began two years before the tax took effect, and the simultaneous decline of nonluxury boat sales, all suggest that factors other than the excise tax also are important determinants of luxury boat sales.

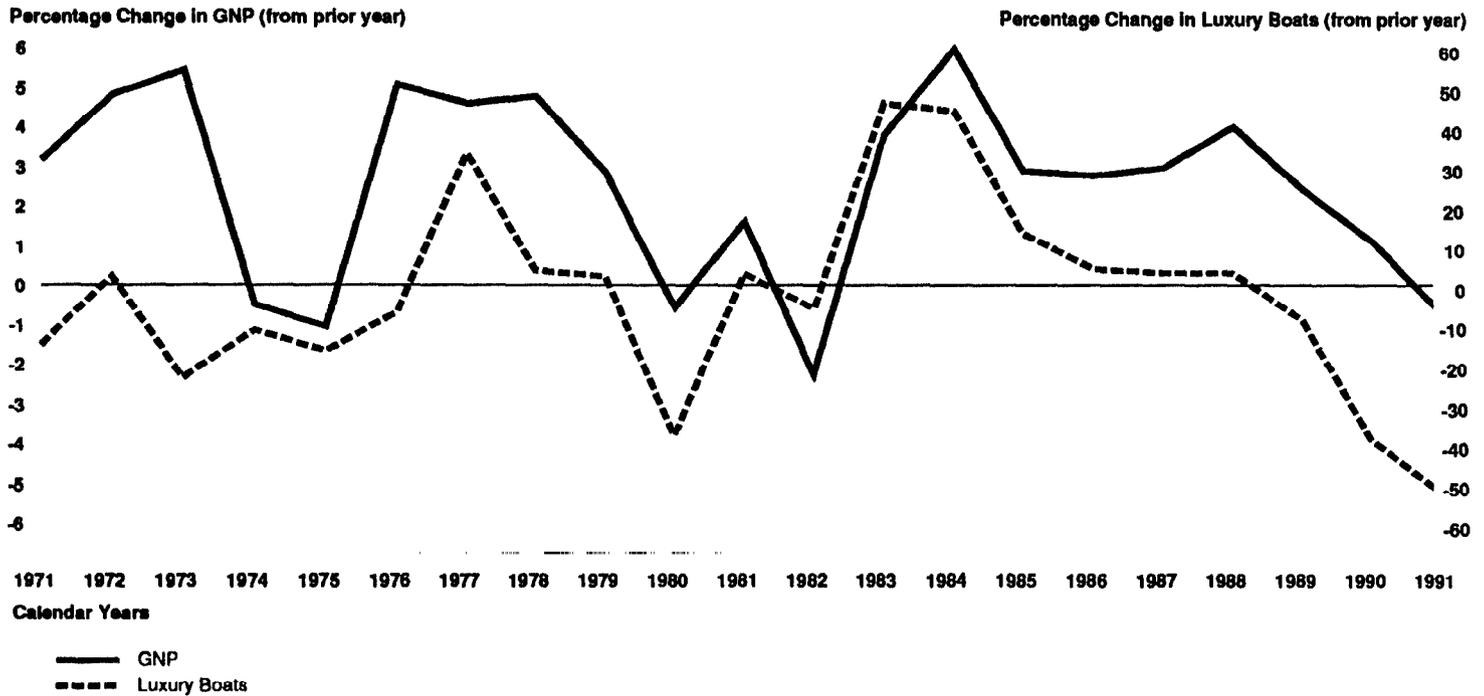
Factors Other Than the Tax May Also Have Affected Luxury Boat Sales

Two factors that may help explain the recent decline in boat sales are the state of the economy and credit availability.

During the last 20 years, inboard cruiser sales have been closely correlated with changes in GNP, which is a measure of the economy's strength. As shown in figure II.2, luxury boat sales and GNP continued to decline in 1991. According to an industry representative, boats are purchased with discretionary income. Purchases may be postponed when potential customers are uncertain about the economy and/or their future income. Therefore, the recession should have depressed sales.

³Commerce Department data show a smaller decline over the same time period (of about 20 percent). However, these data reflect export sales which appear to have increased during these years. See International Trade Administration, U.S. Department of Commerce, 1992 U.S. Industrial Outlook, Chapter 38, "Personal Consumer Durables."

Figure II.2: Percentage Change in Number of Luxury Boats Sold and GNP



Note: The percentage changes are shown on different scales to more clearly illustrate how slight changes in GNP are related to significant changes in luxury boat sales.

Difficulties in obtaining financing or in financing the down payment may also have affected some potential purchasers. Boating industry representatives said that lenders have tightened eligibility requirements for boat loans. Representatives from marine banking and retailers associations also told us that in most cases the tax cannot be financed as part of the loan for a boat, thus increasing consumers' up-front costs.

The Effects of the Tax

Economic theory, described in appendix I, suggests that the luxury excise tax should decrease luxury boat sales. However, data we obtained were not sufficient to allow us to distinguish the tax effect from the effects of other factors such as the 1990-1991 recession and tightened credit. An industry source provided data on the dollar volume of sales and number of units sold. The average price, sales divided by units, was not the needed measure of price because product mix fluctuated. Product mix changes, such as selling one or more super-luxury yachts during a year, could raise the

average price even though the price of no particular model had gone up. The industry source who provided this data said that almost all of the fluctuation in average prices was due to changes in product mix.

Appendix I also suggests that the size of the decrease in new luxury boat sales depends on the availability of untaxed substitutes. Boats, like cars, are durable goods; and potential buyers have several alternatives to buying a new luxury boat. Potential buyers could postpone their purchase, buy a nontaxed boat, or purchase some other product. Although we do not have evidence on the extent that such substitution occurs for boats, substitution occurs for cars, as shown by a 1979 study.⁴

Potential purchasers could also avoid buying luxury boats for other reasons that are related to the luxury excise tax. For instance, anecdotal evidence from industry representatives suggested that some potential buyers might be waiting to see whether the tax is repealed and that others might be protesting the tax by not purchasing a boat.

As discussed in appendix I, the tax-induced decrease in new boats sold should be larger in the short run because the existing stock can substitute for new purchases in the short run.

Conclusions

The decline in luxury boat sales since January 1991 is consistent with a tax effect; but it is also consistent with the effects of other factors, especially the recession which occurred in 1990-1991. Historically, boat sales have fluctuated greatly. Since 1989, luxury boat sales have declined by 64 percent. About one-half of this decline, 30 percent, occurred before the tax took effect and must be attributed to other factors which may have continued to affect 1991 sales. However, due to insufficient data, we could not estimate the magnitude of the tax effect separate from the other factors that may have influenced luxury boat sales in 1991.

⁴Schink, George R., and Colin J. Loxley, "An Analysis of the Automobile Market: Modeling the Long-Run Determinants of the Demand for Automobiles," Wharton Econometric Forecasting Associates, Inc., December 1979.

Several Factors Influenced Luxury Car Sales

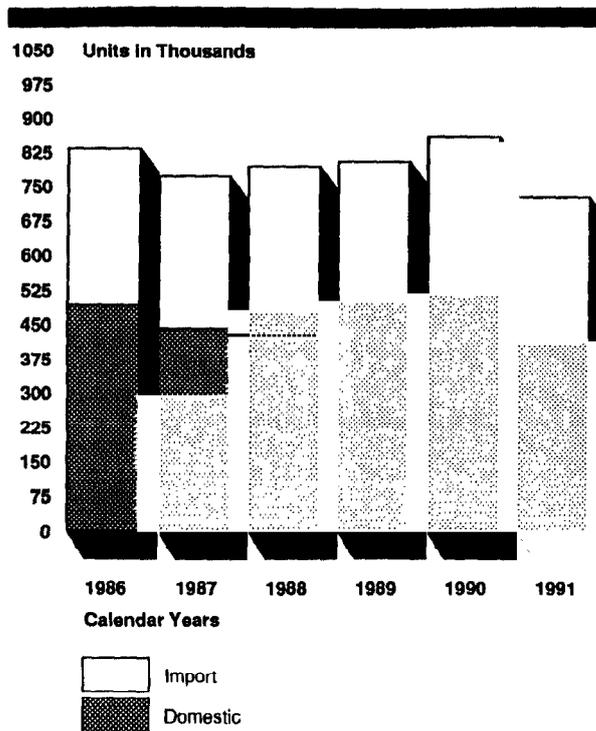
Most of the luxury excise tax revenues generated during fiscal year 1991 were from car sales, which provided \$152 million, or about 90 percent, of the total. Because the tax is not indexed, it is likely that more cars will exceed the threshold as prices increase and, thereby, generate additional tax revenue.

Appendix I and the current economic literature predict that a tax on luxury cars should decrease the sales of luxury cars and increase nonluxury car sales. Decreases in both luxury and nonluxury car sales in 1991 provide strong evidence that factors other than the luxury excise tax are significantly affecting luxury car sales.

Luxury Car Sales

In 1991, American manufacturers produced about 57 percent of the cars sold in the United States that exceed the luxury tax threshold of \$30,000, as shown in figure III.1. Total car sales were down from 9,295,841 in 1990 to 8,176,310 in 1991. During 1991, the number of luxury cars sold decreased about 15 percent, and the number of nonluxury cars sold declined by about 12 percent.

Figure III.1: Number of Luxury Cars Sold in the U.S. During 1986-1991



Source: Automotive News and Congressional Research Service

We based our calculation of the number of luxury cars sold in the United States on work done by the Congressional Research Service (CRS) for its September 17, 1991, memorandum on luxury car sales. CRS listed United States new automobile sales by model and make of car for those cars with transaction prices over \$30,000 in model year 1991. CRS tracked the units sold for each of these cars during the years 1986 through 1990. Using Automotive News data, we updated the units sold in 1991. Because we did not examine transaction prices for all car models each year, it is possible that some models with prices higher than the \$30,000 threshold level (in constant dollars) that were discontinued before model year 1991 were not included in our analysis.

Effects of the Tax

Appendix I and the economic literature predict that luxury car sales will decrease and nonluxury sales will increase. The magnitude of the effects depends on the extent to which consumers are willing to substitute untaxed cars for taxed cars.

The economic theory presented in appendix I also predicts that the short-run decrease in sales due to the tax will differ from the long-run decrease. In the short run, producers are more likely to be willing to pay a portion of the tax than in the long run. While prices are going up, the decrease in new car sales is expected to be larger than the long-run decrease because cars are durable goods. The existing stock of cars can substitute for new car purchases in the short run, magnifying the decrease in new car sales.

From our review of the published literature, the study that came closest to evaluating the effects of the luxury excise tax was done by Wharton Econometric Forecasting, Inc.¹ Although there had been many studies estimating the elasticity of demand for cars, they did not estimate the responsiveness of luxury car demand to a tax imposed only on luxury cars. For example, several articles we reviewed focused on the effects of tariffs on Japanese cars imported into the United States. Because these imports included some that were luxury cars and some that were not, the resulting elasticities were not appropriate for use in estimating the effect of the luxury excise tax.

In the Wharton study, a 5-percent sales tax was imposed simultaneously on luxury, large, and mid-size cars. The authors estimated a relatively small impact on luxury cars—the desired stock of luxury cars declined from 9 percent to 8.9 percent of the United States market. However, this probably underestimated the effects of the luxury excise tax, because the Wharton study assumed that the closest substitutes for luxury cars (i.e. large and mid-size cars) would also be taxed.

Other Factors Explaining the Decline in Luxury Car Sales

In looking at the current sales trends, we believe that the tax is only one of many factors affecting demand for luxury cars. Two factors that are probably important in explaining the recent decline in luxury car sales are the state of the economy and the gas guzzler tax increase on some luxury car models.

¹Schink, George R., and Colin J. Loxley, "An Analysis of the Automobile Market: Modeling the Long-Run Determinants of the Demand for Automobiles," Wharton Econometric Forecasting Associates, Inc., December 1979.

The gas guzzler tax increase, which took effect the same day as the luxury excise tax, would have to be disentangled from the luxury excise tax on cars to determine the impact of the latter. It appears that, on the basis of 1991 sales data, less than 20 percent of luxury cars sold were gas guzzlers. However, the current gas guzzler tax doubled the previous gas guzzler tax, and the increase is large enough for us to expect that sales would be affected for these models. In addition, some manufacturers probably were more affected by the gas guzzler tax than others because more of the cars they produce are gas guzzlers. Any attempt to explain the decline in luxury car sales in 1991 would have to take account of both taxes.

For those models classified as gas guzzlers, a comparison of the gas guzzler tax increase with the luxury excise tax on cars shows, for example, that the purchaser of a \$40,000 car would be liable for \$1,000 in luxury excise tax. In addition, assuming at least 18.5 but less than 19.5 miles per gallon fuel efficiency, the total gas guzzler tax would be \$2,100. In this example, the 1991 gas guzzler tax increase amounted to \$1,050. Therefore, the total tax-induced price increase experienced in 1991 would include effects from both the increase in the gas guzzler tax and the imposition of the luxury excise tax.

Another factor that we believe decreased demand for all cars, including luxury cars, is the 1990-1991 recession. As shown earlier in this appendix, sales of both luxury and nonluxury cars declined in 1991. Purchases of durable goods, such as cars, are especially responsive to economic conditions because they can be postponed when consumers are uncertain about the economy and their future income.

Conclusions

The decline in luxury car sales since January 1991 is consistent with a tax effect, but is also consistent with the effects of other factors, especially the recession which extended through 1991. Luxury car sales probably were affected not only by the luxury excise tax, but also by an increase in the gas guzzler tax—both of which took effect the same day.

The Tax May Affect Few Aircraft Manufacturers

Most aircraft probably will not be taxed by the luxury excise tax. For example, five tax returns, representing about \$53,000 in revenues, were submitted during the first two quarters luxury excise taxes were collected.¹

The number of aircraft shipped from manufacturing facilities declined in 1991. These shipments, however, may have been affected by factors other than the tax, especially the 1990-1991 recession. We were unable to determine the extent the decline in shipments was due to the tax versus other factors.

The Aircraft Market

The general aviation aircraft market consists of four types of planes: piston-powered single-engine and multi-engine, turboprop, and jet aircraft. In 1991, there were 1,021 new aircraft delivered, including 564 single-engine piston aircraft, 49 multi-engine piston aircraft, 222 turboprop aircraft, and 186 jet aircraft. About 38 percent of these 1,021 aircraft were exported and, therefore, would not be taxed.

The average price of single-engine aircraft in 1990—\$111,842—was well below the \$250,000 luxury excise tax threshold. Some single-engine aircraft do exceed the threshold, however, and their taxation depends on the type of use. We did not find data available to help determine specifically how expensive single-engine aircraft are used (i.e., business or personal use). According to a Price Waterhouse study, about 65 percent of all single-engine aircraft were primarily for personal use in 1989.² Single-engine aircraft shipments declined 7 percent during 1991, from 608 planes in 1990 to 564 in 1991.

Industry representatives told us that turboprops and jets are generally used for business purposes. Average 1990 prices for these planes were \$2,291,815 and \$7,571,429 respectively. The Price Waterhouse study showed that less than 3 percent of both turboprop and jet aircraft were for personal use in 1989. One aircraft manufacturer told us that the 80-percent business use test for luxury excise tax exemption, which is stricter than the more-than-50-percent business use test used for claiming accelerated

¹IRS collected \$65,000 from the luxury excise tax on aircraft during fiscal year 1991, according to data on returns processed through the quarter ending in December 1991. However, IRS did not anticipate having data on the number of returns filed in fiscal year 1991 until sometime in March 1992.

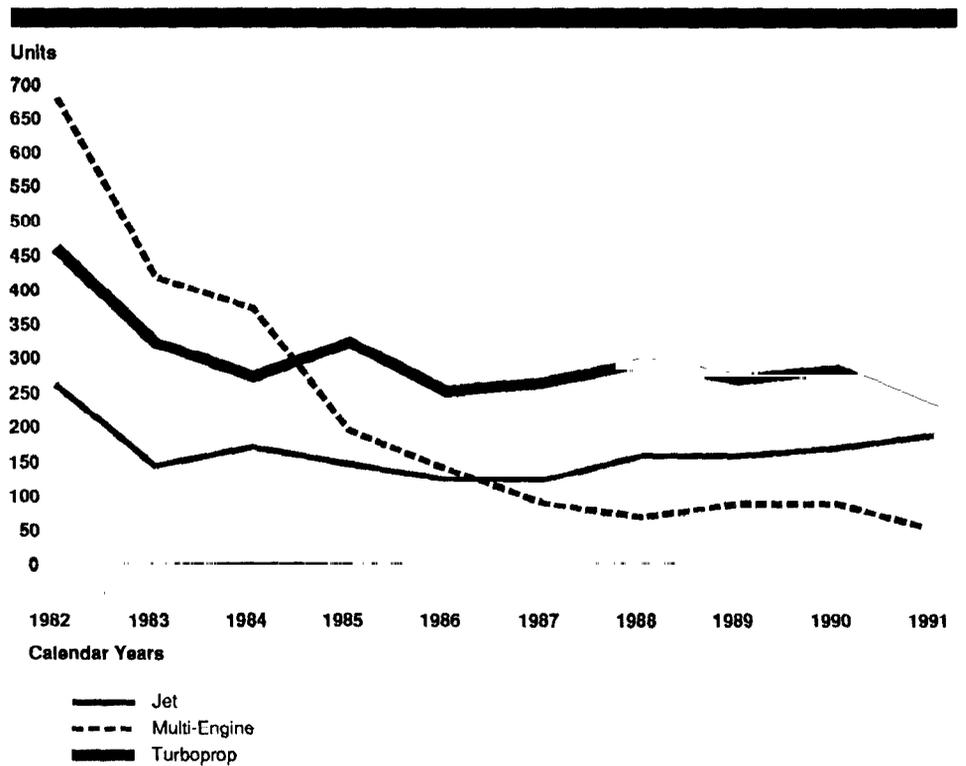
²"The Economic Impact of the Luxury Tax on the General Aviation Aircraft Industry," Price Waterhouse, January 14, 1992. Personal use was measured using the more-than-50-percent test for claiming accelerated depreciation, not the 80-percent test required for the business use exemption from the luxury excise tax. Data cited were from the Federal Aviation Administration's Statistical Handbook of Aviation, Calendar Year 1989.

**Appendix IV
The Tax May Affect Few Aircraft
Manufacturers**

depreciation on aircraft, may affect a customer's decision to purchase a new plane.

Multi-engine aircraft prices averaged \$275,862 in 1990, and thus many could be subject to the tax. Some of the aircraft exceeding the taxable threshold would not be taxed due to business or other exempt use. According to the Price Waterhouse study, about 70 percent of multi-engine aircraft in 1989 met the more-than-50-percent business use test to claim accelerated depreciation. Figure IV.1 shows that shipments of multi-engine piston aircraft and turboprops both declined in 1991, by 44 and 21 percent respectively.

Figure IV.1: Shipments of General Aviation Aircraft by Type



Source: General Aviation Manufacturers Association

Because one company fills a market niche for private pilots of multi-engine and turboprop planes, industry officials told us that this company may have been particularly affected by the luxury excise tax. A company spokesman said that their sales have declined to some extent as a result of the tax. We

do not know to what extent this company's sales decline is due to the tax rather than to other factors, such as the 1990-1991 recession.

Other Factors Affected General Aviation Aircraft Sales

Although tax-induced price changes may have depressed sales for some general aviation aircraft, other factors have also affected aircraft sales. Decreased demand for general aviation aircraft may have been partly due to the 1990-1991 recession. Some customers considering the purchase of an aircraft for business use might defer such purchases during recessions. One industry official said that many of their potential customers have trimmed their capital spending in response to tough economic times. In addition, individuals who were uncertain about their future income due to the economic climate also might defer their purchases of aircraft for personal use.

According to a Department of Commerce report, increased product liability costs have been a major factor contributing to decreased production of general aviation aircraft during the 1980s.³ Industry and government officials said that product liability continues to be a major factor in aircraft production costs. For example, one manufacturer of general aviation aircraft filed for bankruptcy protection in 1991 and, according to these officials, was considering moving manufacturing operations out of the country to limit liability costs. Because generally there is no time limit on product liability until an accident occurs, manufacturers can be held liable for accidents in planes throughout their 20-year, or greater, useful life.

Effect of the Tax

Appendix I and the economic literature predict, for planes subject to the tax, that sales of luxury aircraft will decrease and nonluxury sales will increase to the extent that customers buy nontaxed rather than taxed aircraft. The magnitude of the effect of the tax depends on the substitutes available. Because of large size, price, and performance differences across types of aircraft, we expect most such substitution to occur within types, e.g., buyers of multi-engine planes for personal use might buy fewer options. We were not able to obtain sufficient data to estimate demand and supply elasticities for the aircraft market nor could we estimate the proportion of sales subject to the tax, so we could not determine the magnitude of this effect.

³International Trade Administration, U.S. Department of Commerce, 1992 U.S. Industrial Outlook, Chapter 21, "Aerospace."

Appendix I also predicts that the short-run effect of the tax will differ from the long-run impact. Producers are more likely to be willing to absorb a portion of the tax in the short run than in the long run. In addition, the existence of a large stock of planes can make the tax-induced sales decrease much greater in the short run while prices are increasing, than in the long run.

Conclusions

The decline in sales of single-engine and multi-engine, as well as turboprop, aircraft is consistent with a tax effect; but this decline is also consistent with the effects of other factors, especially the 1990-1991 recession. We were unable to determine the proportion of plane sales subject to the tax or the extent these sales declines were due to the tax versus other factors.

Several Factors Affected the Jewelry and Fur Markets

Jewelry sales amounted to about \$30 billion in 1991, and fur sales totalled an estimated \$1.5 billion in 1990.¹ Appendix I predicts that a tax on jewelry and furs costing over \$10,000 should decrease sales of these products and increase sales of nontaxed jewelry and furs (such as less expensive or used products). Data we found did not allow us to separate out sales of luxury jewelry and furs from all such sales. However, because jewelry and fur sales began to decline well before the luxury excise tax took effect, it is likely that factors, including those discussed below which decreased sales prior to 1991, continue to affect these markets.

The Jewelry Market

Jewelry costing over \$10,000 is generally sold in jewelry specialty shops, the majority of which are small and privately held. Many department stores have jewelry departments that sell jewelry with values generally not exceeding the threshold amount.

Data do not exist pertaining to sales of jewelry costing \$10,000 or more. We could not get a good approximation of the luxury category from the industry data because the price of jewelry can range from costume jewelry costing substantially less than \$100 to fine jewelry with purchase prices exceeding the taxable threshold. The same holds true for total sales by jewelry stores.

Consumer spending on jewelry in 1991 declined slightly (by about 6 percent in real terms) since 1990, as shown in figure V.1. A Commerce Department report states that the jewelry industry is highly cyclical and affected by changes in disposable personal income and consumer confidence.² The report also stated that jewelry sales since 1987 have been adversely affected by increased diamond prices. According to an industry official, both luxury and nonluxury jewelry sales declined during the period 1988 through 1991. Thus, it is likely that factors other than the tax, such as the 1990-1991 recession, also affected jewelry sales.

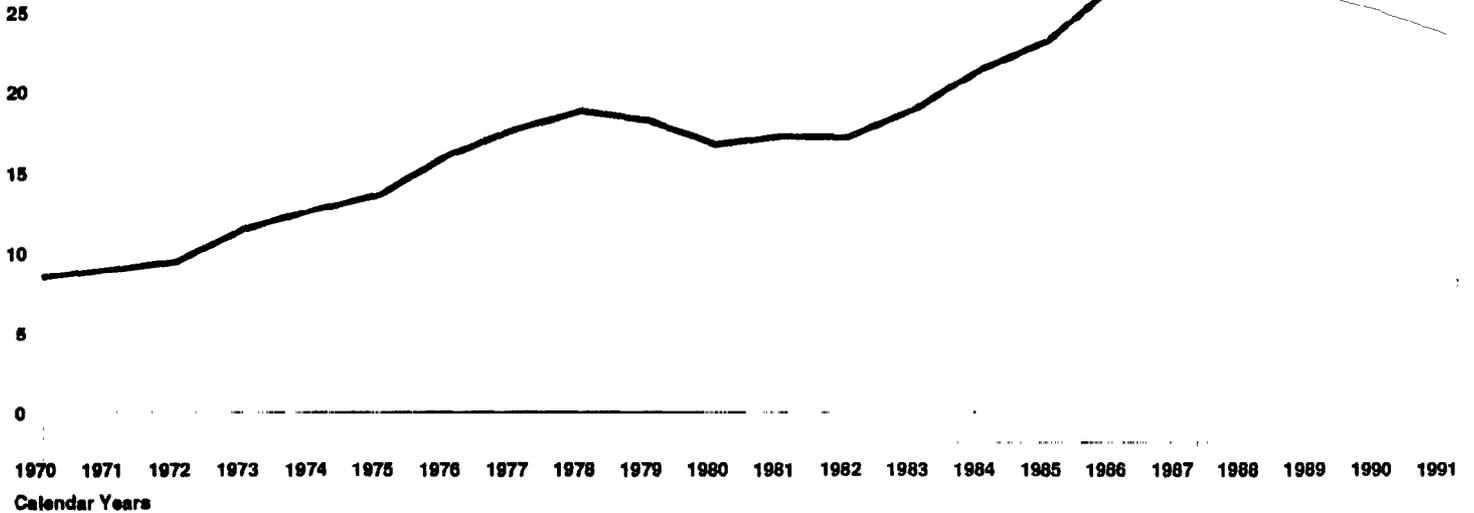
¹The official who provided these *Fur World Magazine* estimates said they were based on survey information and knowledge of the industry. Information on 1991 sales was not available. These data were the only source of comprehensive data on retail fur sales we could find.

²International Trade Administration, U.S. Department of Commerce *1992 U.S. Industrial Outlook*, Chapter 38, "Personal Consumer Durables."

Appendix V
Several Factors Affected the Jewelry and Fur
Markets

Figure V.1: Consumer Spending on Jewelry, Watches, Precious Metals, and Costume Jewelry

30 Dollars in Billions



Note 1: Data are in 1987 dollars.

Note 2: Datum for 1991 is subject to revision.

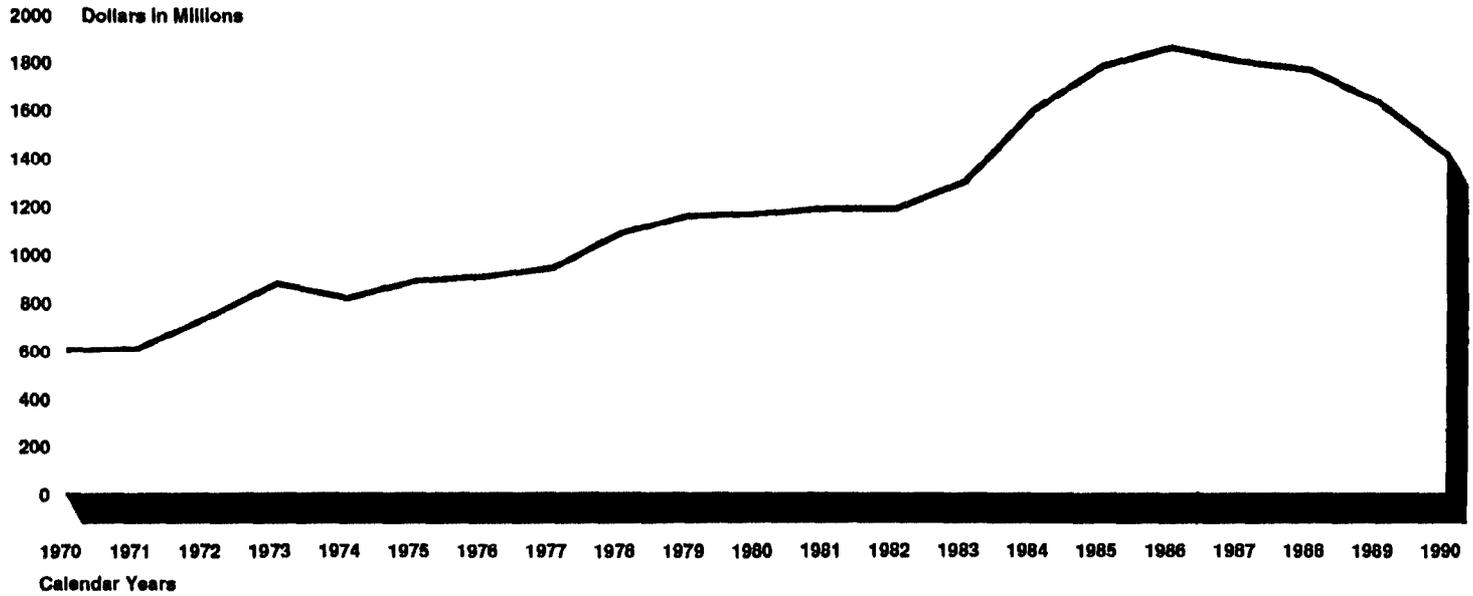
Source: Department of Commerce, Bureau of Economic Analysis

The Fur Market

The fur industry uses pelts from animals such as mink, sable, rabbit, fox, cheetah, leopard, lamb, sheep, muskrat, and lynx. According to an industry representative, the luxury tax generally falls on mink and sable coats because these are high quality fur garments. A manufacturing association official told us that mink makes up about 70 percent of sales of furs in the luxury range.

According to *Fur World*, an industry magazine, estimated retail sales of fur in the United States increased from \$279 million in 1970 to \$1.8 billion in 1986. However, sales have declined 24 percent since peaking in 1986, as shown in figure V.2.

Figure V.2: U.S. Retail Sales of Furs



Note 1: Data are in 1987 dollars.

Note 2: 1991 datum was not available.

Source: Fur World

Industry representatives told us that fur sales are affected by a number of factors, including production levels, consumer tastes, the animal rights movement, the economic climate, and the weather. Both luxury and nonluxury fur sales have declined, according to industry officials. Therefore, it is likely that factors other than the tax, such as the 1990-1991 recession, have affected luxury fur sales.

Conclusions

The decline in jewelry and fur sales is consistent with a tax effect, but is also consistent with the effects of other factors. The fact that sales began to decline in both industries several years before the tax was imposed and that both luxury and nonluxury sales have declined in 1991 are evidence that factors other than the luxury excise tax, including the 1990-1991 recession, probably affected sales.

Luxury Excise Tax Revenues and Administrative Issues

The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) levied a tax on the first retail sale or domestic use of certain luxury products. The tax took effect on January 1, 1991, and is 10 percent of that portion of the retail purchase price in excess of certain thresholds for each product, as follows:

- boats costing over \$100,000,
- cars costing over \$30,000,
- aircraft costing over \$250,000,
- jewelry costing over \$10,000, and
- furs costing over \$10,000.

Various threshold levels were considered. According to a representative from the Joint Committee on Taxation (JCT), the thresholds were not designed to affect equal portions of each industry's products. Rather, they reflect subjective decisions about which products are luxuries.

The JCT representative said that Congress also considered taxing other products. For example, Congress looked at items that had previously been taxed as luxuries.¹ In considering the potential number of transactions involved and the administrative difficulties that could be associated with taxes on some items, Congress decided to levy the luxury excise taxes on the five products we have discussed in the previous appendices: boats, cars, aircraft, jewelry, and furs. Only new products are taxed; products purchased or used before January 1, 1991, are exempt from the tax. Some business, governmental, or other specified uses of boats, cars and aircraft are also exempt, as are exports.

It is common for higher value-added-tax (VAT) rates to be imposed on luxury items such as those that are currently taxed in the United States.² Other products subject to higher VAT rates include perfumes, cosmetics, home appliances, electronics, and firearms. Other countries have taxed entertainment, sporting goods, and cameras. It is likely that countries are not consistent in judging what is a luxury because the choices are somewhat arbitrary and reflect the subjective nature of the definition of luxury.³

¹Many excise taxes were eliminated in the Excise Tax Reduction Act of 1965 (P.L. 89-44), including those on jewelry and furs.

²Most of the nations of Western Europe have value-added taxes, which are consumption taxes collected on the difference between a business's sales and its purchases.

³"History and Economics of U.S. Excise Taxation of Luxury Goods," Congressional Research Service, June 17, 1987 (updated September 20, 1990).

Estimated Revenues From Luxury Excise Taxes

The JCT released an estimate in February 1992 that the luxury excise taxes would generate \$98 million in net revenue during fiscal year 1991.⁴ The estimated luxury excise tax revenues increase over the 5-year period covered in table VI.1 in part because the tax thresholds are not indexed for inflation. The JCT expected that as more products exceed the threshold amounts, the luxury excise tax base will broaden.

**Table VI.1: Estimated Revenues From
Luxury Excise Taxes**

Dollars in Millions

Item	Fiscal year					Total ^a
	1991	1992	1993	1994	1995	
Boats	\$4	\$10	\$25	\$25	\$25	\$89
Cars	88	227	357	368	385	1,425
Aircraft	1 ^b	1 ^b	4	4	4	12
Jewelry	6	11	23	24	24	88
Furs	1 ^b	1	3	3	3	10
Total^a	\$98	\$249	\$411	\$423	\$441	\$1,627

^aMay not add due to rounding.

^bEstimated revenues less than \$1 million.

Source: JCT.

According to a staff member, the JCT revised its January and November, 1991 estimates in response to information on collections obtained from the Internal Revenue Service (IRS). Other factors that the JCT considered in estimating the revenues from luxury excise taxes were data on the taxed industries, the binding contract rule,⁵ pre-purchases (buying products before the tax took effect), and general economic activity.

Most Revenues Were From Luxury Car Sales

IRS collected about \$168 million from luxury excise taxes in fiscal year 1991. Of this amount, 90 percent (\$152 million) was from sales of luxury cars.

⁴Since excise taxes are deducted from income subject to income tax, increases in excise tax collections reduce income tax collections. Thus, the net revenue from an increase in excise taxes will be less than the excise taxes collected.

⁵This rule allowed contracts agreed upon by September 30, 1990, to establish a sale before the tax took effect and thereby avoid the tax, although the final sale would not occur until sometime after January 1, 1991, but still would not be subject to the luxury excise tax.

**Appendix VI
Luxury Excise Tax Revenues and
Administrative Issues**

**Table VI.2: Fiscal Year 1991 Luxury
Excise Tax Collections**

Product	Collections
Boats	\$7,325,000
Cars	151,500,000
Aircraft	65,000
Jewelry	9,172,000
Furs	342,000
Total	\$168,404,000

Source: IRS data on returns processed through the quarter ending in December 1991.

The businesses that collected and remitted luxury taxes in the first quarter are required to file returns on a quarterly basis as long as they remain in the business of selling products subject to the luxury excise tax. If no tax is due on a subsequent quarterly return, they are required to write a zero in the line item and sign the return. A final return should be filed if a company goes out of business or no longer sells the taxed product(s). After March 31, 1991, businesses are required to make semi-monthly deposits of luxury excise taxes. Individuals paying the luxury tax because a product has been used before its first retail sale may attach their payment to a one-time return.⁶

**Administrative Costs
Have Not Been Great
and Should Decrease**

Some people expressed concern that the costs to administer and comply with the luxury excise taxes will be high, while the yield from these taxes will be relatively small. IRS estimated that it will cost about \$200,000 annually to administer the luxury excise taxes. IRS did not have an estimate of the cost to taxpayers to comply with luxury excise taxes.

⁶Generally, any use of an article before the first retail sale will be deemed to be a sale of the article triggering the tax. There are specific uses, however, which do not trigger the tax, such as display of an article in a showroom. In addition to these permitted uses, there are safe-harbor provisions for automobiles, boats, and aircraft. These provisions allow dealers to use these products up to certain limits without having to pay the tax.

**Appendix VI
Luxury Excise Tax Revenues and
Administrative Issues**

Table VI.3: IRS' Administrative Costs

IRS function	Estimated fiscal year 1991 cost	Estimated annual cost in subsequent years
Returns Processing	\$7,463	\$7,840
Forms and Publications	286,000	36,000
Chief Counsel's Office	110,723	11,515
Taxpayer Service	10,000	5,000
Enforcement	67,314	136,745
Accounting	5,300	5,300
Legislative Affairs	5,000	0
Total	\$491,800	\$202,400

Source: IRS.

Higher estimated costs for fiscal year 1991 (about \$500,000) represent one-time expenditures to implement the taxes, such as revising forms and publications, drafting temporary regulations, and publicizing the new tax. The bulk of the one-time cost was for developing and mailing out the forms and instructions for preparing the quarterly federal excise tax return. IRS sent information to organizations whose members could be affected by the luxury excise tax.

IRS' administrative costs were about 0.3 percent of the taxes collected in fiscal year 1991 and, according to IRS' estimates, are likely to represent an even smaller portion of future luxury tax collections. We were unable to compare the cost to administer the luxury excise taxes with other excise taxes IRS administers because IRS does not collect data on the costs associated with collecting other excise taxes.

IRS' estimate of enforcement costs for fiscal year 1992 beyond was based on an average of 5 hours per audit. As of March 1991 IRS' revenue agents were expending an average of 5 hours per excise tax return for all excise taxes. IRS did not receive additional funds or staff to administer the luxury excise taxes and plans to incorporate luxury excise taxes into its ongoing work load.

IRS modified its quarterly federal excise tax return to include luxury excise taxes and plans to process the returns and audit companies in a manner similar to the way it handles other excise tax returns. IRS' district offices will each develop a plan for coverage of all excise taxes, including luxury taxes. An IRS official said that each excise tax requires a unique examination approach.

Estimated annual enforcement costs more than double for the years following fiscal year 1991 (from \$67,314 to \$136,745) because luxury excise tax returns will begin to be selected routinely for audit starting in fiscal year 1992. On the basis of IRS' estimated annual filing volume of 23,000 luxury excise tax returns, from 4 to 6 percent of these filings may be examined annually. Luxury excise taxes are likely to compose about 2 percent of all the excise tax returns IRS receives.

Auditors for the California State Board of Equalization suggested that IRS require retailers to document the date an item was purchased and its price. They cautioned that companies generally keep as little information as possible and, without this requirement, the burden of proof would rest on IRS auditors to compile information on what was purchased, when, and from whom. Therefore, not requiring such documentation could increase administrative costs and decrease revenues.

IRS May Be Able to Use Existing Information to Identify Potential Luxury Excise Taxpayers

States have information that would be useful to IRS in administering the luxury excise taxes. Many retailers are listed in state computer files on various industries. States also have data such as motor vehicle registrations. IRS has requested retailer data from some states and, as its district offices begin to audit returns, more requests may be made.

In addition to collecting from retailers, IRS will be responsible for collecting the excise tax from individuals who import and use items that would have been subject to the luxury excise tax if sold in the United States. A California tax official told us that United States Customs Service declarations for goods brought into the United States could provide useful information for administering the use provisions of the luxury tax by identifying potential luxury tax liabilities. However, a state official said that jewelry modifications are exempt from Customs duties, which would make it hard for IRS to track modifications done overseas. According to an IRS official, if IRS wanted Customs to check for remounted jewelry, IRS would have to reimburse Customs for this work.

Taxpayers' Compliance Costs Vary

The luxury excise tax requires businesses to keep appropriate records and to collect and remit the taxes. These compliance costs vary depending on several factors.

The compliance costs for businesses in states with sales taxes may be marginal. Many of the records needed for the luxury taxes are similar to

those required for sales taxes. On the other hand, businesses in the five states that do not have sales taxes may have to maintain records that they previously did not keep. The costs for businesses in these five states to collect the luxury tax may be similar to the costs for sales taxes because similar records are required. The national average cost for businesses to collect state sales taxes, as reported by the American Retail Education Foundation in August 1990, was 3.48 percent of total sales tax liability.

Some businesses have additional compliance activities as a result of the luxury tax. Two such activities include appraising customers' materials and verifying whether the luxury excise tax applies to vehicles when installing accessories.⁷ However, we could not quantify the additional costs for such activities.

One problem area cited by jewelers was the distinction between a repair and a modification. Repair of an existing article of jewelry without changing its design or pre-existing value is not treated as the production or manufacture of jewelry. The proposed regulations state that changing the style of jewelry is never a repair and is treated as manufacture of new jewelry. Some jewelers believed this is unreasonable. One jeweler suggested, for example, that a slight modification such as adding a small gold loop on the back of a pin to allow it to be worn as a pendant should not subject the entire value of the existing pin to the luxury excise tax.

In contrast, resetting a stone supplied by a customer from one ring to another ring or to a necklace is considered the production of an article of jewelry. In this case, luxury tax would be due on 10 percent of the amount by which the fair market retail value of the modified piece exceeded the \$10,000 threshold. This provision was designed to prevent people from buying gemstones and a setting separately to keep the total purchase price under the threshold amount.

When a jeweler produces a new piece of jewelry from material supplied by a customer, he must appraise whether the new article exceeds the luxury tax threshold. Some jewelers contended in comments to IRS' proposed regulations that it would be difficult to accurately appraise the value of customers' jewelry brought in for modification. According to one letter, many items of jewelry are unique and do not have a manufacturer's suggested retail price, so retail values are inherently subjective. Not all jewelers are trained appraisers, and those who are not may have to either

⁷Legislation has been proposed in Congress to exempt accessories that are added to provide handicapped access to vehicles.

bear the cost of an outside appraisal themselves or charge their customers for appraising their jewelry.

The standard that IRS proposed for appraisals—fair market retail value—is unclear to some in the industry. According to one jeweler, customers are generally advised of the price at which they could sell their jewelry during an appraisal. However, this jeweler contended that the use of the word “retail” was problematic. Customers could not sell a piece of jewelry for the same price at which the retailer would expect to sell the piece. He questioned whether it is fair to tax something at its retail value when this is more than the customer could gain by selling the piece. Other jewelers commented that customers should not have to pay tax again when modifying jewelry that was already taxed under the luxury excise tax provisions.

Provisions regarding the addition of accessories to vehicles place secondary liability for the tax on the installer and require installers to maintain written records they would not otherwise have to keep. Like the jewelry provision, this provision is intended to thwart attempts to avoid the tax by purchasing a vehicle and accessories separately. To comply with the provision, installers may be required to document the answers to several questions about each installation they do, such as when the vehicle was purchased, its price, and the price (including labor) of any accessories previously added. Taxpayer letters to IRS commenting on its proposed luxury excise tax regulations raised concerns about the burden for installers. One letter suggested that these provisions will result in thousands of small businesses being occasionally liable for luxury excise taxes. These businesses would therefore be required to file quarterly excise tax returns as long as they continue to sell accessories that may be taxable under the luxury excise tax provisions.

Taxpayers May Need Additional Information

According to an IRS official, a few years of experience auditing luxury excise tax returns will be needed to obtain sufficient evidence on compliance with these taxes. However, IRS’ initial information from compliance checks of 221 businesses indicated that taxpayers may be

well informed about the tax and complying with it. IRS' efforts to contact potential taxpayers and assess their knowledge of the law was a proactive effort under IRS' Compliance 2000 philosophy of educating taxpayers to avoid future problems.⁸

Between June 15 and July 15, 1991, IRS examiners visited 221 businesses (in 34 of its 63 districts) that it believed could be responsible for the collection and remittance of luxury excise taxes. IRS found that of these 221 businesses, all that were required to file (219) knew about the tax. Two businesses were not fully aware of the tax, but upon inspection IRS found that they did not sell taxable items. From the 221 visits, IRS identified three delinquent returns (1.3 percent) representing about \$17,000 in taxes owed. According to an IRS official, these three taxpayers admitted they knew about the tax but "had not gotten around to filing."

However, information we obtained from site visits and taxpayer letters commenting on IRS' proposed luxury excise tax regulations indicated that some uncertainty existed about specific provisions of the luxury excise tax. Some of the businessmen we interviewed said that they had not received enough information about the tax. For example, one dealer had a yacht in inventory that he had used for about 150 hours during 1990. The dealer was unsure whether he would be liable for the tax on the eventual sale of this yacht. IRS issued a letter ruling in May 1991 stating that "generally the luxury tax will not be imposed on the sale or use after December 31, 1990, of an otherwise taxable article, if the luxury tax would have been imposed on a sale or use of the article that occurred prior to January 1, 1991, had the luxury tax been in effect at the time." However, this dealer did not know this information, which he considered very important for his business, in August, 1991—4 months after IRS had issued the letter ruling.

We interviewed one boat accessory installer who thought the tax was to be applied only on a yacht's initial purchase price, not on any subsequent additions. Consequently, he was unaware of his potential tax liability.⁹ Neither he nor the shipyard official we interviewed had basic information such as which form to file. IRS communications and explanations of luxury excise tax rules targeted industry trade associations and professional tax

⁸Compliance 2000 is a philosophy and program that measures IRS' success by its impact on improving compliance. It involves the use of all available tools to achieve that end, including education and outreach, simplifying forms and procedures, legislative initiatives, and traditional enforcement efforts.

⁹According to Section 4004(b) of the Internal Revenue Code, installers are secondarily liable for the lesser of 10 percent of the sales price of the parts and its installment or 10 percent of the adjusted price of the vehicle that exceeds the threshold.

preparers. According to an IRS official, IRS had not issued as much publicity on installers' obligations. IRS' proposed regulations contain provisions describing installers' secondary liability.

States' Interest in Administering Federal Excise Taxes

Some states have expressed an interest in administering federal excise taxes, specifically luxury excise taxes, for a fee. A task force from the Commissioner of Internal Revenue's Advisory Group is examining this issue.

A proponent of having states administer taxes for the federal government believed that allowing states to administer luxury excise taxes could enhance cost effectiveness by avoiding duplicate systems. A California tax official estimated that it could require from 7 to 40 hours to complete a federal luxury excise tax audit, but only 2 to 12 hours would be needed when done as part of a regular state sales tax audit. According to the official, auditing federal luxury excise taxes alone would duplicate much of the work already performed by a state sales tax auditor.

Both sales and luxury excise taxes require an audit of sales invoices. State administration of these taxes may be less intrusive because taxpayers would have only one auditor (the state) rather than two (state and federal). However, auditors we interviewed from the California State Board of Equalization thought that it would be better for IRS to use its own auditors for luxury excise taxes. They said that IRS' auditors could look at more businesses for more years than the 1-year period covered by California sales tax auditors, allowing, for example, examination of the possible addition of accessories which could occur outside of a 1-calendar-year time frame.

Some states now administer both state and local taxes and charge a fee to the local governments for this service. Information from 10 states indicates that 7 charge fees, ranging from less than 1 percent to 2.5 percent of the dollar amount collected.

Provisions included in the proposed Tax Simplification Act of 1991 would authorize cooperative agreements between IRS and state tax authorities. Under the legislation, these agreements would provide for the joint collection of taxes (other than federal income taxes) and reimbursement for services provided by either party to the agreement; thus, they would enable IRS to pay the states for collecting excise taxes.

Objectives, Scope, and Methodology

Our objectives were (1) to analyze the effect of the tax on the luxury boat, car, aircraft, jewelry, and fur markets; (2) to provide information on the anticipated tax revenues, IRS' actual collections, and the costs and issues associated with administering these taxes; and (3) to discuss other products that have been taxed as luxury items in the United States or that are taxed as luxuries by other countries.

To analyze the effect of the tax, we examined relevant information, including data on sales, industry, and economic trends. We reviewed existing literature on the factors affecting the demand and supply of the five products affected by the luxury excise tax. We also reviewed the literature on the economic effect of excise taxes and the literature on durable goods.

We interviewed officials with, and obtained historical data from, the Department of Commerce (Bureau of Economic Analysis and the Census Bureau), the United States Coast Guard, the Department of Labor (Bureau of Labor Statistics), and the Congressional Research Service.

We interviewed IRS officials and analyzed the information they provided. We examined some of the letters from the public commenting on IRS' proposed luxury excise tax regulations, focusing primarily on the letters IRS planned to use in developing its final regulations. We interviewed some California state tax officials who were familiar with proposals for the states to assist IRS in administering luxury excise taxes or who had experience in auditing the industries taxed by luxury excise taxes.

We met with consultants who were studying the impact of the tax on the boating industry and interviewed three boat manufacturers, two dealers, and two accessory installers. We interviewed representatives from each of the affected industries and obtained and analyzed information and data they provided.

We did our work from May 1991 through December 1991 in accordance with generally accepted government auditing standards. We discussed the draft report with IRS officials. They agreed that the information we presented regarding the IRS is accurate, and we have included their comments where appropriate.

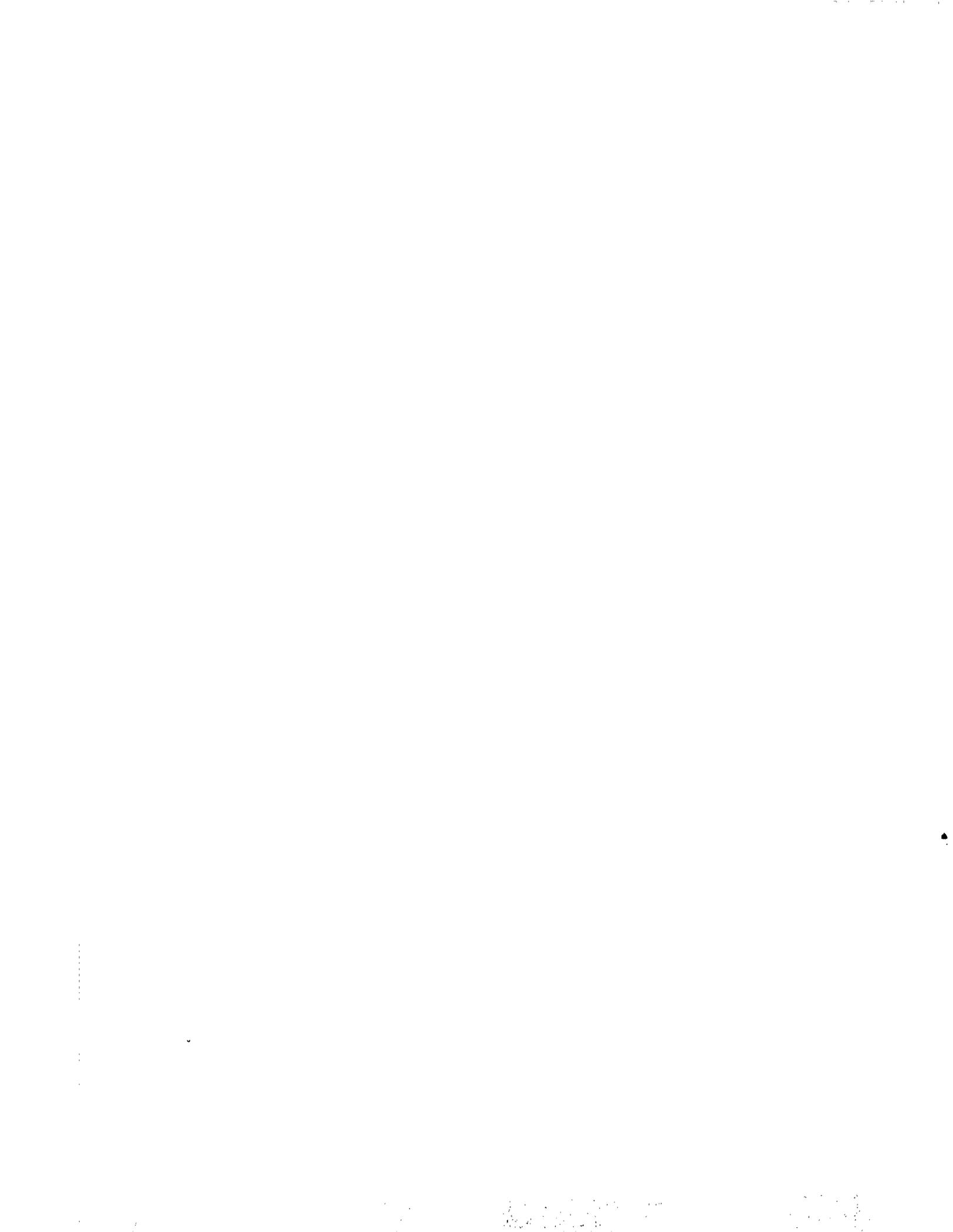
Major Contributors to This Report

General Government
Division, Washington,
D.C.

Michael Brostek, Assistant Director, Tax Policy and Administration Issues
Thomas J. McCool, Assistant Director, Tax Policy and Administration
Issues
Susan Ragland, Assignment Manager
Duewa Kamara, Staff Economist
Don Phillips, Staff Economist
Cathleen Koch, Intern

Office of the Chief
Economist,
Washington, D.C.

James White, Assistant Director



Ordering Information

The first copy of each GAO report is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877**

Orders may also be placed by calling (202) 275-6241.

**United States
General Accounting Office
Washington, D.C. 20548**

**Official Business
Penalty for Private Use \$300**

**First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100**
