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TAX ADMINISTRATION

Potential Impact of Alternative Taxes on Taxpayers and Administrators



General Government Division

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The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

The Honorable Daniel Patrick Moynihan
Ranking Minority Member, Committee on Finance
United States Senate

The Honorable Bill Archer
Chairman, Committee on Ways and Means
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In the past few years, many proposals have been put forward to comprehensively reform the federal income tax system. Proponents of tax reform believe that replacing the current income tax system would improve the performance of the economy and make the tax system fairer. Proponents of several proposals also believe that reform would make administration of the tax law easier and less costly for the government and make compliance with the law easier for taxpayers.

To help Congress evaluate how tax reform would affect tax administration and the burdens taxpayers face in complying with the tax law, we studied, at our own initiative, the basic design features of several kinds of tax systems.¹ The generic systems we studied are a national retail sales tax (RST), two types of value-added taxes (VAT), a flat tax, a personal consumption tax, and several versions of broad-based income taxes. Various forms of these alternative tax systems have been included in specific legislative proposals in the current and past sessions of Congress or have been prominent in tax reform discussions generally.

In this report, we describe (1) the major differences in design among the alternatives we studied and (2) how the alternatives, by incorporating different design features, may affect the taxpayers' burden of complying with the tax laws and the government's responsibilities for administering those laws. The basic design features we considered in contemplating

¹For information on how comprehensive tax reform could affect the economy, see Congressional Budget Office, The Economic Effects of Comprehensive Tax Reform, July 1997.

alternative systems are the tax base (what is taxed); the types of taxpayers (whether individuals, businesses, or both are legally subject to tax); tax preferences (tax system provisions, including exemptions, deductions, credits, and multiple rates, directed at various economic and social goals); and the tax rate(s). We considered taxpayers' compliance burden to include the time, effort, and cost of filing the required returns and maintaining necessary records. We defined tax administration as including the government processing taxpayer returns, assessing compliance with tax laws, collecting taxes owed, and providing taxpayer assistance.

This report is intended to be a reference document for readers with different interests and needs. The letter summarizes (1) how the basic design features are included in the current income tax system and could be incorporated into alternative tax systems and (2) what the resulting impacts on compliance burden and administration could be. For readers who want more details on particular alternative tax systems, the relevant appendixes contain more in-depth treatment.

Background

Tax systems can have multiple goals. For example, in addition to the common goal of raising revenue for the government, goals can also include redistributing income, stabilizing the economy, and achieving various other social and economic objectives through the use of preferences. Generally speaking, the greater the number of goals, the more complex is the tax system.

Criteria and Trade-Offs Relating to the Design of a Tax System

Tax systems are commonly judged and compared according to four criteria: equity, economic efficiency, simplicity, and administrability. A tax system is generally considered better than alternatives that raise the same amount of revenue if it is more equitable, more economically efficient, simpler for taxpayers to comply with, and easier and less costly to administer.² In this report, we focus on simplicity and administrability and do not analyze equity and efficiency. In deliberating on any changes to the current tax system, Congress would need to consider each of the four criteria.

²Equity refers to value judgments about how to tax taxpayers with either similar or differing abilities to pay tax; thus, different people have different views of what constitutes a fair tax system. A tax is economically efficient if, in the absence of market failures or other distortions, it does not alter or distort incentives, such as incentives to save, work, and consume. See, also, Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995, pp. 58-59.

Designing a tax system that is superior on each of the four criteria is difficult because the criteria frequently conflict with one another and trade-offs must be made. For example, a tax system that provides credits to low-income individuals may be judged by some to be more equitable than a system without this feature. However, if including credits makes it necessary for more individuals to calculate their income and file tax returns, the tax system could become more complex for both taxpayers and tax administrators.

The Current System

The federal tax system raised about \$1.4 trillion in fiscal year 1995 through individual and corporate income taxes, payroll taxes, various excise taxes on certain goods and services, and estate and gift taxes. Income taxes accounted for 62 percent of total federal tax revenue.

The current income tax system includes an individual tax and a business tax. Wages, interest and dividend income, capital gains, and some types of business income, including that of sole proprietorships and partnerships, are taxed under the individual income tax. Individual income is taxed at graduated rates. Income earned by certain corporations is subject to a separate business income tax, also at different rates.

The current system provides exemptions and different tax rates on savings and investment through a variety of special provisions, such as the preferential treatment of pensions, individual retirement accounts, life insurance, annuities, state and municipal bonds, and capital gains. The result is a hybrid income-consumption system of taxation that exempts some types of saving and investment from tax but taxes others.³

The current system includes numerous other tax preferences. Examples include the earned income credit; specific deductions for home mortgage interest, charitable contributions, and state and local taxes; and exclusions of employer contributions for health insurance.

Requirements for filing returns and performing other tax-related functions vary. All individuals with gross income above certain thresholds based on personal allowances and a standard deduction must file returns. Businesses have certain responsibilities beyond filing returns, including withholding and remitting employee income and payroll taxes, such as Social Security, Medicare, and unemployment taxes. Further, many

³A consumption tax is designed to tax only income that is used for consumption, effectively exempting from tax income that is saved or invested.

businesses must send information returns to the Internal Revenue Service (IRS) and to individuals detailing income paid as wages, interest, and dividends.

For more detailed descriptions of the federal income tax system, as well as its complexity and burdens for both taxpayers and tax administration, see appendix II.

Kinds of Alternative Tax Systems We Studied

In the last several years, proposals for making fundamental changes to the tax system have been discussed by policymakers and tax experts in government, academia, and the private sector. An overview of tax reform design issues appears in appendix III. The alternative tax systems we studied are briefly described below and are further detailed in appendixes IV through VIII.

- A national RST would generally be collected by businesses making retail sales to final customers, with sales to other businesses generally not taxed.
- VATS, now widely used internationally, are business-level taxes levied directly on the sales of goods and services. All types of businesses, not just retail businesses, are subject to the tax, and sales to both consumers and other businesses are taxable. With the credit method VAT, used by most industrialized countries, businesses claim a credit for tax paid on their purchases from other businesses, and with the subtraction method VAT, businesses deduct the amount of their purchases of goods and services from other businesses. Thus, under a VAT, businesses pay tax on the value they add to the goods and services they purchase.
- The flat tax discussed in this report would have both business and individual components. The business tax would be similar to the subtraction VAT, except that wages, salaries, and pensions would be deducted by businesses. Individuals would pay tax on wages, salaries, and pensions received above levels of allowances for themselves and their dependents. The same, single (flat) tax rate would apply to both individuals and businesses.
- A personal consumption tax would look much like the current individual income tax in that individuals would continue to pay tax on many kinds of income, such as wages, salaries, and interest and dividend payments received. It would differ in that borrowed funds would be included in the tax base, and funds that are saved or invested would be deducted. In most proposals, the personal consumption tax has been supplemented by a business tax designed to ensure that business purchases of goods and

services for consumption, such as nonpension fringe benefits, would be taxed.

- Income tax reform options that would replace the current income tax with a more broadly based income tax have been discussed by the Department of the Treasury and others over the years. Instead of being replaced by a consumption tax system, the current tax system could be changed to a broad-based income tax system by, for example, eliminating preferences on certain types of income. Some proposals for reforming the income tax would also change the collection point, or level, of tax. Options we studied include levying taxes on businesses only, on businesses combined with a relatively simple individual tax, and primarily on individuals.

Results in Brief

The alternative tax systems we studied differ in their potential impacts on taxpayer compliance burden and tax administration. The different potential impacts of the tax systems can largely be explained by four basic design features: (1) the basis for taxation (income or consumption); (2) the type of taxpayer (individuals, businesses, or both); (3) preferential tax treatment (e.g., exemptions, special deductions, and credits) for certain individuals, businesses, or goods and services; and (4) the rate structure for individuals (single or multiple rates). Table 1 compares the design features of the tax systems we studied and shows:

- Many of the alternatives, namely, a national RST, VAT, flat tax, and personal consumption tax, would tax the same base—consumption.
- Two consumption tax alternatives—the national RST and the VAT—would levy tax only on businesses, while the other two—the flat tax and the personal consumption tax—could tax both individuals and businesses. Similarly, an income tax could be designed to tax individuals only, businesses only, or both individuals and businesses.⁴
- Regardless of the base or the type of taxpayer, preferences could be included in any tax option, although the types of preferences provided would differ among systems.
- Finally, under income or consumption tax systems that include a tax on individuals, individuals could be taxed at different tax rates, possibly including a zero rate.

⁴Regardless of whether a tax is levied on individuals or businesses, individuals will ultimately bear the economic burden of any tax. For example, while an RST is levied on, or collected by, businesses, individuals are commonly thought to bear the economic burden of the tax through higher prices. Because this report focuses on compliance burden rather than on economic burden, we use the term taxpayer to refer to the individual or other entity on whom the tax is levied rather than to whoever bears the economic burden of the tax.

Table 1: Major Design Features of Alternative Tax Systems and the Current System

Tax system alternative	Tax base		Type of taxpayer		Tax preferences		Number of tax rates for individuals ^a		
							One	More than one	Possibly more than one
	Income	Consumption	Individuals	Businesses	Yes	Possibly			
Current system	x	x	x	x	x			x	
Reformed income tax alternatives	x		x ----- x -----	x ----- ----- x		x			x
National RST		x		x		x	N/A	N/A	N/A
Value-added tax		x		x		x	N/A	N/A	N/A
Flat tax		x	x	x		x	x		
Personal consumption tax		x	x	^b		x			x

N/A = not applicable

^aOther than a tax rate of zero.

^bAppendix VIII discusses options for taxing business purchases of consumer goods and services, such as nonpension fringe benefits. One option would be to supplement the personal consumption tax with a business-level cash flow tax.

Source: GAO analysis of the designs of alternative and current tax systems.

The differences in the four basic design features of the tax systems we studied explain in large part the differing potential impacts of the tax systems on taxpayer compliance burden and tax administration. For example, consumption-based taxes, such as the national RST, VAT, flat tax, and personal consumption tax, would eliminate many of the issues of defining and recognizing income that complicate income tax systems and, in this respect, reduce taxpayer compliance burden and tax administration activities. This is because under an income tax, taxpayers would be required to establish depreciation costs for different types of assets, account for income earned but not necessarily received, and keep records on the value of assets over time. Conversely, under a consumption tax, taxpayers could generally rely on records of sales, of purchases, or of funds actually received to calculate their tax liability. Simplifying the determination of tax liability for taxpayers could simplify assessing compliance and providing taxpayer assistance for tax administrators.

While different from income tax systems, the consumption-based systems could also differ from each other in their potential impact on taxpayer compliance burden and tax administration. For example, the personal consumption tax, requiring individuals to report their borrowing and saving, could be more burdensome for both taxpayers and administrators than other consumption-based systems. Another example involves a VAT and a national RST. Because all sales, not just retail sales, are included in a VAT, more recordkeeping and taxpayers could be required under a VAT than under a national RST. However, some experts believe that the additional records could make compliance assessment simpler for tax administrators.

Tax systems that would tax only businesses, rather than individuals and businesses, could reduce taxpayer compliance burden and the costs of tax administration by greatly reducing the number of taxpayers required to file returns. With a VAT, a national RST, or a business-level income tax, only businesses would be responsible for determining tax liability, filing returns, and remitting taxes. Individuals' compliance burdens could be eliminated. Tax administrators could focus on many fewer taxpaying entities, thus reducing the numbers of returns processed, actions taken to collect taxes owed, and taxpayer questions needing answers. In addition, businesses would no longer be required to withhold individual tax and file many types of information returns.

Tax systems that combine a business tax with a relatively simple individual tax, such as the flat tax or some versions of a reformed income tax, could add limited burden relative to a business-only tax. A simple individual tax, if administered largely through withholding and document matching, would have little need for the filing of individual tax returns. Tax systems requiring individuals to report more information about their personal finances, such as a personal consumption tax or a more complicated individual income tax, could add more burden than a business tax combined with a simple individual tax because more individuals could have to file tax returns and the returns would be more complicated. More tax returns and more complicated returns would make returns processing, assessing taxpayer compliance, and answering taxpayer questions more difficult for tax administrators.

The alternative tax systems in table 1 could all incorporate tax preferences. But, incorporating tax preferences—exemptions, special deductions, credits, or multiple rates on goods and services aimed at various economic and social goals—would generally add complexity. Tax

preferences generally increase taxpayer compliance burden by complicating the determination of tax liability, adding recordkeeping requirements, and creating incentives to engage in tax planning. Similarly, tax administration would be made more complicated because tax administrators would need more information and time to verify the accuracy of tax returns and collect taxes owed. Tax administrators would also face more questions from taxpayers.

Tax systems with multiple tax rates for individuals, which could include income taxes and a personal consumption tax, do not need to add burden to taxpayers' calculation of tax liability compared to single-rate systems. Multiple rates for individuals add little to the burden of computing tax liability because the use of tax tables minimizes this burden. Rate schedules for multiple rate systems could include a zero rate or provide one implicitly through a standard deduction or personal exemptions. A zero rate or its equivalent would limit the number of taxpayers having to file returns and reduce the processing volume for tax administrators. However, tax systems with multiple rates could encourage tax planning, which would increase burden for taxpayers and make tax administration more complex.

In addition to impacts due to the four basic design features, the transition to an alternative tax system could affect taxpayer compliance burden and tax administration. The extent of the impact would depend on the type of transition allowed. For example, if a consumption tax system were adopted, a transition might allow for the gradual phaseout of depreciation. In the event of such a transition, taxpayers and tax administrators could be required to keep and check records for both the old and the new systems, complicating the determination and verification of tax liability during the transition period.

Major Design Differences Among Alternative Tax Systems

Table 1 lists four basic design features of the tax systems we studied: (1) the basis for taxation (income or consumption); (2) whether individuals, businesses, or both would be subject to tax; (3) whether tax preferences could exist for certain individuals, businesses, or goods and services; and (4) the rate structure for individuals (single or multiple rates).

An Income or Consumption Tax Base

One major difference in the design of alternative tax systems is whether the tax base is income or consumption. An income tax system generally

does not allow deductions for savings and requires that earnings on savings be measured and taxed as they are earned. Also, it generally requires that businesses depreciate their purchases of assets, that is, deduct the cost of assets over time rather than at the time they are purchased.

Consumption-based tax systems differ from income-based tax systems in that they generally exempt from tax income from savings and investment. The national RST, VAT, flat tax, and personal consumption tax would achieve this exemption in different ways. Under a national RST, businesses would generally not pay tax on goods and services they buy. Under the VAT and the flat tax, businesses could immediately deduct purchases of goods and services, including purchases of plant and equipment, that they made from other businesses. Under a personal consumption tax, funds that are saved or invested would be deducted by individuals.

Type of Taxpayer

Another major design difference among alternative tax systems is who would be subject to tax. Consumption and income taxes could be levied on individuals, businesses, or both. By levying tax directly on individuals, a tax system can make distinctions among individuals or households to account for varying individual circumstances by, for example, allowing deductions and multiple rates. Alternatively, a tax system could focus only on businesses and thus require fewer taxpayers.

The alternative consumption tax systems we considered differ from one another according to who would be taxed.

- The national RST and the VAT generally would only tax businesses. All types of businesses, including corporations, as well as partnerships and sole proprietorships, could be subject to tax. A national RST would differ from a VAT in that only businesses making retail sales would be subject to a national RST, while retail and wholesale businesses could be VAT taxpayers.
- The flat tax would collect much of the tax base from businesses but also would include a relatively simple individual tax.
- The personal consumption tax would continue to tax individuals. In conjunction with this tax, businesses could be subject to a supplemental tax.

Similar to the national RST, VAT, or flat tax, an income tax could be designed to collect taxes from businesses rather than from individuals. Such an income tax could, for example, disallow business deductions for

wages and free individuals from filing returns. It would collect tax on all or part of individuals' incomes where the incomes were generated and before they were paid. Other income tax options would, like the current income tax system and the personal consumption tax system, tax most types of income at the individual level.⁵

Preferential Treatment

Each of the various alternatives could include tax preferences, although the types of preferences provided would differ among alternatives. These preferences could include special deductions, exemptions, and/or credits, as well as various tax rates on different types of income or goods and services.

The types of taxpayers in a tax system would influence the type of preferences that could be allowed. Alternatives that tax individuals directly could include preferences designed to target specific groups of individuals. It would be more difficult for a tax system, such as a national RST or a VAT, that applied only to businesses to provide preferences for groups of individuals because businesses can apply different tax rates to goods and services but cannot distinguish among individuals. Preferences under business-level taxes could also include exemptions of specific types of businesses or activities.

Tax Rates

The fourth design difference is the rate structure for individual-level income or consumption tax systems. The alternatives that we considered that include an individual-level tax—the flat tax, the personal consumption tax, and several income tax options—could tax different individuals at different rates. All these options could include what is, in effect, a zero tax rate by providing a standard deduction or personal allowances. For example, under the flat tax, individuals with wage income under the personal allowance amount would not owe any individual tax; wage income above the deduction or allowance amounts would be taxed at a single rate. Individual-level taxes in general could apply a single tax rate or multiple rates.

⁵The various income tax options are described in appendix IV.

Implications of the Alternative Tax Systems for Taxpayer Compliance Burden and Tax Administration

Because of differences in the four basic design features, the tax systems we studied would have different impacts on taxpayers' and tax administrators' responsibilities, and thus on taxpayers' compliance burden and the costs of tax administration. This section describes basic types of taxpayer and administration responsibilities and the potential effects of the alternative tax systems on each of them.

Taxpayers' and Tax Administrators' Basic Responsibilities

The taxpayer compliance burden created by any tax system will depend on how many taxpayers have tax-related responsibilities, such as filing tax returns, and on what difficulties these taxpayers face carrying them out. Similarly, tax administration is affected both by the number of taxpayers and by the difficulty of carrying out administrative responsibilities related to each taxpayer. Table 2 shows the basic taxpayer and tax administration responsibilities we identified.⁶

Table 2: Basic Responsibilities of Taxpayers and Tax Administrators

Taxpayers' responsibilities	Tax administrators' related responsibilities
File tax returns	Process filed returns and maintain accurate taxpayer accounts
Determine correct tax amounts, maintain supporting documentation, and produce support for information on returns upon request of tax administrator	Devise programs, such as examination and document matching programs, to assess taxpayers' compliance with laws
Remit taxes owed	Collect taxes owed but not remitted
Get assistance, if necessary, from tax administrators or paid preparers to voluntarily comply	Assist taxpayers by answering specific questions, providing tax forms and publications, or helping with tax return preparation

Source: GAO analysis of taxpayer and tax administrator responsibilities under tax systems in general.

In many respects, tax systems that are relatively easy for taxpayers to comply with will also be relatively easy to administer, and alternatives that are relatively burdensome for taxpayers will also be more difficult to administer. For instance, the more taxpayers that have to file returns, the more returns the administrators must process and accounts they must maintain. Likewise, a system's complexity resulting from exemptions,

⁶In this report, we do not focus on tax administrators' activities, such as monitoring private pension plans, that do not fall under one of the four basic responsibilities we describe. Similarly, we do not address whether new government spending programs that could require separate administration would replace certain activities now encouraged through the tax system.

deductions, and other preferences could affect taxpayers and administrators similarly by increasing their respective burdens.

However, in some instances, burden could be shifted from government administrators to taxpayers or from taxpayers to government administrators. For example, U.S. businesses currently perform some duties to help ensure compliance, such as withholding and providing information returns, that tax administrators could do through other means.

Potential Effects of Alternative Tax Systems on Taxpayers' and Administrators' Basic Responsibilities

The overall costs to taxpayers and tax administrators of carrying out their basic responsibilities under the tax systems we studied are difficult to quantify. Even for the current income tax system, while IRS' administration costs are known, only very rough estimates exist for taxpayer compliance burden. This is because of the difficulty in separating accounting and recordkeeping costs for tax purposes from those that are incurred for other purposes and because taxpayers may not measure such costs. Estimates of taxpayer compliance burden for the current income tax vary widely, but all are many times larger than IRS' fiscal year 1998 budget of \$7.8 billion.

In a qualitative sense, changing from the current income tax system to an alternative system would potentially affect each of the basic responsibilities that taxpayers and tax administrators have. The following discussion of possible impacts on each area of responsibility precedes a table summarizing them and relating them to different tax systems.

Return Filing and Processing

The tax systems we studied could differ significantly from each other in the number of returns filed by taxpayers and processed by administrators. Business-level tax systems generally have fewer filers than individual-level tax systems or systems that combine a business and individual tax. Business-level tax systems also generally require less information reporting.

The current income tax system is relatively complex in the sense that some income is taxed at the individual level, some at the business level, and some at both levels. In 1995, taxpayers filed and IRS processed about 116 million individual tax returns, of which about 18 million reported income from a sole proprietorship. Another 6 million returns were filed by partnerships and corporations. Employers, investment institutions, and

others sent IRS about 1.1 billion information returns, including withholding documents for wages and information on investment earnings.

The alternative tax systems that would only tax businesses, such as the national RST or the VAT, would eliminate individual tax filing requirements. In addition, businesses would not be required to file information returns related to individuals. The total number of returns filed under these options would depend on how many businesses were subject to tax and on how frequently returns were required. For instance, while only businesses would be required to file tax returns under a national RST or a VAT, they could be required to file quarterly or monthly. Under a VAT, small businesses could be exempted, and under a national RST, wholesalers would not have to file tax returns.

The alternatives that include a business tax and a relatively simple individual tax would likely require return filing by businesses and by some individuals. However, the number of individual returns filed and processed under these alternatives could be significantly less than under the current income tax system. Under a flat tax or one reformed income tax option, a “return-free” filing system could be feasible because wages and salaries would be the only type of income subject to tax for many individuals. These employees would not have to file returns if employers withheld tax on wages during the year and made any necessary adjustments in withholding at the end of the year so that the amount of tax withheld equaled tax liability. If these alternatives also featured large standard deductions or personal allowances, the need for individual returns would be further reduced.

Under the personal consumption tax or certain reformed income tax options we studied, large numbers of individual tax returns and information returns could still be required. The individual tax under these systems would be relatively complex in the sense that many types of funds or income would be taxable for individuals. Withholding correct amounts of tax would be more difficult for employers and other businesses because final tax liability would depend on the total amount of income or funds individuals receive from many sources. Unless withholding was extended to other types of taxable funds, individuals would likely be required to account for all types of taxable funds on their tax returns, and employers and businesses could be required to provide information returns to both individuals and tax administrators. Under a personal consumption tax, additional information returns related to borrowing and saving could be

Determining Correct Tax
Amounts and Assessing
Compliance

required, resulting in increased burden for the businesses required to file the returns and for tax administrators.

Because of differences in the four design features we discussed earlier, the tax systems we studied would differ in the burden experienced by taxpayers in determining their tax liability and in the costs to tax administrators of assessing compliance.

In terms of the first design feature, the basis for taxation, consumption-based taxes, such as the national RST, VAT, flat tax, and personal consumption tax, could make determining tax liabilities by taxpayers and, correspondingly, tax administrators' assessment of taxpayers' compliance simpler in some respects than income-based taxes. This is because many difficulties of defining and recognizing income would be eliminated. To measure income from saving and investment as it is earned, taxpayers have to estimate costs for depreciation, account for income earned but not necessarily received as cash, and keep records on the value of assets over time. Also, taxpayers could have to decide if expenses are deductible or must be capitalized. Similarly, tax administrators must be able to verify the income measurements required under an income tax. In contrast, consumption tax liability can generally be accurately calculated by taxpayers and verified by tax administrators by using records of sales, purchases, and funds actually received.

Whether an income or consumption tax system includes an individual tax and how complex that tax is would also affect the ease or difficulty of determining taxes and assessing compliance. Under the flat tax and one income tax option we considered, many individuals would face relatively few recordkeeping responsibilities and determining tax liability would be relatively simple, especially if taxes on wages were withheld by businesses. Tax administrators could largely administer these individual taxes by checking that proper amounts were withheld or by matching individual tax returns with information returns. Based on experience with the current income tax system, compliance would likely be high and few audits of individuals might be necessary. In contrast, under alternatives with more complex individual-level taxes, recordkeeping and tax determination burdens would likely be higher. For example, under some individual income tax options, individuals would have to keep records or receive information reports for many types of income. Under a personal consumption tax, individuals could be responsible for keeping records on borrowing and saving and including these amounts in their tax

calculations. More extensive document matching and auditing would probably be needed to ensure a high level of compliance.

Even though a national RST and a VAT tax the same base—consumption—and the same type of taxpayer—businesses—they could still affect assessing tax compliance differently. For a national RST and a subtraction VAT, administrators would have to rely on businesses' own records to verify that the proper tax had been paid. However, with a credit VAT, there would be a certain amount of checking available through records of other businesses; this is thought by some tax specialists to improve compliance. Also, based on state and international experience, many experts believe that including sales of all types in the tax base and allowing businesses to deduct or receive a tax credit for purchases from other businesses, as under a VAT or flat tax, would have some compliance advantages over a national RST. While including sales of all types in the tax base would require more recordkeeping and more taxpayers, it could better ensure that business purchases would not be overtaxed, taxes of sales to households would be reported, and a paper trail would be created so that compliance could be better assessed.

Preferences—that is, exemptions, deductions, credits, and multiple rates on goods and services—could be part of any of the alternative tax systems we considered and could often complicate, but sometimes simplify, how tax liability is determined and verified. Preferences could force taxpayers to determine and tax administrators to verify whether an income or consumption item is taxable, nontaxable, deductible, or taxable at a different rate. The burdens associated with extensive use of preferences could include (1) more recordkeeping than otherwise, as was the case for the estimated 33 million individuals who reduced their tax liability by itemizing tax deductions for tax year 1993; (2) more time for determining and reporting tax liability; and (3) more tax planning by taxpayers. These burdens would require more audit time from tax administrators. On the other hand, in some instances, preferences given through exemptions could simplify taxpayers' burden. For example, if, as is commonly done with a VAT, large numbers of small businesses were exempted, they would not have to file returns or remit tax, thus easing their compliance burden. However, tax administrators would have to verify compliance by determining that only eligible taxpayers took the exemption.

The fact that some tax systems—the current income tax, versions of a reformed income tax, and the personal consumption tax—have or could have multiple rates on individuals imposes little additional burden on

taxpayers or tax administrators except to the extent that multiple rates encourage tax planning. Graduated rates alone have little effect on the actual tax calculation burden of taxpayers who can determine their tax liability through a tax table. Tax administrators still must verify that proper rates have been applied. However, multiple tax rates could encourage taxpayers to devote resources to tax planning in order to avoid high marginal rates.

Tax Remittance and Collection

The issues related to this third area of taxpayer and tax administration responsibilities we discuss—tax remittances and collections—may not differ greatly among the tax systems we considered except that widely different numbers of taxpayers would be responsible for remitting the taxes. If individuals, including the 18 million individuals owning sole proprietorships, no longer had to file tax returns as individuals but only in their capacity as business owners, nonbusiness collection issues related to them would disappear. Similarly, if a simpler tax reduced the problems tax administrators found during examinations, or if changes in withholding or other information reporting reduced the number of mismatches requiring follow-up, tax administrators would be less likely to assess additional taxes they would then have to collect.

In its responsibility for collecting unpaid taxes from taxpayers who filed but did not pay the required tax or who did not file required returns, in fiscal year 1995, IRS' collection function disposed of millions of taxpayer delinquencies. Business delinquencies most commonly involved employment taxes.

An issue of concern to administrators in the current tax system involves businesses, particularly small ones, getting into financial difficulty and using collected taxes as working capital rather than remitting them to the administrators. This problem could continue under many of the alternatives we considered, including a national RST or a VAT, and it could be more pervasive if the amounts of taxes to be collected and remitted by businesses were higher than under the current income tax system or state sales tax systems. The amounts could be higher because specific businesses would be processing federal taxes on their sales in addition to their payrolls and could face a greater temptation to retain some of the money for their own use. More frequent remitting and filing could reduce noncompliance but increase the burden on businesses.

Taxpayer Questions and Assistance

Although the universe of taxpayers who must file returns could change under the various alternatives, those who would still need to file would

likely have questions that still needed to be answered. Even if a “return-free” tax system were adopted, questions about individuals’ involvement with the system would still arise. However, the probable reduction in the number of taxpayers, particularly individuals, under some of the alternatives and the removal of certain complex provisions, such as defining and recognizing income and providing deductions, would likely reduce the overall level of assistance needed.

On the other hand, the more complications introduced under any alternative tax system, such those introduced with many preferences, the greater would be the need for tax administrator assistance in those areas. Greater assistance would also be needed for certain alternatives’ distinctive complicating features, such as the personal consumption tax’ reliance on borrowing and savings information. The more radical the departure from the current income tax system, the more likely that assistance or education would be needed in the short term.

Table 3 provides primarily qualitative information about alternative tax systems in the four areas of taxpayer and tax administrator responsibilities we have just discussed. More detailed tables for each tax system are shown in appendixes IV through VIII.

Table 3: Potential Implications of Alternative Tax Systems for Taxpayers and Tax Administrators

Tax system alternative	Return filing and processing
Current system	In 1995, 116 million individual tax returns, including 18 million sole proprietorships; 6 million corporate and partnership tax returns filed; 1.1 billion information returns filed by businesses and other payers
Reformed income tax alternatives	For individual tax, number of filers contingent on amounts of standard deduction and withholding; number of tax and information returns reduced (or possibly eliminated) by options taxing more income at business level
National RST	Businesses, including at least 10 million retailers and service providers, responsible for filing periodically during the year if they sell to final consumers; information returns generally eliminated
VAT	About 24 million businesses (corporations, partnerships, and sole proprietorships) responsible for filing, unless small businesses exempted; information returns eliminated
Flat tax	Both individuals and businesses responsible for filing, though nearly half of individuals possibly excused owing to large personal allowances; no information returns for savings or investment
Personal consumption tax	Large number of individual filers likely; business filings or allocations to individuals needed; new information returns possible

Taxpayer and tax administrator responsibilities

Determining correct tax amounts and assessing compliance	Tax remittance and collection	Taxpayer questions and assistance
Need to define and recognize income; wide range of exemptions, deductions, and credits; complex calculations; documents matched, enhancing compliance; about 1.7 and 2.0 percent of individual and corporate returns, respectively, examined in fiscal year 1995	Collections needed from millions of nonfilers and filers without full remittance; small businesses' employment taxes a particular problem	Almost 111 million calls answered by IRS in fiscal year 1995
Complexity owing to measuring capital income; continuing need to match documents and/or examine returns; possibly complex changes needed to tax all income but tax planning possibly reduced	For individual tax, most tax remitted by businesses through withholding, but delinquent accounts possibly increased by taxing more types of income; individual remittances and delinquent accounts possibly reduced under other options	Most current questions still relevant, unless individual-level tax simplified or eliminated
No need to define and recognize income; difficulties arising from exemptions for goods and services or sales to businesses and from incompatible state and federal tax systems; compliance chiefly verified by checking records on sales, not income	Nonbusiness collection issues eliminated; delinquent amounts a continuing concern given large collections by businesses and possible temptation for small businesses, especially, to use collections as working capital	Fewer questions than under the current system because of individuals not filing and fewer likely areas of inquiry
No need to define and recognize income; fraud potential related to exports; credit VAT: tax system complicated by exemptions of goods or services and multiple rates, administration simplified by invoice mechanism; subtraction VAT: unlike credit VAT situation, multiple rates and exemptions not suitable and auditing dependent on business' own records	Nonbusiness collection issues eliminated; tax payment spread over all businesses, not just those selling to final consumers; if small businesses not exempt, collection problems increased	Fewer questions than under the current system because of individuals not filing and fewer likely areas of inquiry
Compliance aided by no need to define and recognize income, by fewer deductions, and by continued withholding; unlike credit VAT situation, auditing dependent on business' own records	Fewer delinquency problems for individuals likely if withholding continues, but small business difficulties similar to difficulties with employment taxes	Taxpayer assistance on many complex issues unneeded owing to tax's simplicity, although individual returns still possibly required
Many issues of defining and recognizing income eliminated; information returns, audits needed to verify borrowing (e.g., on credit cards), proceeds from sales of assets, and savings	Withholding possibly not closely matching tax liability, with more returns owing taxes after matching, possibly leading to more delinquent accounts than otherwise	Questions on filing requirements, filing status, account information continued but not on calculations of capital income; new questions on borrowing, proceeds from sales of assets, savings

Source: GAO analysis of tax system alternatives.

Transition to a New Tax System

A wide range of options exist for moving from the current income tax system to an alternative tax system, and the way that any transition is formulated could have significant effects for economic efficiency, equity, taxpayer compliance burden, and tax administration. Many transition

issues involve how income and deductions related to saving done before the transition to the new system should be treated. Consumption taxes, while designed to encourage new saving, could tax existing saving when it is used for consumption; in general, existing saving would not be subject to tax again under the current income tax system. Special rules designed to exempt existing saving from tax could burden individuals with additional recordkeeping, filing, and tax determination requirements and create additional tax compliance issues for tax administrators. Another transition issue involves whether tax credits and other tax benefits already earned under the current tax should be made available under a new system. For example, what would happen to depreciation expenses for existing investments that businesses would have been able to deduct if the current tax were retained? Depending on how these and other compliance issues are addressed, taxpayer compliance burden and tax administration responsibilities could be greater in the transition period than when a new system is fully phased in. We discuss transition broadly in appendix III and on an alternative-by-alternative basis in appendixes IV through VIII.

Other Issues

Other issues, many of which are hard to handle even now, could also have significant implications for both taxpayers and tax administrators under most, if not all, of the alternative tax systems we discuss. Some of these issues are (1) the extent to which employee benefits, such as employer-provided health insurance, should be included in the tax base; (2) how to deal with the special complexity and difficulty of taxing financial services; (3) how housing would be taxed; (4) whether governments and nonprofit organizations should be taxpayers and filers; and (5) how international activities would be taxed.

Another important issue would be the relationship between federal tax filing and reporting requirements and those of states and localities, especially in those jurisdictions that currently piggyback on the federal income tax system. Changing the federal system could effectively force states to change or even abandon their own income tax systems because they depend on the federal tax infrastructure. For example, states depend on IRS' information reporting program and use income reported on federal tax returns as a starting point on state returns.

These issues are discussed broadly in appendix III or in separate sections in the appendixes for the various tax system alternatives.

Scope and Methodology

To accomplish our objectives related to the different alternatives, we (1) studied relevant literature, (2) reviewed our previous reports covering taxpayer compliance burden and tax administration issues throughout the 1980s and 1990s, (3) held discussions with tax specialists inside and outside IRS, and (4) examined data related to current tax systems. The bibliography at the end of this report lists our major references on alternative tax systems. We did our work in Washington, D.C., between August 1995 and November 1997 in accordance with generally accepted government auditing standards. Our objectives, scope, and methodology are further discussed in appendix I.

The alternatives included in this study were chosen because they represented different approaches that have emerged in public discussions about tax reform. They do not include all possible ways of changing the current income tax system. The report focuses on the implications for compliance burden and administration of replacing the current income tax system, although some advocates for changing the tax system have proposed replacing other taxes as well. The report does not analyze implications for the economy, such as effects on saving, work incentives, and economic growth, or for the distribution of the tax burden among different types of individuals.

Agency Comments and Our Evaluation

We provided a draft of this report to the Secretary of the Treasury and the Acting Commissioner of Internal Revenue for comment. IRS deferred to Treasury, and responsible Treasury officials, including the Director of the Office of Tax Analysis, provided comments in a July 31, 1997, meeting. The Treasury officials had no major problems with the draft but suggested various points that we should emphasize, make parallel, or clarify. We have incorporated their comments as appropriate.

We will send copies of this report to the Secretary of the Treasury, the Commissioner of Internal Revenue, other interested committees, and other interested parties on request.

This work was done under the direction of Mark J. Gillen, Assistant Director for Tax Policy and Administration Issues; other major contributors are listed in appendix IX. If you have any questions, please call either one of us on (202) 512-9110.



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Abbreviations

AMT	Alternative minimum tax
CBIT	Comprehensive Business Income Tax
CBO	Congressional Budget Office
FICA	Federal Insurance Contributions Act
IRA	Individual retirement arrangement
IRS	Internal Revenue Service
OECD	Organization for Economic Cooperation and Development
RST	Retail sales tax
TDA	Taxpayer delinquent account
TDI	Taxpayer delinquency investigation
VAT	Value-added tax

Objectives, Scope, and Methodology

Our work had two objectives. The first was to describe major differences in attributes among alternative tax systems. Our second objective was to describe how the alternatives, by incorporating these differences, may affect taxpayers' burden of complying with the tax laws and the government's responsibilities for tax administration. Taxpayers' compliance burden includes their filing the required returns, maintaining the necessary records to support the information reflected on those returns, and accurately calculating their tax liabilities in the face of whatever complexity the tax code presents. Tax administration responsibilities include processing taxpayer returns and maintaining accurate taxpayer accounts, verifying the accuracy of return information, collecting the proper amount of taxes owed and considered delinquent, and providing taxpayers with needed information or assistance. We selected the major alternatives we studied based on the ideas that have emerged in public discussions about tax reform.

To accomplish our first objective—describing the major differences in attributes among alternative tax systems—we studied the literature related to the current income and sales tax systems and to various alternative tax systems that have been developed over the years. This literature included our own reports on income and consumption taxes and reports of other government organizations, journal articles, academic and research papers, and other materials related to the various alternatives. A bibliography of sources we used discussing alternative tax systems appears at the end of this report. We also attended tax conferences to enhance our understanding of these tax system alternatives and how they related to specific proposals that have emerged. In the report, we limited ourselves to discussing the basic features of each alternative system, knowing that any implementing details would have to evolve through the political process.

In accomplishing the first part of our second objective—describing how alternative systems might affect taxpayer compliance responsibilities—we considered what categories of taxpayers might still have to file returns under the various systems. We also researched the literature for information that would enable us to analyze items, such as the amount of taxpayer recordkeeping and calculations that would be required in preparing tax returns, the type of information that would be included in the returns, and filing frequency. Finally, we pinpointed references in our previous reports to taxpayer compliance burden issues and assessed how these issues would be affected under new systems.

We did similar work in accomplishing the last part of our second objective—describing the alternative systems’ potential impacts on tax administration. In reviewing the relevant literature, we specifically examined our previous reports covering various aspects of the tax systems and IRS. We also discussed specific administrative functions with tax specialists inside and outside IRS, reviewed data on IRS’ recent administrative experiences from published sources and from within IRS, and studied summaries of state sales tax experiences. In analyzing the alternatives, we addressed (1) the administrative functions of returns processing, document matching and examination, collections, and taxpayer services; and (2) issues pertaining to transition, state tax administration, and international tax administration.

In addition, to help accomplish the second objective, we interviewed officials of, and reviewed documents from, three state tax administrations and two state tax associations. The three states were New York, Florida, and New Mexico. We selected these three states based on suggestions from the Federation of Tax Administrators of states that were knowledgeable about issues we were examining. Because of the existence of actual sales tax systems in the various states and credit-invoice value-added taxes (VAT) in different countries, the collective experience with these taxes was more specific than the experience with other alternatives we were studying.

Our intention in doing this study was to stress compliance and administration issues associated with the alternative systems using knowledge that we had accumulated throughout the 1980s and the 1990s. Our intention was not to examine other implications of the alternatives, such as their effect on the economy or on the distribution of the tax burden. Nor did we rank them against each other, assess the relative severity of the various implications, or weigh the administrative arguments and counterarguments regarding particular ideas.

In identifying issues in as broad an arena as the potential impact of alternative tax systems on taxpayers and the potential implications for tax administration, we touched on some topics only briefly or not at all. For example, we did not do an in-depth analysis of the relationship of alternative systems to IRS’ sweeping Tax Systems Modernization plans. This IRS effort, inextricably linked with streamlining whatever IRS-administered tax system might exist, regardless of whether it modified or replaced the current income tax, involves years of work and billions of dollars. However, basic tax administration functions, such as returns

processing, document matching and examination, collections, and taxpayer services, would still be in place under a new system. We did not try to estimate the resources or costs involved in administering any of the systems, regardless of how the modernization effort proceeded.

Similarly, our study did not focus on the relationship of individual alternatives to the particular problems of taxpayer compliance and tax system administration for specific types of entities. For example, this report does not concentrate on the special considerations that would apply under different alternatives regarding the financial services industry and nonprofit organizations. It does, however, describe how financial and nonprofit services might present administrative difficulties under a consumption tax.

In focusing on the effects on the agency primarily responsible for tax administration, we did not analyze the impacts on other agencies. For instance, we did not examine how the U.S. Customs Service's taxation of imports and tracking of exports would be affected. Nor did we evaluate the role of the Federal Reserve System in receiving payments under a new tax system.

We requested comments on a draft of this report from the Secretary of the Treasury and the Acting Commissioner of Internal Revenue. IRS deferred to Treasury, and we met with Treasury officials on July 31, 1997, to discuss the report. Treasury's comments are characterized near the end of the letter of this report and incorporated into the letter and appendixes as appropriate.

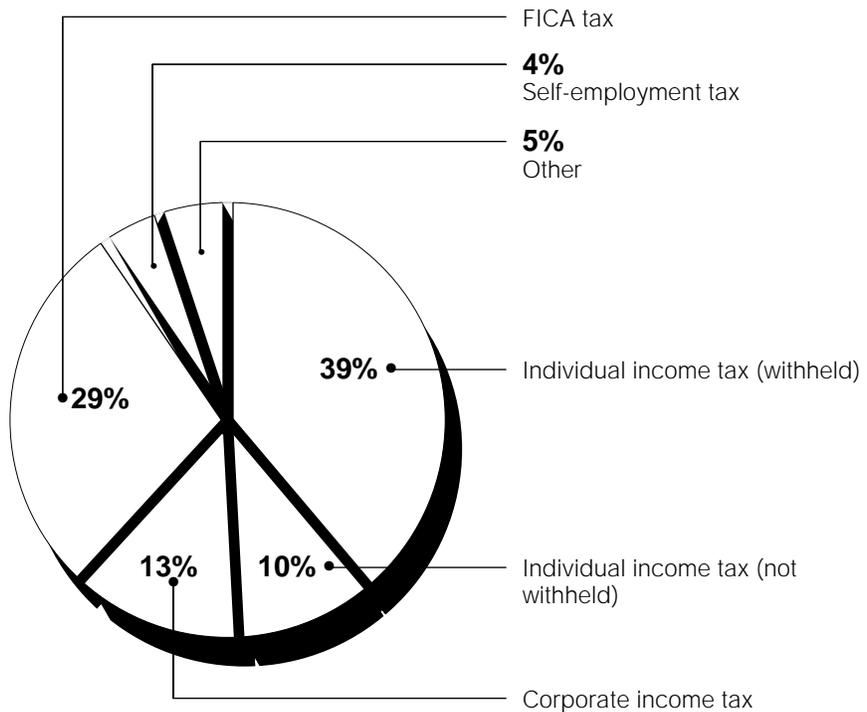
We did our work in Washington, D.C., between August 1995 and November 1997 in accordance with generally accepted government auditing standards.

Current Income Tax

Background

In fiscal year 1995, IRS' revenues totaled about \$1.4 trillion from a variety of sources.¹ As shown in figure II.1, about half came from the individual income tax, more than three-quarters of which had been withheld by employers. About a third more arrived through employment taxes, with the largest component by far being Social Security and Medicare taxes under the Federal Insurance Contributions Act (FICA). Another 13 percent of IRS' total revenues resulted from the corporate income tax.²

Figure II.1: Sources of IRS Gross Revenue, Fiscal Year 1995



Source: IRS, 1995 Data Book.

Individual Income Tax

As shown in table II.1, depending on its amount, individuals' income is taxed at five different rates, ranging from 15 to 39.6 percent, with most

¹This amount is before considering refunds of \$106 billion and associated interest.

²Based on IRS estimates projected from samples, about 2 percent of the 2.1 million income year 1993 returns of active corporations (not including S corporations, real estate investment trusts, and regulated investment companies) accounted for about 96 percent of the income tax after credits due from those corporations for that year.

taxpaying individuals falling into the 15-percent tax bracket. Individuals in certain circumstances are not liable for any income tax at all and may even be eligible for the earned income credit, which can pay them money. The credit is available to low-income working people with children and, beginning in tax year 1994, to certain people without children.

Table II.1: Estimated Number of Tax Year 1993 Individual Tax Returns Classified by the Highest Marginal Rate at Which Tax Was Computed

Tax rate category	Number of returns (in millions)
15 percent	65.6
28 percent	21.2
28 percent (capital gains)	0.3
31 percent	2.2
36 percent	0.8
39.6 percent	0.5
Form 8615 ^a	0.3
All categories ^b	90.7

Note: This table excludes individual tax returns with no tax liability.

^aThis form contained certain investment income reported by children under age 14.

^bThe number in this row does not equal the sum of the other rows because of rounding.

Source: IRS, Individual Income Tax Returns 1993.

Individuals figure their income tax by going through a series of steps. First, they compute their taxable income by determining their filing status (e.g., single versus married); the exemptions to which they are entitled; their total income; adjustments to income; and deductions from income, either a standard deduction based on filing status or deductions itemized to their specific circumstances. They then use their taxable income to compute their tax liability, which may be adjusted by, among other items, tax credits and other taxes such as the alternative minimum tax (AMT).

Corporate Income Tax

Corporations determine their income tax in the same basic way as individuals do: they subtract various deductions from their income to reach taxable income, and they compute their final tax, considering AMT if needed. The corporate AMT is intended to ensure that taxpayers with substantial economic income or with positive financial statement income in a given year remit tax for that year. Deductions subtracted from income in computing regular taxable income include the cost of goods sold, wages, interest, contributions to employee benefit programs, and

depreciation of assets, such as equipment whose full value cannot be deducted immediately. Depreciation spreads the cost of such assets over time to reflect their benefits in the periods the businesses use them. Depending on their taxable income, corporations remit regular tax (as opposed to AMT) using four rates, ranging from 15 to 35 percent.

Relationship to State and Foreign Income Taxes

For reasons of simplicity and compliance, state income tax systems greatly depend on the federal system. According to the Federation of Tax Administrators, 37 states (including the District of Columbia) with an individual income tax use either the individual's federal tax liability, taxable income, or adjusted gross income as a starting point for the individual's state income tax computation. Forty-two of the 47 jurisdictions with a corporate income tax start their calculations with the corporations' federal taxable income. In addition, as the Multistate Tax Commission has pointed out, states rely on federal information reporting and withholding rules for their own administrative purposes and depend extensively on federal audits of taxpayers.³

Both U.S. individuals and corporations are subject to U.S. income tax on their worldwide taxable income. If they remit foreign income taxes on foreign-source income, they may, in a complicated calculation, generally take foreign tax credits against U.S. income tax imposed on that income. The United States has a network of about 50 bilateral tax treaties that cover how nations interact on the income tax.

Impact on Taxpayers' Compliance Burden

As taxpayers strive to comply with federal, state, and local tax requirements, they spend time, incur costs, and experience frustration. We refer to this time, cost, and frustration as taxpayer compliance burden. Table II.2 summarizes key aspects of the burden, which can vary from little to great from taxpayer to taxpayer, that taxpayers experience under the current income tax.

³According to its executive director, the Multistate Tax Commission is an interstate compact agency created to preserve federalism and promote fairness in state and local taxation of businesses.

Table II.2: Summary of Some Key Aspects of the Compliance Burden of the Current Income Tax on Taxpayers

Burden	Characteristics of the burden
Burden on individual taxpayers	
Return filing	116 million returns filed in 1995
Records kept	Records supporting tax returns supposed to be kept—e.g., receipts, proof of payment, and documentation supporting deductions and credits; burden alleviated by information reports given to individuals
Calculations made	Complicated calculations for some taxpayers included for provisions such as dependency tests and capital gains
Complexity faced	Many pages of instructions involved and millions of supplemental forms and schedules filed—e.g., 33 million schedules of itemized deductions for tax year 1994; difficulties existing in defining and recognizing income; however, in actual practice, minimal complexity faced by millions of individuals
Burden on business taxpayers	
Return filing	24 million returns filed in 1995
Records kept	Records supporting income and expenses supposed to be kept
Calculations made	Complicated calculations included for provisions such as depreciation, the alternative minimum tax, and the foreign tax credit
Complexity faced	Detailed rules involved; complexity reflected in areas such as depreciation, the alternative minimum tax, and the foreign tax credit; difficulties existing in defining and recognizing income
Requirement to furnish information returns	1.1 billion information and withholding documents filed

Source: GAO analysis of available information about the current income tax.

Documents Filed

One indicator of this burden is that every year taxpayers and others file millions of documents with IRS, with some filing one and others filing many. For example, in 1995, individuals filed 116 million personal income tax returns, with most of them including salaries, wages, or pensions.⁴ These individuals included 18 million schedules for sole proprietorships. Because corporations and partnerships filed another 6 million income tax or income returns, the total number of business returns filed was

⁴The potential universe of individual filers is larger than the 116 million filers in 1995. For instance, for tax year 1992, IRS identified almost 60 million potential individual nonfilers, mostly by matching data on information returns, such as wage statements from employers, with data on filed income tax returns. However, IRS took no enforcement action on most of them, primarily because it later determined that the individuals had no legal filing requirement. For instance, the individual might not have had enough gross income to have to file.

Appendix II
Current Income Tax

24 million. In addition, employers submitted 29 million employment tax returns. Finally, as table II.3 shows, employers, financial institutions, and others filed 1.1 billion information and withholding documents, which ease the burden recipients would bear if they had to generate the information on their own. Documents, such as wage and various other income statements, are important for compliance purposes but not very burdensome for recipients to retain, although employers must generate them. Although almost all information returns were filed with IRS in nonpaper format through magnetic tape filing, electronic filing, or diskette filing, most business income and employment tax returns and most individual tax returns were not filed electronically.

Table II.3: Information and Withholding Documents Filed in 1995

Type of filing	Number of filings (in millions)
W-2: Wage and Tax Statements	205
1099DIV: Dividends and Distributions	101
1099INT: Interest Income	259
1099MISC: Miscellaneous Income	74
1099R: Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.	49
1099B: Proceeds From Broker and Barter Exchange Transactions	92
1099G: Certain Government Payments	59
5498: Individual Retirement Arrangement Information	63
1098: Mortgage Interest Statement	64
K-1 (Form 1065): Partner's Share of Income, Credits, Deductions, Etc.	21
1099SSA/RRB: Social Security Benefit Statement and Payments by the Railroad Retirement Board	46
Others	30
Total	1,062

Note: Total does not add due to rounding.

Source: IRS, Calendar Year Projections of Information and Withholding Documents for the United States and Service Centers: 1996-2003, 1996 Update.

Although in recent years over 100 million individuals filed income tax returns annually, as table II.4 shows, most of them did not report many common income, adjustment, deduction, and credit items every year. For instance, for tax year 1993, most of the 114.6 million individuals who filed did not claim such items as capital gains or losses, rental income, itemized deductions, the earned income credit, or the foreign tax credit, minimizing

their compliance burden. And, although almost 33 million individuals itemized their deductions and included themselves in the millions of taxpayers filing supplemental forms and schedules, relatively few of those itemized, for instance, miscellaneous deductions that generally involve much taxpayer time and recordkeeping whether claimed or not. Over a lifetime, of course, circumstances could allow taxpayers to include many items on their returns that do not show up every year.

Table II.4: Estimate of Individuals Reporting Different Items on Their Tax Returns for Tax Year 1993

Item	Number reporting (in millions)
Salary and wage income	98.0
Taxable interest income	65.2
Dividend income	24.7
Business or professional net income or loss	15.6
Net capital gain or loss	18.4
Pensions and annuities in adjusted gross income	17.4
Rent and royalty net income or loss	11.0
Partnership and S corporation net income less loss	5.5
Primary taxpayer IRA adjustment	4.0
Standard deduction	80.8
Any itemized deduction	32.8
Medical and dental expenses	5.5
Taxes paid	32.3
Interest paid	27.5
Charitable contributions	29.8
Total miscellaneous deductions	8.3
Earned income credit	15.1
Foreign tax credit	1.3

Source: IRS, Individual Income Tax Returns 1993.

Another indicator of the tax system's impact on taxpayers is how often they must file returns and remit taxes—the greater the frequency, the more the burden. Generally, individuals must file annually, even though their wages and salaries may be withheld throughout the year. Individuals, including sole proprietors, however, did file 36 million estimated tax returns in 1995, and they paid estimated taxes as many as four times during the year. Businesses generally file income tax returns annually and often remit estimated tax four times a year. They also withhold income,

Social Security, and Medicare taxes from their employees periodically, file quarterly employment tax returns, and transfer the funds withheld to a financial institution monthly, semiweekly, or even more often depending on the amount of tax.

Records Kept

Another burden of complying is that individuals and businesses must keep records supporting their tax returns. For instance, individuals should keep receipts, canceled checks or other proof of payment, and documentation to support any deductions or credits claimed. Similarly, for small businesses, IRS requires that records be kept to support the income, expenses, and credits reported. IRS believes, though, that generally these are the same records needed for businesses to monitor themselves and prepare financial statements. Nevertheless, the corporate tax return does have a schedule on which the taxpayer reconciles the income or loss shown on its books with that shown on its tax return. The schedule includes such items as depreciation and contribution carryovers.

Individuals and businesses can use various methods of accounting, although many businesses are precluded from using the cash method for tax purposes. Instead, they use the accrual method, designed to match income and expenses in the correct year. The accrual method is required when income-producing inventory is involved.

Keeping the right documentation has been a problem for some taxpayers. We found this, for example, when we reviewed 185 Tax Court petitions dealing with “ordinary and necessary” business expenses related to a taxpayer’s trade or business. For sole proprietors, small and medium-sized corporations, and individuals claiming employee business expenses, the most frequent source of disagreement with IRS in those petitions was the adequacy of documentation for a given expense deduction. These disputes were especially frequent where the documentation requirements were the most rigorous—for entertainment, travel, meals, and automobile expenses.⁵

In another example, we found that the test that taxpayers used to claim other people as dependents on their tax returns was too complex and burdensome for them to voluntarily comply with. The test required taxpayers to maintain detailed records and make complex calculations. According to our estimates, 43 percent of taxpayers that IRS found had not

⁵See Tax Administration: Recurring Issues in Tax Disputes Over Business Expense Deductions (GAO/GGD-95-232, Sept. 26, 1995).

met the dependent support test did not have adequate records to show whether they provided the necessary support.⁶

Level of Simplicity or Complexity

The forms that taxpayers need to file vary with the circumstances, as does the use of paid preparers. In 1994, we reported that IRS publishes about 400 tax forms and accompanying instructions each year. More detailed guidance is provided in about 100 publications.⁷ Still, as reflected in table II.4, most individuals file relatively basic forms, such as the estimated 71 percent of about 115 million individual filers for tax year 1993 (almost 81 million) that took the standard deduction as opposed to itemizing deductions and needing a separate schedule.

As shown in table II.5, for tax year 1993, 48 million of 115 million individuals (42 percent) filed the Form 1040EZ or the Form 1040A instead of the standard Form 1040. As table II.5 further shows, although these individuals filed income tax returns designed to be easier than the standard return, they still sometimes paid preparers to complete them. In all, about half of all individual tax returns had a paid preparer's signature on them. Some of the taxpayers who filed the simpler forms and claimed the earned income credit may have paid a preparer simply as a way to file their returns electronically and get their credit early.

Table II.5: Individual Tax Returns Showing a Paid Preparer's Signature, Tax Year 1993

Form	Number filed (in millions)^a	Number with paid preparer's signature (in millions)	Percentage with paid preparer's signature
1040EZ	20.4	1.5	7%
1040A	27.9	5.8	21
1040	66.4	49.2	74
Total	114.6	56.6	49%

Note: Numbers do not add to total because of rounding.

^aThese numbers are estimates based on samples.

Source: IRS, SOI Bulletin (Winter 1995-1996).

⁶See Tax Administration: Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993). We were 95-percent confident that the true percentage of these taxpayers with inadequate records was between 33 percent and 52 percent.

⁷See Tax Administration: IRS Efforts to Improve Forms and Publications (GAO/GGD-95-34, Dec. 7, 1994).

The complexity of the tax code, itself, is a major reason why federal tax compliance is burdensome. It stems from areas such as depreciation requirements, which all 17 businesses we interviewed for testimony told us caused them to keep some detailed records solely for tax purposes; uniform capitalization rules and the AMT requiring time-consuming calculations; and inventory, foreign income, and capital gains calculations.⁸ In 1994 testimony, IRS noted that the code had grown from 504 pages in 1939 to over 2,700 pages, and this did not include implementing regulations. A guiding principle we have stated regarding tax rules and compliance is “the simpler . . . the better.”⁹

Much of the complexity of the tax code stems from the difficulties faced in defining income and determining when to recognize it on the tax return. For instance, the complexity surrounding calculations and records needed for determining capital income is great, creating accompanying compliance and administrative costs. To determine capital income, taxpayers must separate capital gains from ordinary income, determine depreciation, and decide if expenses are deductible or must be capitalized. Complexity is also created by the tension between the ideal economic definition of income—changes from one year to the next in asset value—and the need to recognize income only when it is actually realized—in a market transaction, such as a sale of stock. For instance, the tax law has provisions to keep taxpayers from borrowing money to buy assets, deducting the interest, and not paying current tax on the assets’ appreciation. This contributes to different kinds of interest expense being treated differently for tax purposes.¹⁰

Interaction of Taxpayers and Tax Administrators

A final aspect of the current system’s (and any system’s) burden on taxpayers is the amount and nature of interaction the public has with tax administrators. As we allude to later, taxpayers annually experience millions of IRS notices; more than a million examinations; when delinquent, hundreds of thousands of tax liens placed against their assets; and millions of unanswered telephone calls. Neither we nor IRS know the level of any alleged IRS “abuse” of taxpayers through the public’s interactions with IRS employees. When we studied the issue in 1996, IRS, while improving certain controls, had not yet established a capability to capture management

⁸See *Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers* (GAO/T-GGD-95-42, Dec. 9, 1994).

⁹See *Taxpayer Compliance: Reducing the Income Tax Gap* (GAO/T-GGD-95-176, June 6, 1995).

¹⁰Henry J. Aaron and Harvey Galper, *Assessing Tax Reform* (Washington, D.C.: The Brookings Institution, 1985), pp. 22-24.

information that is needed to ensure that abuse is identified and addressed.¹¹

Estimates of Compliance Costs for Existing Taxes

As described in appendix III, compliance cost studies in general have been limited by different factors. These factors include the difficulty in differentiating between recordkeeping for tax purposes from recordkeeping that would have been done anyway and the difficulty in generalizing to all taxpayers from surveys with low response rates.

Because of the importance of the issue of compliance costs and their possible magnitude, various efforts have been made to measure compliance costs. These included several academic studies of compliance costs for U.S. income taxes, a study of paperwork burden of U.S. taxes done for IRS, and recent estimates based on the IRS-sponsored burden study.

Studies of Compliance Costs of U.S. Taxes

Several compliance cost studies have been done by Joel Slemrod of the University of Michigan and co-authors.¹² Two studies were done on compliance costs for the individual income tax, and one study was done on compliance costs for large corporations, all using mailed questionnaires. The studies of the individual income tax surveyed Minnesota residents; the more recent of the two studies found that on average taxpayers spent about 27 hours on federal and state income tax matters and spent about \$66 on tax assistance and other expenses. The study also obtained information on the wages of the respondents to place a value on the time spent on taxes.

The consulting firm Arthur D. Little studied paperwork burden for IRS in 1984.¹³ The Little study used questionnaires to gather information on how much time individuals and businesses spent in 1983 to meet tax filing requirements. Individual costs were also measured through a diary study,

¹¹See Tax Administration: IRS Is Improving Its Controls for Ensuring That Taxpayers Are Treated Properly (GAO/GGD-96-176, Aug. 30, 1996).

¹²See Joel Slemrod and Nikki Sorum, "The Compliance Cost of the U.S. Individual Income Tax System," *National Tax Journal*, Vol. XXXVII, No. 4 (Dec. 1984), pp. 461-74; Marsha Blumenthal and Joel Slemrod, "The Compliance Cost of the U.S. Individual Income Tax System: A Second Look After Tax Reform," *National Tax Journal*, Vol. XLV, No. 2 (June 1992), pp. 185-202; and Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," *Public Finance Quarterly*, Vol. 24, No. 4 (Oct. 1996), pp. 411-38. Also see Joel Slemrod, "Which Is the Simplest Tax System of Them All?" in Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (Washington D.C.: Brookings Institution Press, 1996) for a summary of the strengths and limitations of this work.

¹³The methodology of the Little study is reviewed in Slemrod (1996).

in which taxpayers were asked to contemporaneously record costs as they occurred rather than recall costs. For businesses, burden categories included recordkeeping, getting advice and learning about filing requirements, obtaining materials, finding and using tax preparation services, preparing the tax return, and filing the tax return. For individuals, burden categories included recordkeeping; learning about the tax law; preparing the tax return; and copying, assembling, and sending the return to IRS. Little obtained a 65-percent response rate from the individual questionnaire and a 37-percent response rate to the business questionnaire.

The purpose of the Little study was to gather data and develop a methodology that IRS could use to estimate the average number of hours taxpayers spend to complete particular tax forms. To do this, Little used a statistical analysis to find variables, such as the number of lines on a tax form and associated worksheets and the number of attachments required, that could predict the level of burden found in the questionnaires.¹⁴ While several models were evaluated, the models ultimately chosen were those that could be easily updated by IRS rather than those that best predicted the survey results. The study noted that “in a few instances significant accuracy was sacrificed by selecting a simplified model” over a more complicated and accurate model. As a result, IRS estimates of recordkeeping burden for a business tax form are only dependent on the number of lines on the form and associated worksheets, and the estimated time for preparing a form is dependent on the number of lines on the form and worksheets, the number of references in the instructions to the Internal Revenue Code and accompanying regulations, and the number of attachments that are requested. One researcher has called these models “transparently implausible” and also pointed out that the model estimates of burden for corporations and partnerships in 1983 were five times higher than the results found in the survey for the same year.¹⁵

Recent Estimates of Compliance Costs of Current Tax System

Two authors have used the paperwork burden hours estimates from the IRS models to estimate income tax compliance costs in terms of both hours and dollars. To convert hours of burden into an estimate of the dollar value of these hours, the authors generally multiplied the hours estimate by an amount representing the time value of each hour. The estimates therefore rely on the underlying IRS methodology and are sensitive to the hourly dollar amount used. In theory, the dollar value chosen should

¹⁴Little adjusted the individual questionnaire results to reflect the generally lower cost estimates found in the diary study.

¹⁵Slemrod (1996), pp. 383-84.

represent the opportunity cost of spending an hour on tax matters; for individuals, for example, this could be an additional hour of wages, the value of an hour spent in a leisure activity, or the hourly amount that an individual would be willing to pay to not have to calculate taxes.

Arthur Hall of the Tax Foundation, citing IRS and Office of Management and Budget historical data, recently estimated that taxpayers would spend about 5.3 billion hours complying with federal tax laws in 1996. Hall then applied an hourly rate of \$42.40 to this hours estimate to obtain an estimate of \$224.7 billion of compliance costs for the entire federal tax system.¹⁶ Based on his calculations, he asserted that at least 70 percent of this cost was due to the income tax. Applying this 70 percent to the total burden would make income tax compliance costs \$157 billion for 1996. Hall estimated that business compliance costs would be \$105 billion, leaving individual compliance costs at about \$52 billion.

In his book and in testimony before the Ways and Means Committee, James Payne also made estimates of compliance burden resulting from the tax system. In his 1993 book, Payne estimated that federal compliance costs in 1985 amounted to \$159.42 billion.¹⁷ This estimate was made by multiplying the Little model estimates of 5.4 billion taxpayer burden hours for 1985 by an hourly value of \$28.31 (an average of IRS and Arthur Andersen labor costs) and adding an estimate for tax preparer costs. In 1995 testimony, Payne estimated that taxpayer burden in terms of hours for 1995 was 10.2 billion hours.¹⁸ The increase in the estimate reflected, in part, increases in the number of taxpayers and an increase in total burden of 3.7 percent in each year from 1985 through 1995, based on findings in Blumenthal and Slemrod (1992) that individual burden had increased by 26 percent from 1982 to 1989.

Recently, Slemrod offered what he described as “back-of-the-envelope” estimates of the compliance costs of the income tax, based on his views on the strengths and weaknesses of the existing evidence.¹⁹ Adjusting the results from the 1989 Blumenthal and Slemrod survey of individual taxpayers and using \$15 for the per hour cost, Slemrod estimated that the

¹⁶See Arthur P. Hall, “Compliance Costs of Alternative Tax Systems,” *Tax Notes*, Vol. 71, No. 8 (May 20, 1996), pp. 1081-89.

¹⁷James L. Payne, *Costly Returns: The Burdens of the U.S. Tax System*, (San Francisco: Institute for Contemporary Studies, 1993).

¹⁸Statement of James L. Payne prepared for the House Ways and Means Committee Hearings on *Replacing the Federal Income Tax*, June 6, 7, and 8, 1995.

¹⁹See Slemrod (1996).

cost of the individual income tax was probably around \$50 billion. He also estimated that businesses (partnerships and corporations) spend about 800 million hours complying with taxes, a figure in line with the results of the Little survey rather than derived from the IRS model estimates. Valuing business hours at \$25 per hour, Slemrod estimated the cost of compliance for these businesses at about \$20 billion.

Impact on Tax Administrators

Table II.6 summarizes some of the key impacts of the current income tax system on tax administrators.

Table II.6: Summary of Some Key Impacts of the Current Income Tax on Tax Administrators

Item	Characteristics of the current income tax
Number of returns processed	Hundreds of millions of returns and other materials received
Refund processing	92 million refunds issued in fiscal year 1995
Examination approach	Tax returns matched with information returns; fiscal year 1995 examination coverage at 1.36 percent, with corporate audits taking longer than individuals' audits
Compliance problems	Compliance problems related to income definition, unreported income, and more specific issues identified in areas such as transfer pricing, depreciation, deductibility of business expenses, small businesses, independent contractors, and the underground economy ^a
Collections from tax delinquents	Millions of taxpayer delinquent investigations and accounts disposed of, with most of the latter being for individuals and most business dispositions covering employment taxes
Individuals' questions received	Millions of taxpayer inquiries fielded, covering a wide variety of questions

^aTransfer prices are prices companies charge related parties for goods and services. Inaccurate transfer pricing can result in improper allocation of income among interrelated companies.

Source: GAO analysis of available information about the current income tax.

Table II.7 shows IRS' fiscal year 1996 actual budget along functional lines to help put the discussion that follows into perspective.

Table II.7: Summary of IRS' Fiscal Year 1996 Budget

IRS function	Full-time equivalent positions		Budget dollars	
	Number	Percentage of total	Amount (in millions)	Percentage of total
Returns processing	20,460	19%	\$781	11%
Document matching	2,086	2	73	1
Examination	27,327	26	1,555	22
Collection	17,916	17	855	12
Taxpayer services	8,031	8	492	7
Other	30,822	29	3,461	48
Total	106,642	100%	\$7,217	100%

Note 1: Percentages do not add to totals due to rounding.

Note 2: The budget for IRS' appeals function is included in the counsel part of the "other" category, as opposed to the examination category where IRS put it for fiscal year 1997. Counsel's fiscal year 1996 budget was 4,999 full-time equivalents and \$362 million. "Other" also included positions and funds supporting functions such as examination and collection.

Source: IRS fiscal year 1998 budget estimates, Feb. 6, 1997.

Processing of Returns

When IRS annually receives the hundreds of millions of returns, remittances, and other materials from taxpayers and others, the first thing it must do is process them. Returns processing includes (1) receiving, sorting, and establishing controls over the materials; (2) editing, perfecting, and coding them for transcription onto computer tape; (3) transcribing, verifying, and correcting tax document information; (4) maintaining accounting records for assessments, collections, receivables, refunds, and other transactions affecting taxpayer accounts; and (5) preparing correspondence to taxpayers. IRS' fiscal year 1996 budget for returns processing was almost \$800 million for more than 20,000 full-time equivalent positions.

IRS' returns processing workload is primarily affected by the number of returns filed and the work needed to prepare those returns for posting to taxpayer accounts. For instance, according to IRS data, it takes significantly fewer keystrokes to enter data into the computer from a paper Form 1040EZ and Form 1040A than from an average Form 1040. Although generally more and more tax returns are being filed electronically and processed by computer, thus minimizing the human effort needed to prepare them for posting, the vast majority of returns are

still filed on paper and processed manually by IRS. Consequently, a significant part of IRS' returns processing effort involves error correction because returns filed on paper and processed manually are more prone to errors by both preparers of the returns and the IRS staff processing them.

Statistics on the number of notices sent and refunds given to taxpayers illustrate the level of IRS activity involved in processing returns. For instance, as we noted in a 1994 report, IRS sent more than 60 million notices to taxpayers in 1993 concerning the status of their tax accounts.²⁰ (Recently, IRS announced a dramatic reduction in the number of notices to be sent.) Similarly, in fiscal year 1995, IRS issued 92 million refunds to taxpayers.

Matching and Examination Programs

A taxpayer's most likely enforcement contact with IRS is receiving word about a computer match of income reported on his or her return with information returns provided to IRS by third parties. These third parties include employers and payers of interest and dividends. Discrepancies between the amounts reported on the tax return and the information return indicate potential underreporter cases. When a tax return is not filed for income that is reported on an information return, IRS is to establish a nonfiler case. IRS' fiscal year 1996 budget for document matching was \$73 million and about 2,100 full-time equivalent positions.

As another part of its enforcement efforts, IRS' examination function, funded in fiscal year 1996 at almost \$1.6 billion and about 27,000 full-time equivalents, administers a nationwide audit program to see if taxpayers correctly determined their tax liabilities. One of the ways IRS selects returns to audit is by using a system that scores each return's audit potential. After learning the results of an audit, taxpayers may agree with the findings, appeal them through IRS' appeals function, or take IRS to court. As shown in table II.8, in fiscal year 1995, IRS had many different kinds of examinations, with an overall examination coverage rate of 1.36 percent. Although many more examinations were done of individuals than of corporations, corporate examinations took much longer.

²⁰See *Tax Administration: IRS Notices Can Be Improved* (GAO/GGD-95-6, Dec. 7, 1994).

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Table II.8: IRS' Fiscal Year 1995 Examination Coverage

Numbers in thousands			
Category of tax return	Returns filed in calendar year 1994	Total examinations	Percentage of examination coverage
Individual	114,683	1,919	1.67%
Corporation	2,530	52	2.05
Fiduciary, estate, and gift	3,384	18	0.52
Employment	29,298	54	0.18
Excise, partnership, S corporation, and other	4,399	57	1.30
Total	154,294	2,100	1.36%

Note: Percentages do not always compute exactly due to rounding of other numbers.

Source: IRS, 1995 Data Book.

Although IRS does not generally track noncompliance by subject matter through its examination program, it does know quite a bit about taxpayer noncompliance. Its knowledge comes from its random, though dated, detailed audits of tax returns through its Taxpayer Compliance Measurement Program and from other sources. As we testified using 1988 IRS estimates of tax year 1992 compliance, individuals voluntarily paid 83 percent of the income taxes they owed, and corporations remitted 81 percent.²¹ In addition, as shown in table II.9, according to IRS estimates, compliance was not uniform across groups of taxpayers. IRS data show that compliance was highest for individuals where there was tax withholding, a little lower where there was information reporting to IRS, and much lower where there was neither. The complexity of tax rules was another factor influencing the level of compliance, with a more complicated tax code allowing more opportunities for disagreement over the “fine points” of the law.

²¹See [GAO/T-GGD-95-176](#). In 1996, IRS also reported that the tax year 1992 noncompliance estimate as a percentage of the “true” tax liability for individuals was about 83 percent.

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Table II.9: Percentage of Earnings Categories Reported by Different Taxpayer Groups

Taxpayer group	Percentage of earnings category reported	Is information reporting generally required?	Is withholding generally required?
Wage earners	97 percent of their wages	Yes	Yes
Interest recipients	90 percent of their interest income	Yes	No
Dividend recipients	87 percent of their dividend income	Yes	No
Self-employed (sole proprietors)	36 percent of their income	No	No
Informal suppliers (self-employed individuals operating on a cash basis)	11 percent of their income	No	No

Note: These percentages take into account individuals who did not file tax returns.

Source: [GAO/T-GGD-95-176](#).

Variations in compliance patterns also existed in the corporate sector. Small corporations, whose compliance level for 2.3 million firms was 61 percent for tax year 1987 (down from 81 percent for a smaller number of tax year 1980 firms), tended to mirror the compliance patterns of sole proprietors. Underreported income was the biggest compliance problem and enough documentation was often a difficulty. Large corporations, in contrast, tended to have issues associated with the ambiguity and complexity of the tax code. Table II.10 shows, as of late 1995, the largest open examination issues in the examination program covering various tax years for the nation's largest corporations.

Table II.10: Largest Open Examination Issues for Largest Corporations as of December 12, 1995

Issue	Proposed IRS adjustments to income and credits
Transfer pricing	\$7.2
Availability of the installment method of income recognition	5.9
Deductibility of trade or business expenses	3.4
Deductibility of capital expenditures	3.4
Depreciation	1.9

Note: According to an IRS official, these dollar figures are not precise because they include only the top 10 issues in the corporations being audited and reflect conservative estimates of case managers.

Source: IRS.

In 1988, IRS estimated a “tax gap” of as much as \$127 billion between tax year 1992 income taxes owed on income from legal sources and income taxes voluntarily remitted. This gap did not include taxes that go uncollected from illegal activities, such as drug dealing and prostitution. Thus, the gap reflected part of the underground economy—the legal transactions that occurred without being reported to the tax agency—but not the other part—the illegal transactions. As shown in table II.11, IRS attributed about three-fourths of the tax gap to individuals and about one-fourth to corporations.

Table II.11: 1988 Gross Tax Gap Estimate for Tax Year 1992

Dollars in millions		
Source of tax gap	Tax gap amount	Tax gap distribution (percent)
Individual tax gap	\$93,994	73.9%
Corporate tax gap	33,135	26.1
Small corporations	6,999	5.5
Large corporations	23,716	18.7
Other	420	0.3
Corporate remittance gap	2,000	1.6
Total tax gap	\$127,129	100.0%

Source: Income Tax Compliance Research, IRS Publication 1415 (7-88) and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

In 1996, IRS presented new estimates of the individual income tax gap, this time using compliance data for tax years 1985 and 1988, as opposed to 1982. The gap consisted of a nonfiling gap, or tax liability owed by those not filing required returns voluntarily and in a timely manner; an underreporting gap, or liability not voluntarily reported by filers; and an underpayment gap, or liability reported but not paid voluntarily and in a timely manner.

As shown in table II.12, the largest dollar components of the underreporting part of the individual tax gap (covering underreported income and overstated deductions and credits) were ranges related to nonfarm proprietor income and informal supplier income. The items with the highest reporting noncompliance, as shown by the ranges of net misreporting percentages, were informal supplier income, tax credits (reflecting overreporting of the earned income credit), nonfarm proprietor income, farm income, and income from the sale of business property.

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Table II.12: 1996 Ranges of Estimates of the Tax Year 1992 Gross Individual Tax Gap

Dollars in billions

Gross tax gap component	Dollar amount		Net misreporting percentage ^a	
	Low	High	Low	High
Nonfiling gap	\$13.5	\$13.8	N/A	N/A
Underpayment gap	8.4	8.4	N/A	N/A
Underreporting gap	71.3	73.1	N/A	N/A
Capital gains	2.4	2.5	6.9%	7.2%
Income from sales of business property	0.7	0.7	27.1	28.0
Nonfarm proprietor income	16.4	16.9	31.3	32.3
Informal supplier income	12.3	12.3	81.4	81.4
Farm income	3.3	3.4	31.3	32.2
Rents and royalties	3.6	3.7	16.6	17.2
Tax credits	6.0	6.2	38.9	40.2
Other items	26.6	27.3	N/A	N/A

Legend: N/A = Not applicable or not available.

^aNet misreporting percentage is the ratio of the net amount of income misreported on the tax return in the taxpayer's favor to the sum of the absolute values of what should have been reported.

Source: Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992, IRS Publication 1415 (4-96).

According to a 1993 IRS report on the employment tax gap, noncompliance with employment taxes was relatively low except in the self-employment area. For self-employment taxes estimated for tax year 1987, the tax liability not paid voluntarily was more than half the "true" tax liability. This estimated ratio of unpaid liability to true liability was projected to remain relatively stable for tax years 1984 through 1997.

Although for FICA taxes the equivalent 1987 estimated ratio of unremitted liability to true liability was only about 4 percent, almost all of the underreported wage and salary part of the FICA tax gap was attributable to misclassification of employees. In June 1996, we testified that from fiscal year 1988 through fiscal year 1995, IRS' almost 13,000 Employment Tax Examination Program audits resulted in reclassifying 527,000 workers from independent contractors to employees.²² Common-law rules for classifying workers as employees or independent contractors were unclear and subject to conflicting interpretations. IRS' strategy is to reduce

²²See Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors (GAO/T-GGD-96-130, June 20, 1996).

independent contractor noncompliance by requiring businesses to treat misclassified independent contractors as employees subject to withholding taxes. Efforts to improve the misclassification situation were continuing during our review.

Just because IRS proposes adjustments does not mean taxpayers will agree. In 1993, we reported on the most prevalent issues appealed by taxpayers. As of September 30, 1992, out of about 12,000 disputed relatively large issues that IRS stated were predominately corporate, almost a quarter involved trade or business deductions, gross income, or depreciation.²³ Similarly, of all the cases contained in Tax Analysts' Index to U.S. Tax Court Petitions and Complaints Filed in the Court of Federal Claims and the 94 U.S. District Courts During 1993, about a third of the pages of listings involved just two Internal Revenue Code sections—those dealing with gross income and trade or business expense deductions. When we analyzed appealed trade or business deductions in a separate report, we found that large corporate taxpayers disagreed with IRS most frequently over the issue of capital expenditures, more specifically over whether large expenses were immediately deductible.²⁴ IRS was unable to provide us with a breakdown by subject matter of all 219,000 cases closed by its Chief Counsel in fiscal year 1994.

Collection Activities

With a fiscal year 1996 budget of almost 18,000 full-time equivalent positions and about \$850 million, IRS' collection function is responsible for collecting taxes from taxpayers who did not file required returns or those who filed returns but did not remit the required tax. Its first step is to notify taxpayers in writing and ask them either to remit outstanding taxes or to file unfiled returns. If taxpayers do not respond at the notification stage, IRS generally refers the cases to its automated call sites, where IRS employees may telephone taxpayers to ask for remittance. At that time, balance-due accounts are referred to as taxpayer delinquent accounts (TDA), and nonfiler cases are called taxpayer delinquency investigations (TDI). If telephone calls are not successful, IRS revenue officers must try to collect higher priority cases through personal visits to taxpayers and other collection enforcement actions. The cases may be resolved in many ways, ranging from taxpayers' voluntarily making full remittances to IRS' taking actions involving liens, levies, or seizures. As an example of the volume of activity that is involved, in fiscal year 1995, IRS issued about 800,000

²³See Tax Administration: Recurring Tax Issues Tracked by IRS' Office of Appeals (GAO/GGD-93-101, May 4, 1993).

²⁴See GAO/GGD-95-232.

notices of tax liens, sent out 2.7 million notices of levies, and made 11,000 seizures.

IRS is involved with millions of TDA and TDI cases, although not all of them eventually need the attention of IRS collection officials. In fiscal year 1995, IRS disposed of 4.2 million TDAs and 1.7 million TDIs. About two-thirds of the accounts were for individuals, and about three-quarters of the business accounts related to employment tax returns. The business returns most commonly resulting in investigations were also employment tax returns. According to an IRS official, businesses holding employment taxes are tempted to keep them to overcome cash shortfalls.

Our high-risk series 1995 report on IRS' accounts receivable illustrates how the problems in different IRS functions affect each other and therefore how a change in problem levels can affect a tax administrator's other operations.²⁵ We pointed out that if returns processing did not properly account for a taxpayer's remittance, collection personnel may have to try resolving an invalid account receivable.²⁶ Similarly, if an IRS compliance effort overstated a taxpayer's liability, it would make additional work for collection personnel with no guarantee of revenue generation.

Concerning IRS' accounts receivable, we reported that individual taxpayers with primarily nonwage income owed about three-quarters of IRS' September 30, 1993, tax debt owed by individual taxpayers of \$79.2 billion. Half of the total debt was owed by taxpayers whose primary source of income was from self-employment (27 percent) or from interest and dividends (23 percent).²⁷

Taxpayer Services

With a fiscal year 1996 taxpayer services budget of about 8,000 full-time equivalents and \$500 million, IRS did various things to try to help taxpayers comply with tax laws. In fiscal year 1995, for example, it answered the telephone in almost 111 million instances to provide various forms of assistance. For instance, although IRS received many more calls than it was able to answer, IRS personnel staffing its toll-free system did respond to almost 38 million procedural, account, and tax law calls. Of these contacts, IRS disposed of over 29 million account calls concerning tax bills and

²⁵See High-Risk Series: Internal Revenue Service Receivables (GAO/HR-95-6, Feb. 1995).

²⁶According to a recent report, Tax Administration: Alternative Filing Systems (GAO/GGD-97-6, Oct. 16, 1996), when IRS investigated 1.8 million potential 1991 underreporter cases in certain categories, about half resulted in no change to the taxpayers' tax liabilities.

²⁷See Tax Administration: Tax Compliance of Nonwage Earners (GAO/GGD-96-165, Aug. 28, 1996).

notices, and it handled almost 8 million calls on tax law matters, which included technical tax information related to specific laws and regulations. IRS estimated that 8 different categories each covered almost 10 percent of the tax law calls, with each call being counted only once. These categories were (1) filing information; (2) dependents, exemptions, and filing status; (3) individual income; (4) individual business income and deductions; (5) capital gains and losses; (6) pensions and deferred compensation; (7) individual deductions and adjustments; and (8) tax computation, credits, and payments. Thus, not only did the tax law calls fall into a number of similarly sized categories, but also each category comprised only a very small percentage of the 38 million toll-free calls answered.

Tele-tax is another form of IRS telephone assistance, one through which taxpayers can receive recorded tax information on the status of their refunds and on many tax law issues. In fiscal year 1995, IRS counted about 61 million “hits,” or tape menus accessed by callers, about double the year before. According to an IRS official, 80 to 90 percent of these hits involved questions about refunds. Refunds were especially problematic in 1995 when IRS enhanced its efforts to ensure the appropriateness of refund claims, resulting in millions of refunds being delayed and much adverse reaction. For the hits that did not involve refunds, IRS supplied us with lists of topics accessed by taxpayers for the years ended in June 1994 and June 1995. Other than general subjects, topics receiving more than 75,000 calls and thus ranking in the top 15 of the 1995 list were (1) electronic filing; (2) dependents; (3) medical and dental expenses; (4) earned income credit; (5) menu of filing requirements, filing status, and exemptions; (6) filing status; (7) which form—1040, 1040A, or 1040EZ; (8) business entertainment expense; (9) moving expenses; (10) child and dependent care credit; and (11) collection issues.

In fiscal year 1995, IRS also provided over 4.2 million people with taxpayer education programs. It reached over 80 percent of them through the Volunteer Income Tax Assistance and Tax Counseling for the Elderly Programs and the rest of them through a community outreach program, small business workshops, and tax practitioner institutes.

Overview of Alternative Tax Systems and Design Issues

In recent years, several proposals for fundamental tax reform have been put forward. These proposals would significantly change tax rates, the tax base, and the level of tax (whether taxes are collected from individuals, businesses, or both). Some of the proposals would replace the federal income tax with some type of consumption tax levied only on businesses. Consumption taxes levied only on businesses include retail sales taxes (RST) and value-added taxes (VAT). The flat tax would also change the tax base to consumption but include both a relatively simple individual tax along with a business tax. A personal consumption tax, a consumption tax levied primarily on individuals, has also been proposed. Similar changes in the level at which taxes are collected could be made while retaining an income tax base.

If Congress were to decide to fundamentally reform the tax system, it would have to make choices on several basic issues, all of which have ramifications for tax compliance and administration. First, should the tax base be income or consumption or, as under the current system, contain elements of both? Second, should taxes be levied on businesses, individuals, or both? Third, should the preferential tax treatment now given certain goods and services and types of income be maintained or eliminated, thereby affecting not only the economic and social purposes for which they were established but also the ease of tax compliance and administration? Fourth, if consumption is chosen as the appropriate base for taxation, what issues arise in making the transition to a new tax base, and how should certain types of consumption that are difficult to tax be treated? Fifth, how should a new system be designed to balance other goals for the tax system with the goals of minimizing administration costs and taxpayers' costs of compliance?

This appendix provides some information to clarify these issues. To summarize, the fundamental difference between income and consumption taxes lies in the treatment of saving and investment. A broad-based income tax would tax all income, regardless of how it is used and regardless of its source. In particular, a broad-based income tax would tax income regardless of whether it is used for consumption or for saving and investment and would tax all income earned from saving and investment. In contrast, consumption taxes are designed to tax only income used for consumption, exempting from tax income used for saving and investment. Under certain conditions, this is equivalent to exempting income earned from saving and investment. As a result, different consumption taxes can in effect exempt saving and investment in different ways, so taxes that appear to be different may actually tax the same base—consumption.

Either income or consumption taxes could be levied on individuals, businesses, or both. The choice of level of tax (or collection point) alone does not determine the base of a tax or who will bear its economic burden. The choice does affect how equitable and how complicated a tax may be because it determines whether a tax can treat different individuals differently. A tax levied on individuals, whether income- or consumption-based, can tax different individuals at different rates or allow for adjustments such as standard deductions or exemptions for dependent children. Such provisions may make a tax system more equitable but may also make it more complicated. A tax levied solely on businesses (corporations, partnerships, and sole proprietorships) may be simpler to administer and less costly for taxpayers to comply with because the number of tax return filers may be substantially reduced and because only businesses would be burdened with tax-related recordkeeping and accounting tasks. Businesses may keep some of the same records for nontax purposes and are likely to be more efficient at recordkeeping and accounting than individuals. However, taxes levied solely on businesses are generally less able to make distinctions between individuals for reasons of equity.

The current income tax is actually a hybrid tax because it exempts or lightly taxes some types of saving and investment from tax but fully taxes other forms. The current tax also grants preferential treatment to some types of consumption, such as employer-provided health insurance. A reformed tax system could treat saving and investment more uniformly, either by taxing all saving and investment (income tax) or by exempting all saving and investment (consumption tax). A reformed tax system could also eliminate the current tax code preferences for certain items of consumption, or it could maintain them.

Any tax reform that replaces the current income tax with a consumption tax would have to address transition issues. In particular, the decision on whether to tax existing wealth could raise issues of fairness and administrability, as well as revenue. Moving to a consumption tax would also raise issues involving the taxation of some types of goods and services that could be difficult to tax from an administrative viewpoint. In particular, decisions would have to be made on whether to tax and how to tax financial services, housing, fringe benefits, and goods and services produced by governments and nonprofit organizations. Some of these items are also difficult to tax under an income tax.

While some information is readily available on administration costs, policymakers have little quantitative evidence on compliance costs available to help them design new tax systems. Compliance costs are costs that individuals and businesses incur, in terms of both time and money directly spent, because of the requirements of the tax system. Compliance and administrative costs are interrelated because some of the tasks that need to be done to collect taxes can be done by the public sector or by the private sector. As a result, costs can be shifted from one sector to another. The distribution of compliance costs among different businesses and individuals is also important for understanding the full effects of a tax system. A major difficulty in measuring compliance costs is disentangling accounting and recordkeeping costs due to taxes from the costs that would have been incurred in the absence of the tax system. As a result, the reliability of the results of most compliance cost studies that have been done to date is limited.

Differences Between Income and Consumption Taxes

The fundamental difference between income and consumption taxes lies in their treatment of saving and investment.¹ Income can be used for either consumption or saving and investment, so if income used for saving and investment can be exempted from tax, the result will be a tax only on consumption. As described below, the exemption of saving and investment can be done in different ways, so consumption taxes can be structured differently and yet still have the same overall tax base. In contrast, income taxes do impose a tax on income used for saving and investment. The current tax system is considered to be a hybrid between a pure income tax and a pure consumption tax because it effectively exempts some types of saving and investment from tax but taxes other forms of saving and investment.

Tax Treatment of Saving and Investment

Consumption taxes exempt income used for saving and investment in one of two ways. First, tax could be levied only on income used to buy consumption goods and services. This could be done by either taxing the sale of goods and services to consumers or by allowing individuals to deduct the amount that they saved from their income. Under either method, the income that an individual saved or invested would not be taxed until it was used to buy goods and services for consumption.

¹For a similar discussion, see Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform* (Cambridge, Mass.: The MIT Press, 1996), pp. 168-71.

A second way to in effect exempt saving and investment from tax would be to exempt income earned by saving and investment. Over time, not taxing the earnings from savings can be economically equivalent to not taxing the amount saved originally. As shown below, under certain conditions, these two methods are equivalent in that what individuals earn through saving, the rate of return to saving and investing, is the same under these seemingly different taxes.²

In contrast to consumption taxes, a broad-based income tax would levy tax on income from all sources and tax income regardless of whether it is used for consumption or saving. In particular, all income earned from saving and investment would be taxed, and income used for saving and investment would not be deductible.

A simple example focusing on the treatment of saving under alternative taxes is shown in table III.1. The example compares an income tax to two forms of consumption taxes and also illustrates the equivalence between a consumption tax that exempts saving and a tax that exempts the income earned by saving. The three cases all assume that \$100 of wage income is earned in the first year, all after-tax income is saved the first year and used for consumption in the second year, the interest rate is 10 percent, and the tax rate is 20 percent.

²Michael Graetz, "Expenditure Tax Design," in Joseph A. Pechman, ed., *What Should Be Taxed: Income or Expenditure?* (Washington, D.C.: The Brookings Institution, 1980), pp. 172-73, lists the conditions that must hold for the taxes to be equivalent. For example, the tax rate an individual faces must be constant over time, taxpayers must consume all the income they earn during their lifetime, and individuals must be able to borrow and lend unlimited amounts at a constant rate of interest. Consumption taxes effectively exempt the "normal" or competitive rate of return on investment but can tax rates of return above this level. For a discussion of whether consumption taxes exempt the return for risk-taking, see William M. Gentry and R. Glenn Hubbard, "Distributional Implications of Introducing a Broad-Based Consumption Tax," in James M. Poterba, ed., *Tax Policy and the Economy*, Volume 11 (Cambridge, Mass.: MIT Press, 1997).

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**Table III.1: Tax Treatment of Saving
Under Income and Consumption Taxes**

	Income tax	Consumption tax income from saving not taxed	Consumption tax saving not taxed
First year			
Wages	\$100	\$100	\$100
Tax	20	20	0
Amount saved or invested	80	80	100
Second year			
Additional income from saving or investment	\$8	\$8	\$10
Tax	1.6	0	22
After-tax return on saving	8%	10%	10%
Present value of taxes	\$21.45	\$20	\$20

Source: GAO analysis of alternative taxes.

The first column shows how a person would be taxed under an income tax. In the first year, the individual pays \$20 in tax and saves the balance (\$80). In the second year, the individual earns \$8 in income from saving, and pays \$1.60 in tax on this income, leaving \$86.40 available for consumption. Because the earnings from saving were subject to income tax, the after-tax rate of return on the individual's saving is 8 percent (\$6.40 of \$80) instead of the 10-percent rate (\$8 of \$80) that would be earned without the income tax.

The second column shows how the same individual would be taxed under a consumption tax that does not tax the earnings from saving. In the first year, the individual would be taxed on all income (\$100), so as in the income tax case, \$20 would be paid in tax and \$80 would be available for saving. Once saved, the \$80 would earn a 10-percent rate of return (\$8), as in the income tax case, but the earnings from saving would not be taxed. Thus, in the second year, the individual has \$80 in saving and \$8 in earnings on saving available for consumption, for a total of \$88. In comparison to the income tax, which reduced the after-tax return to saving, the rate of return on saving is not changed by the consumption tax, so incentives to consume today or save for the future are not affected by the tax.

The third column shows how the individual would be taxed if a deduction from income for saving were allowed and all income was taxable when used for consumption. In the first year, the individual owes no tax because all income is saved. The \$100 saved earns a 10-percent rate of return, so in the second year \$110 would be available for consumption before tax. The individual would owe \$22 in tax (20 percent of \$110), leaving \$88 for consumption after tax, the same amount as under the first consumption tax.³

While the two consumption taxes differ in the timing of the tax payment, as shown under this simple scenario, they would be equivalent in terms of the present value of the taxes owed. Under the first consumption tax, the individual owes \$20 in tax the first year and none in the second; under the alternative consumption tax, the individual owes no tax in the first year and \$22 in the second. In this case, having no tax liability in the first year would enable the person to save an additional \$20 and therefore earn an additional \$2, just enough to pay the additional tax in the second year. Therefore, under the consumption tax in column 2, the individual effectively prepays the consumption tax in the first year by paying \$20; the individual has paid an amount that if saved, would earn just enough to pay the tax owed when the income was actually used for consumption.

Income and Consumption Taxes Can Be Levied on Individuals or Businesses

Both income and consumption taxes can be levied on individuals or businesses. Whether collected from individuals or businesses, ultimately, individuals will bear the economic burden of any tax.⁴ The choice of whether to collect a tax at the business level or the individual level depends on whether it is thought to be desirable to levy different taxes on different individuals. A business-level tax, whether levied on income or consumption, can be collected “at source”—that is, where it is generated—so there can be many fewer tax filers and returns to administer. Business-level taxes cannot, however, directly tax different

³Alternatively, the same \$22 tax liability could be expressed as 25 percent of consumption. Since RSTs are computed as a percentage of consumption rather than as a percentage of income (less saving), the appropriate RST rate would be 25 percent. The result would be the same—under either an RST or a personal consumption tax, income (less saving) would be reduced by 20 percent by the tax, and the tax liability would amount to 25 percent of consumption.

⁴For example, most economists would agree that the economic burden of a tax on wages would be generally borne by workers, regardless of whether workers directly remit tax (send a payment) to the government, businesses withhold tax from paychecks and remit the tax, or businesses are required to remit tax on wages they paid. Alternatively, because taxes can be shifted through price changes and changes in income, the statutory incidence of a tax (who is legally responsible to remit tax to the government) “tells us essentially nothing” about economic incidence (whose real income is changed as a result of the tax). See Harvey Rosen, *Public Finance*, 3rd ed. (Burr Ridge, Illinois: Irwin, 1992), pp. 274-77.

individuals at different tax rates. Individual-level taxes can allow for distinctions between different individuals; for example, standard deductions and/or graduated rates can be used to tax individuals with low income (or consumption) at a lower rate than individuals with greater income (consumption). Other individual characteristics can also be taken into account. For example, adjustments can be made for family size, and additional deductions could be allowed for individuals who have very large medical expenditures. However, individual-level taxes require more tax returns, impose higher costs to comply with the tax laws, and would generally require a larger tax administration system.

Table III.2 shows alternative income and consumption taxes that are levied on businesses only, individuals only, or both. The current tax, while including a separate corporate income tax, could be considered primarily an individual tax because most types of income are taxed under the individual tax. As mentioned earlier, the current tax is somewhere in between a pure income and pure consumption tax because under the current tax some forms of income from saving are taxed, while others, particularly income from saving for retirement, are not taxed. We describe each of the alternative taxes in the next two sections.

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Table III.2: Alternative Income and Consumption Taxes by Level of Tax

Level of tax/features	Consumption type	Income type
Business level	National RST	Income VAT
Tax collected at source	Consumption VAT	
No filing by individuals	Credit method	
No way to vary tax rates or base according to characteristics of individuals	Subtraction method	
Mixed business/individual	Flat tax	Comprehensive Business Income Tax discussed by Treasury, augmented with wage tax at individual level
Many parts of tax base collected at source		
Simplified individual tax base		
Standard deductions or exemptions can be used for progressivity, but no way to apply different rates to entire tax base		
Individual level	Personal consumption tax	Integrated individual income tax
Tax levied on individuals		
Business must allocate income or consumption to individuals; may also withhold and remit tax		
Tax rates can vary according to individual characteristics		

Source: GAO analysis of alternative tax systems; also, see Joel Slemrod, "Deconstructing the Income Tax," *The American Economic Review*, Vol. 87, No. 2 (May 1997), pp. 151-55.

Alternative Types of Consumption Taxes

The second column of table III.2 shows two business-level consumption taxes (a national RST and a VAT), a mixed business/individual-level consumption tax (a flat tax), and an individual-level consumption tax (a personal consumption tax). Table III.3 shows an overview of the major components of the alternative consumption taxes and details the major differences between them. While the taxes differ because they tax consumption at different levels, they ultimately all tax the same base.

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Table III.3: Components of Alternative Consumption Taxes

Component	National RST	VAT	Flat tax	Personal consumption tax
Business level				
Included				
Sales of consumption goods and services	•	•	•	
Sales of goods and services to other businesses, including investment goods		•	•	
Deducted				
Purchases of goods and services from businesses, including investment goods		•	•	
Wages			•	
Individual level				
Included				
Wages			•	•
Cash flows received: interest and dividend income, funds from asset sales, withdrawals from accounts, borrowed funds				•
Distributions from sole proprietorships, partnerships				•
Deducted				
New saving: purchases of stock, bonds; deposits in accounts, repayment of debt				•
Contributions to sole proprietorships, partnerships				•

Source: GAO analysis and compilation of available information on alternative consumption taxes.

National Retail Sales Tax

The consumption tax that Americans are most familiar with is the retail sales tax, which in many states, is levied when goods or services are purchased at the retail level. The RST is a consumption tax because only goods purchased by consumers are taxed, and sales to businesses, including sales of investment goods, are generally exempt from tax. In

contrast to an income tax, then, income that is saved is not taxed until it is used for consumption.

Under a national RST, different tax rates could be applied to different goods, and the sale of some goods could carry a zero tax rate (exemption). However, directly taxing different individuals at different rates for the same good would be very difficult.

Value-Added Tax

The second column in table III.3 shows the components of a VAT, which like the RST, is a business-level consumption tax levied directly on the purchase of goods and services. The two taxes differ in the manner in which the tax is collected and paid. In contrast to a retail sales tax, sales of goods and services to consumers and to businesses are taxable under a VAT. However, businesses can either deduct the amount of their purchases of goods and services from other businesses (under a subtraction VAT) or can claim a credit for tax paid on purchases from other businesses (under a credit VAT). Under either method, sales between businesses do not generate net tax liability under a VAT because the amount included in the tax base by businesses selling goods is equal to the amount deducted by the business purchasing goods. The only sales that generate net revenue for the government are sales between businesses and consumers, which is the same case as the RST.

Flat Tax

The flat tax was developed in the early 1980s by economists Robert Hall and Alvin Rabushka.⁵ The Hall-Rabushka flat tax proposal includes both an individual tax and a business tax. As described by Hall and Rabushka, the flat tax is a modification of a VAT; the modifications make the tax more progressive (less regressive) than a VAT. In particular, the business tax base is designed to be the same as that of a VAT, except that businesses are allowed to deduct wages and retirement income paid out as well as purchases from other businesses. Wage and retirement income is then taxed when received by individuals at the same rate as the business tax rate. By including this individual-level tax as well as the business tax, standard deductions can be made available to individuals. Individuals with less wage and retirement income than the standard deduction amounts would not owe any tax.

Personal Consumption Tax

A personal consumption tax would look much like a personal income tax. The major difference between the two is that under the consumption tax, taxpayers would include all income received, amounts borrowed, and cash flows received from the sale of assets, and then deduct the amount they

⁵See Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, Calif.: Hoover Press, 1995).

saved. The remaining amount would be a measure of the taxpayer's consumption over the year. When funds are withdrawn from bank accounts, or stocks or bonds are sold, both the original amount saved and interest earned are taxable because they are available for consumption. If withdrawn funds are reinvested in another qualified account or in stock or bonds, the taxable amount of the withdrawal would be offset by the deduction for the same amount that is reinvested.

While the personal consumption tax would look like a personal income tax, the tax base would be the same as an RST. Instead of collecting tax on each sale of consumer products at the business level, a personal consumption tax would tax individuals annually on the sum of all their purchases of consumption goods. Because it is an individual-level tax, different tax rates could be applied to different individuals so that the tax could be made more progressive, and other taxpayer characteristics, such as family size, could be taken into account if desired.⁶

Alternative Types of Income Taxes

Table III.2 also shows three alternative integrated income taxes: a business-level tax (income VAT), a mixed business/individual-level tax (Comprehensive Business Income Tax (CBIT)), and an individual-level income tax (integrated individual income tax).

All income taxes, including the current tax, differ from consumption taxes in their treatment of investment. To produce the goods and services they sell to customers, businesses purchase a variety of goods and services themselves. While some of the goods and services that businesses buy are used up immediately in production, other goods and services, such as plant and equipment, for example, can be used for production over time. The purchase of goods and services of this type is referred to as investment, and such goods and services are also referred to as business assets.

Under consumption taxes, investment is either exempt from tax or deducted immediately (expensed). In fact, all business purchases of goods and services, regardless of how long they are used in production, are

⁶To tax certain types of consumption that can occur within a business, such as fringe benefits or the personal use of goods such as cars, many personal consumption tax proposals also include a business-level "cash flow" tax. Investment would be expensed under such a tax to ensure that the overall tax base would be consumption. See appendix VIII for more details.

exempted or expensed because business purchases generally do not represent consumption.⁷

Investment is treated differently under an income tax. Under an income tax, income is calculated by deducting costs from revenue; therefore, the costs that businesses incur from purchasing goods and services, including the costs from owning assets, should be deductible. For goods and services that are used up or become worthless in the same year as they were purchased, the economic cost to the business will be the entire amount they paid for the goods and services, and therefore the entire amount should be deductible immediately (in the same tax year as the goods or services were purchased). However, business assets do not lose all their value immediately; rather, they wear out or become obsolete over time (the assets depreciate). The economic cost incurred by owning an asset during a particular year is the reduction in the value of the asset during that year, so under an income tax businesses should be allowed a deduction for depreciation that reflects this reduction in value. Depending on the rate at which an asset loses economic value, a proportion of the amount originally paid for the asset can be deducted for depreciation each year until the total amount deducted over time is equal to the amount originally paid.⁸

The current income tax differs from the other three income tax options in that the current corporate income tax is not integrated with the personal income tax. For example, under the current tax, corporations cannot deduct dividends paid to shareholders, and shareholders pay tax on the dividends they receive. Noncorporate income, however, is taxed only once, at the individual level. The three options would tax all forms of business income, corporate and noncorporate, once.

Table III.4 shows the components of the current tax and three alternative income taxes that would integrate the business and individual taxes. The alternative income taxes differ in that they would tax income at different levels. The income VAT would tax all income at the business level. Wage income would be taxed at the business level by denying businesses a deduction for wages. The CBIT option would tax business income,

⁷Investment in plant and equipment, like the purchase of financial assets such as corporate stock or bonds, is a form of saving. By investing in assets like plant and equipment and using them over time to earn income from the production and sale of goods and services, owners of businesses postpone consumption today to make possible additional consumption in the future.

⁸This tax treatment would be appropriate if there is no inflation. In appendix IV, we discuss how inflation creates problems in measuring depreciation.

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including profits and the interest income earned by lenders, at the business level. Wage income would be taxed at the individual level.

Table III.4: Components of Alternative Income Taxes

Component	Current tax	Income VAT	CBIT	Integrated individual income tax
Business level				
Included				
Sales of goods and services	•	•	•	
Interest, dividend income	•			
Deducted				
Purchases of goods and services, except investment goods	•	•	•	
Depreciation on investment assets	•	•	•	
Wages	•		•	
Interest paid	•			
Dividends paid				
Individual level				
Included				
Wages	•		•	•
Interest income	•			•
Dividend income	•			•
Capital gains	•		•	•
Income from sole proprietorships, partnerships	•			•
Share of undistributed corporate income				•

Source: GAO analysis and compilation of available information on alternative income taxes.

Integrated Individual Income Tax

An integrated individual-level income tax would be much like the current tax. Individuals would be responsible for filing returns containing information on all taxable forms of income. The taxation of business income would change so that all business income, corporate and noncorporate, would be taxed at the individual level. The tax rate would apply to all forms of income that an individual receives, and individuals could be taxed according to graduated rates if desired. Other taxpayer

characteristics, such as the number of dependent family members, could be taken into account.

CBIT

The CBIT option would move much of the taxation of business income to the business level, leaving a simplified individual tax return (primarily wages). Business deductions for interest and dividends would not be allowed, so this form of income would be taxed at the business level. The business tax would effectively withhold tax on business income at the tax rate that was applied to the business. Since individuals would file returns, standard deductions and dependency exemptions could be part of the system. A flat rate could be levied at the individual level, or multiple rates chosen, but the multiple rates would only apply to the simplified base.

Income Value-Added Tax

An income VAT would move the taxation of wage income to the business level as well. No individual returns would be necessary, so the burden of complying with the tax law would be eliminated for individuals. An income VAT would not allow businesses to deduct dividends, interest, or wages, so the income VAT remitted by businesses would include tax on these types of income. Calculations would not have to be made for different individuals, which would simplify tax administration and compliance burdens but not allow for treating different individuals differently.

How Consumption Taxes or a Reformed Income Tax Could Affect Tax Expenditures and Therefore the Tax Base

If Congress decides to reform the current tax, it could incorporate existing tax preferences into a new tax system or eliminate the current preferences and replace them with direct expenditure programs. These preferences are referred to as “tax expenditures” because they can be thought of as alternatives to direct outlay programs. They may take the form of exclusions, credits, deductions, preferential tax rates, or deferral of tax liability.⁹

Tax Expenditures for Saving and Investment

The current tax system taxes some types of income from saving and investment but exempts others. The alternative tax systems would treat all types of income from saving and investment uniformly either by exempting all types of income from saving or by taxing all types of income

⁹For a more extensive classification of current tax expenditures according to whether current tax treatment would be automatically provided for under consumption taxes, see Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (New York: American Institute of Certified Public Accountants, Dec. 1995), pp. 91-96.

from saving. Consumption tax proposals would expand existing incentives and narrow the tax base by effectively exempting all saving and investment from tax, and an income tax reform could end the incentives by including income from all forms of saving and investment in the tax base.

Table III.5 shows a list of major projected fiscal year 1997 tax expenditures for saving and investment in the current tax code. For instance, under current law, some forms of saving, such as those producing pension and certain interest income, are already effectively exempt from tax. A move to a broad-based consumption tax would effectively exempt all saving, treating it like pension or tax-exempt interest income is treated today. While some types of investment are granted relatively favorable tax treatment currently, under a consumption tax all investment would be expensed (deducted immediately). A tax reform designed to tax all income would also move toward uniformity by removing the relative preference now given to some forms of saving and investment to tax income of all types equally.

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Table III.5: Fiscal Year 1997 Saving and Investment Income Tax Expenditures

Tax expenditure category	Amount (in billions)
Exclusion of employer plan pension earnings and contributions	\$70.5
Exclusion of investment income on life insurance and annuity contracts	21.6
Deferral of gain on sale of owner-occupied housing	18.6
Exclusion of \$125,000 of capital gains from sale of principal residences for persons age 55 and over	4.9
Exclusion of capital gains at death	15.5
Maximum 28-percent rate on long-term capital gains	10.5
IRAs	9.3
Keogh plans	3.7
Exclusion of interest on public purpose state and local government debt	14.1
Exclusion of interest on state and local government bonds for private nonprofit hospitals ^a	1.7
Exclusion of interest on state and local government bonds for rental and owner-occupied housing	3.0
Reduced rate on first \$10 million of corporate taxable income	4.1
Expensing of certain depreciable property ^b	1.0
Expensing of research and experimental expenditures ^c	2.4
Accelerated depreciation for equipment	28.7
Accelerated depreciation for structures	4.6

^aTax expenditures of \$1 billion or less would also be potentially eliminated for tax-exempt bonds for each of the following purposes: industrial development; community development; and sewage, water, hazardous waste, and other facilities.

^bInvestments in the following categories are also expensed: (1) certain fuel, mineral, and timber development costs; (2) agricultural costs; and (3) others. The estimated revenue loss for each of these tax expenditures is less than \$500 million annually.

^cThe tax credit for qualified research expenditures, as well as credits for certain other investments, could potentially be eliminated under consumption taxes.

Source: Joint Committee on Taxation data on tax expenditures; Sullivan, p. 93; and GAO analysis of consumption tax proposals.

Other Current Tax Expenditures

Table III.6 shows a number of other tax expenditures under current law and fiscal year 1997 revenue loss estimates associated with them. Both income and consumption tax reform could eliminate these preferences, thereby broadening the tax base. Any tax reform would have to decide

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whether to continue the relative tax preference for certain fringe benefits, government benefits, and a number of other items.

Table III.6: Other Current Tax Expenditures, Fiscal Year 1997 Estimates

Tax expenditure category/provision	Amount (in billions)
Fringe benefits (other than pensions)	
Exclusion of employer contributions for health insurance, medical care	\$51.5
Exclusion of benefits provided under cafeteria plans	5.0
Exclusion of miscellaneous fringe benefits	5.5
Exclusion of premiums on group term life insurance	1.7
Exclusion of employer-paid transportation benefits	3.1
Government benefits	
Exclusion of Social Security and Railroad Retirement benefits	25.3
Exclusion of Medicare hospital insurance benefits	12.2
Exclusion of Medicare supplementary insurance benefits	5.5
Exclusion of workers' compensation	3.8
Other	
Deduction of nonbusiness state and local government income and personal property taxes	27.3
Mortgage interest deduction for owner-occupied residences	41.3
Deduction for property taxes on owner-occupied residences	15.6
Charitable deductions for social services	16.1
Charitable deductions for education	3.0
Charitable deductions for health	2.2
Deduction for medical expenses and long-term care	4.3
Earned income credit (not including direct outlays)	3.5
Low-income housing tax credit	2.8
Credit for child care and dependent care expenses	2.8
Additional standard deduction for the blind, elderly	1.9
Tax credit for Puerto Rico and possession income	3.2

Source: Joint Committee on Taxation data on tax expenditures; Sullivan, pp. 95-96; and GAO analysis of alternative consumption taxes.

**Consumption Tax
Design Issues
Affecting Tax
Administration**

In addition to the issue of whether currently tax-favored items should maintain some tax preference in a new system, some other issues in the design of a potential consumption tax would have an effect on tax administration. A transition from the current tax to a consumption tax base could raise significant administration issues. In addition, if a consumption tax base is chosen, important decisions would have to be made regarding whether particular hard-to-tax goods and services are included in the tax base.

**Implementing a
Consumption Tax May Tax
Existing Wealth**

Under an income tax, no deduction for saving is allowed, and the income from saving is taxed as it is earned by the saver. However, the amount that was saved is not subject to further tax. For example, a bondholder will pay tax on interest income but does not owe tax on the principal when it is repaid.

If the income tax was replaced by a consumption tax, the saving that has been done in the past using taxed funds might be subject to tax again. For example, suppose that an individual buys a bond while the income tax is in effect. Then suppose that the income tax is replaced by a national RST, and the bondholder receives interest income and the principal is returned as the bond matures. If the bondholder uses all of these funds for consumption, all—interest income and principal—would be subject to tax. In this way, replacing the income tax with a consumption tax could levy a one-time additional tax on saving done before the tax change.

If it is thought to be unfair to subject prior saving to tax again, transition rules would have to be written so that prior saving could be recovered tax-free, as it would have been under the income tax. One difficulty is that to replicate the treatment that saving and income from saving would have received under the income tax, income from saving would have to be separated from the return of the original amount saved. Otherwise, taxpayers might get a windfall gain if they were able to get their previous capital income back tax-free along with their prior saving. The particular administrative challenges that would have to be addressed for a transition to the alternative consumption taxes are briefly discussed in appendixes V through VIII.

A Consumption Tax May Be Difficult to Administer for Certain Goods and Services

Any consumption tax proposal would have to address several areas where levying tax might be difficult in terms of compliance and administration. These items can be taxed if special rules are developed and taxpayers and administrators devote resources to compliance. Including these items would broaden the base of a consumption tax, enabling the same amount of revenue to be raised at a lower rate than otherwise. Exempting these items would also be possible, but exempting some goods and services while taxing others would create administrative difficulties.¹⁰

Fringe Benefits

Some fringe benefits can be thought of as consumption that takes place within a business. As such, no separate transaction between an individual and a business takes place that would be subject to tax under the normal rules for an RST or a VAT, and there is no cash flow to an individual that would normally be included under a personal consumption tax. The same difficulties are present for the current income tax and would be present for any modification of the income tax that sought to broaden the income tax base.

To illustrate, consider employer-provided health insurance, perhaps the most significant fringe benefit aside from employer-provided pensions. The purchase of an employer-provided health insurance plan is a business-to-business transaction, and the payment of medical bills by insurance companies is also a business-to-business transaction. Ordinarily, business-to-business transactions are ignored under an RST and deductible (or creditable) under a VAT, so under normal rules, the consumption of medical services would not be taxed.

If the purchase of health insurance was to be taxed under tax reform proposals, exceptions to the general rules would have to be written. Under a national RST, the purchase of health insurance or medical services could be taxable regardless of whether they were purchased by an individual or a business. For a VAT, the purchase of health insurance or payments for medical services by businesses for their employees could be nondeductible (or noncreditable). In either case, the taxable transactions or purchases that would not be deductible would have to be specified.

Similarly, under the personal consumption tax, a business-to-business transaction would never be reflected in an individual's cash flow, so under general rules, the consumption would not be taxed. To include this consumption in the tax base, the value of the fringe benefit would have to

¹⁰For a discussion of the specific items in this section in the context of a VAT, see Congressional Budget Office (CBO), Effects of Adopting a Value-Added Tax (Feb. 1992).

be imputed or allocated to the employee so that it could be included in taxable receipts. The same steps would have to be taken to include the value of this form of compensation for income tax purposes.

Financial Services

Financial services can be difficult to tax under a consumption tax because the recipients of the services are not always charged explicit service fees. Financial institutions typically do not charge explicit service fees for maintaining checking and saving accounts and for arranging loans. Instead, they charge higher interest rates on loans and offer lower rates on deposits than otherwise. To include financial services in the tax base, consumption taxes that do not include all types of cash flows in the tax base (such as an RST, VAT, or flat tax) would include some rules to impute the value of the sale of the financial service.¹¹

Housing

Taxing the consumption of services from owner-occupied housing poses a potential problem for consumption taxes.¹² Housing, like other durable consumption goods, provides consumption services over time. For rental housing, this is not a problem; rent could be taxed like any other consumption item because there is a transaction between an individual and a business (owner of the rental unit), so the normal rules can apply. For owner-occupied housing, the individual consuming housing services and the supplier of the house are the same person, so there is no transaction to tax.

Consumption taxes could overcome this problem by subjecting the full purchase price of owner-occupied housing to tax at time of purchase, even though the house will not be consumed all at once. This essentially prepays the consumption tax. However, this raises potential problems of liquidity (the one-time payment of tax may be very large), and taxing existing housing, as well as new housing, may be difficult. To tax new housing, a business (the developer, for example) could charge tax on the purchase price of the house.

Government and Nonprofit Services

As under income taxes, consumption taxes must include rules for sales and purchases of goods and services by government entities and nonprofit organizations. In theory, consumption taxes could tax all goods and

¹¹See David F. Bradford, "Treatment of Financial Services Under Income and Consumption Taxes," in Henry J. Aaron and William G. Gale, *Economic Effects of Fundamental Tax Reform* (Washington, D.C.: Brookings Institution Press, 1996) and references he cites for arguments on whether financial services should be included in a consumption tax base. Bradford also points out that financial services pose similar difficulties for income taxes as well as for consumption taxes.

¹²Housing services may be more difficult to tax under an income tax than a consumption tax. See appendix IV for information on the treatment of housing under an income tax.

services used for consumption in the same way, regardless of whether they are produced by governments and nonprofit organizations or by private for-profit businesses. However, because governments and nonprofit organizations do not charge a price for many of the goods and services they provide, these goods and services would be undertaxed relative to those sold by the private sector under the normal application of an RST or VAT. Under an RST, goods and services produced by governments and nonprofit organizations could be implicitly taxed to some extent by treating these entities as consumers rather than businesses. This would tax the purchases they make from businesses. Under a credit method VAT, governments and nonprofit organizations could be exempted from tax; this means that they would be unable to obtain credits for taxes they paid on purchases they made from businesses.

Under the flat tax, governmental entities, nonprofit organizations, and businesses could be treated more uniformly than under the RST and VATs because wages paid to employees of all these organizations can be taxable and government entities and nonprofit organizations would be taxed on fringe benefits provided for workers. A personal consumption tax could tax state and local government services by not allowing a deduction for state and local taxes.¹³

Definition and Measurement of Compliance Costs

Taxes impose three types of costs on society as a whole as resources are transferred from the private sector to the public sector. First, taxpayers must use resources to comply with the requirements of the tax system (compliance costs). Second, resources must be provided to the public sector to administer the tax, including collecting the revenue and ensuring that taxpayers comply with the requirements (administration costs). Third, taxes can also distort economic behavior, leading to a misallocation of resources (excess burden). Ideally, in determining the amount of revenue to be raised and the type of tax used to raise the revenue, the level and distribution of each of these costs would be weighed against the benefits derived from the use of the revenue by the public sector.¹⁴

¹³For more details on these issues, see Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax (JCS-4-96)*, April 30, 1996. Also, for a discussion of whether state and local business taxes should be deductible under consumption tax alternatives and other issues, see Douglas Holtz-Eakin, "Fundamental Tax Reform and State and Local Governments," *National Tax Journal* Vol. XLIX, No. 3 (Sept. 1996), pp. 475-86.

¹⁴Compliance cost assessments are done in the United Kingdom for major tax provisions. For examples of these assessments and summaries of several recent studies on compliance costs, see Cedric Sandford, ed., *Tax Compliance Costs: Measurement and Policy* (Perrymead, England: Fiscal Publications in association with the Institute for Fiscal Studies, 1995).

Compliance costs are costs that individuals and businesses incur, in terms of both time and money directly spent, because of the requirements of the tax system. Ideally, compliance costs should be measured by calculating the value of the time and the resources used doing tax-related tasks in their best alternative use (opportunity cost) net of any value derived from the information produced by complying with the requirements.¹⁵

Compliance costs and administrative costs are interrelated because some of the tasks that need to be done to collect taxes can be done by the public sector or by the private sector. As a result, costs can be shifted from one sector to another. For example, in the United States, businesses take on some responsibilities that encourage compliance by withholding tax on wages and providing information returns on payments of interest and dividend income. As a result, a high level of compliance on those forms of income may be achieved at lower administrative cost because matching information returns with tax returns can substitute for large numbers of audits. Also under the current system, taxpayers receive information and help with their tax filing responsibilities through both the private sector paid preparer industry and IRS taxpayer service activities.

The distribution of compliance costs among different businesses and individuals is also important for understanding the full effects of a tax system. For example, withholding tax on wages and providing information returns are costly tasks for businesses, but receiving these documents lowers compliance costs for individuals.¹⁶ Some studies have indicated that small businesses may bear higher compliance costs as a percentage of sales than larger businesses, and some businesses may receive cash flow benefits from being able to retain tax they collect for a period until remittance to the government is required. A full analysis of the distributional effects of different tax policies would take these effects of compliance costs into account.

Measurement of Compliance Costs

A major difficulty in measuring compliance costs is disentangling accounting and recordkeeping costs due to taxes from the costs that would have been incurred in the absence of the tax system. For example, where the rules regarding the calculation of income for tax purposes

¹⁵Some experts believe that some businesses may derive managerial benefits from accounting information produced for tax purposes. See Cedric Sandford, *Administrative and Compliance Costs of Taxation* (Perrymead, England: Fiscal Publications, 1989), p. 13.

¹⁶The economic burden of these costs may not reduce business profits if they result in higher prices, lower wages, or lower interest payments.

coincide with rules for determining income for financial statement or regulatory purposes, the additional costs of taxation can be minimal. Because public corporations must report financial statement income under the rules of the Securities and Exchange Commission, some recordkeeping useful in calculating tax liability may be done for nontax purposes. For other businesses, calculating financial statement income may be required by banks or other potential lenders. Some individuals may need to calculate their income in order to apply for mortgages or financial aid for college. However, significant compliance costs may arise when the tax code requires businesses or individuals to keep records and calculate income differently than they do for other purposes.

A related issue is whether other government agencies would require taxpayers to produce the same or similar information if it is not required for tax purposes. For example, the federal government might need a measure of individuals' income to determine eligibility for means-tested transfer programs, and state and local governments that now rely on federal income tax records might need to have similar information for their own tax and transfer programs even if the federal income tax were eliminated. To the extent that income tax requirements would be recreated by other government agencies if the income tax were repealed, compliance costs would have to be considered to be government compliance costs rather than stemming solely from the tax system.

The reliability of the results of most compliance cost studies that have been done to date is limited by several factors, which are commonly acknowledged by the authors of the studies. First, written or telephone questionnaires have generally been used to ask individuals or businesses how much money or time they spend on tax matters. In evaluating these studies, it is difficult to know whether respondents can differentiate between recordkeeping that would have been done anyway and recordkeeping that is only done for tax purposes. Reported compliance costs may be exaggerated if respondents include costs for nontax purposes. In addition, it is not known whether respondents did everything required to fully comply with the tax law. For example, if a particular tax rule was so complex that taxpayers did not even attempt to comply, respondents might truthfully answer that they spent no time or money to comply with the rule. The compliance costs as measured by the survey would be zero, so the results of the survey would not give an indication of just how complex the rule really is. Finally, response rates for these studies have generally been low, so the results from the surveys may not reliably estimate costs for taxpayers in general.

Income Tax Reform Options

Description

In this appendix, we describe several options for reforming the income tax and also the administrative issues that would be important if these options were considered. The four options we describe are based on past and current proposals and academic discussions and analyses. The options were chosen to best describe the trade-offs and choices that would have to be made in reforming the income tax and to best facilitate comparisons of income tax reform options and consumption tax proposals.

The goal of each of the four income tax reform options we discuss is to have a more comprehensive and accurately measured income tax base than under the current income tax. To do this, all of the reform options could make three major changes to the current system. First, the income tax base could be broadened so that most forms of income would be taxed annually. This could be done by including more types of income in the tax base and by eliminating some adjustments, credits, and deductions. Second, the calculation of income could include explicit inflation adjustments so that the tax base would better measure the real income of individuals and businesses. Under the current tax, inflation can lead to an overstatement or an understatement of real income. Third, the corporate and personal income taxes could be integrated so that business income would be taxed once annually, regardless of the legal form of the business. Under the current tax, corporate income is taxed differently than the income of noncorporate businesses, such as sole proprietorships and partnerships.

The income tax options we discuss would integrate the corporate and personal taxes but would do so in different ways. Just as consumption taxes can be levied on businesses, individuals, or both, the income tax options would levy the income tax at different levels. Two options would tax individuals directly on most or all of their income. These options, like the current system, would allow for many individual characteristics to be taken into account when determining tax liability. Administration of these options would also be similar to that under the current system, with individuals filing returns and information returns used to check compliance. Two other options would tax most or all income at the business level, essentially withholding tax before income is received by individuals. These options could reduce the need for individual returns and information reporting; administration efforts would be focused primarily on business returns. These options would not be as able to take individuals' characteristics into account and would be facilitated by a flatter tax rate structure.

This appendix first describes the changes that any of the four income tax reform options could make to more comprehensively and accurately measure income and elaborates on the options themselves. Then, it discusses the potential impact of these options on taxpayers' compliance burden and on tax administration.

**Broadening the Income
Tax Base**

The income tax base could be broadened by taxing certain types of income that are now exempt from tax and by eliminating some adjustments, deductions, and credits. Broad-based taxes can offer several advantages in meeting the goals of the tax system—promoting economic efficiency and equity and reducing taxpayer compliance burden and administration costs. By making fewer distinctions among activities, a broad-based tax can be simpler and easier to administer, and because under a broad base a given amount of revenue can be raised with a relatively low tax rate, economic efficiency may be enhanced. However, a more narrowly defined tax base, while generally requiring higher tax rates to raise the same amount of revenue, could be preferable to a broad tax base if exemptions, credits, or deductions promote economic efficiency and equity or simplify compliance and administration to a sufficient extent.

Broadening the tax base could in some respects increase the complexity of the tax system, but it could simplify it in other respects. For example, including some forms of income in the tax base could in some circumstances complicate compliance and administration, particularly if these forms of income are difficult for taxpayers to calculate and administrators to verify. However, if one form of income was exempted and other forms were taxed, rules and definitions would have to be developed to differentiate one form of income from the others. These rules would have to be followed by taxpayers and compliance with the rules checked by tax administrators.

**Taxing Additional Types of
Income**

Table IV.1 shows major types of income that are currently reported on Form 1040 and the number of returns that reported some amount of each type of income in tax year 1993. It also shows how the tax treatment of some items that are currently reported could change under a more broadly based tax, and it shows some additional income items that are not taxed or reported under current law. The major changes from the current system are discussed following the table.

Appendix IV
Income Tax Reform Options

Table IV.1: Income Items and Number of Returns Reporting Them, Tax Year 1993

Item	Current tax treatment	Millions of returns reporting item	Possible reformed income tax treatment
Currently reported items			
Salaries and wages	Taxed	98.0	Taxed
Taxable interest	Taxed	65.2	Taxed, adjusted for inflation
Tax-exempt interest	Taxed under some circumstances	4.7	Taxed, adjusted for inflation
Dividends	Taxed	24.7	Taxed
Net capital gain or loss	Taxed when realized, nominal gain included	18.4	Taxed on accrual basis, indexed for inflation
Distributions from pensions and annuities	All distributions taxed	17.4	Not taxed
Unemployment compensation	Taxed	9.7	Taxed
Social Security benefits	Taxed under some circumstances	5.7	Amounts above contributions taxed
Business or profession net income or loss (sole proprietorships)	Taxed	15.6	Taxed
Rental and royalty net income or loss	Taxed	11.0	Taxed
Partnership and S corporation net income less loss	Taxed	5.5	Taxed
Estate and trust net income less loss	Taxed	0.5	Taxed
Farm net income less loss	Taxed	2.3	Taxed
Additional income items			
Contributions to pension plans; earnings from life insurance, annuity, and pension plan reserves	Not taxed	N/A	Taxed
Employer-paid fringe benefits (other than pensions)	Not taxed	N/A	Taxed
Government benefits (Medicare, workers' compensation)	Not taxed	N/A	Taxed
Imputed service value of owner-occupied housing and other household durables	Not taxed	N/A	Taxed

(Table notes on next page)

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Legend: N/A = not applicable.

Sources: IRS, Statistics of Income Division, Individual Income Tax Returns 1993. Additional income items from David Bradford, Untangling the Income Tax (Cambridge, Mass.: Harvard University Press, 1986), pp. 33-34.

Tax-exempt interest income. Current law allows interest income from bonds issued by state and local governments and tax-exempt organizations to be exempt from tax if the bonds are used for certain purposes. While in some circumstances this interest income can be taxable and is therefore reported on tax forms, it is not subject to information reporting. The income tax base could be broadened by removing the tax exemption for this interest income.

Accrued capital gains. Under current law, capital gains are generally subject to tax only when assets are sold or otherwise disposed of. Owners of assets that have appreciated in value over the course of a year but have not been sold generally do not report the increase in asset value as income. Since such income is not reported until the asset is sold, tax on this income is deferred.¹

Capital gains could in effect be taxed as they are earned (on an accrual basis) in two ways. First, the owner of the asset could calculate the difference between the value of the asset at the end of the year and the value of the asset at the beginning of the year. Tax would be paid on the amount of the difference, regardless of whether the asset was actually sold. This could be done most readily for assets that are bought and sold frequently, such as publicly traded corporate stock, because the market values of the assets would be relatively easy to obtain and check. Under a second approach, taxation of gains could occur only when assets are sold, as under current law. However, an interest charge could be imputed and added to the gain so that the tax saving from the deferral of income would be offset.² This approach could be applied to assets for which market values are not readily available because they are bought and sold infrequently, or for all assets generally.

¹The current tax code contains several provisions to force the recognition of income to prevent deferral of gain in some circumstances. Shuldiner notes that Internal Revenue Code sections 475 and 1256 require mark-to-market for the inventory of security dealers and certain financial instruments; sections 453A and 1291 impose interest charges on deferral. Reed Shuldiner, "Indexing the Tax Code," Tax Law Review, Vol. 48 (1993), pp. 556-57, notes 70, 72.

²For details of such an approach, see Alan J. Auerbach, "Retrospective Capital Gains Taxation," The American Economic Review, Vol. 81, No. 1 (Mar. 1991), pp. 167-78. Also, see David J. Shakow, "Taxation Without Realization: A Proposal For Accrual Taxation," University of Pennsylvania Law Review, Vol. 134, No. 5 (June 1986), pp. 1111-1205.

Contributions to pension plans and retirement accounts; earnings from retirement accounts and life insurance, annuity, and pension plan reserves. In general under an income tax, income that is saved is taxed, and income from saving is taxed when it is earned. Under the current tax, there are significant exceptions to this general rule, and in some cases saving is treated as it would be under a consumption tax. In particular, contributions to pension plans and certain individual retirement arrangements (IRA) are not included in an individual's income, and earnings in these plans are not taxed until they are distributed. In addition, earnings in certain life insurance and annuity plans are not taxed until they are distributed. The income tax base could be broadened by taxing contributions to pension plans and IRAs, and by taxing earnings in pension, IRA, life insurance, and annuity plans when they are earned.

Employer-paid fringe benefits. In addition to pensions, under current law businesses can provide several types of fringe benefits to employees on a tax-favored basis.³ Qualified expenditures on these fringe benefits, including premiums paid for employer-provided health insurance, are deductible for the business as are other forms of compensation. However, unlike many other forms of compensation, the value of the benefits is not taxable to the employee.

The income tax base could be broadened either by making expenditures for fringe benefits nondeductible for businesses or by including the value of the benefits in the taxable income of the employee. If benefits were not deductible, they would in effect be taxed at the tax rate that the business faces. If benefits were included in the taxable income of the individual, they would be taxed at the individual's tax rate.

Government benefits. Currently, several types of government benefits are not taxed, including Medicare benefits and workers' compensation. Also, Social Security benefits under a certain level are not taxed when they are received. The income tax base could be broadened by including more of these benefits in taxable income.

Income from owner-occupied housing. Under the current tax and income taxes in general, income earned through the ownership of assets is generally subject to tax, and the costs of earning the income are deductible. However, under the current tax, the treatment of owner-occupied housing represents a significant exception to the general

³More detail on the tax treatment of fringe benefits is presented in Tax Policy: Effects of Changing the Tax Treatment of Fringe Benefits (GAO/GGD-92-43, Apr. 7, 1992).

rule. If a home is rented, the income earned by the owner of the home is taxed much like the income earned from owning other assets is taxed. In this case, the owner of the house would receive rent in exchange for the housing services provided to the renter. The rent received by the owner would be taxable, and costs, such as depreciation, maintenance, and interest expense, would be deductible. In contrast, if the homeowner occupies the house, the value of the housing services received by the owner is not included as income, and maintenance and depreciation are not deductible. However, mortgage interest is deductible.

Most analysts believe that it would be very difficult to tax income from owner-occupied housing precisely. The major administrative difficulty in taxing income from owner-occupied housing like income from other investments is the lack of a transaction, the rent payment, that would measure the income earned. An amount would have to be estimated, or imputed, possibly based on the market value of the house. Estimating market values for housing on an annual basis is a challenge for local property tax administration. Here, too, the problem is a lack of a transaction on which to base a measurement because only a fraction of houses are sold within a given year.⁴

Eliminating Some Deductions and Credits

As noted in Treasury's 1984 study of tax reform, broadening the income tax base by eliminating certain adjustments, deductions, and credits would also be possible.⁵ To measure income accurately, an income tax should allow deductions for the costs of earning income, and the current income tax allows some costs to be deducted. Other adjustments, deductions, and credits represent subsidies designed to encourage certain types of spending thought to be socially beneficial. Still, others represent additional modifications of the income tax base to better measure an individual's ability to pay tax. For example, individuals with sufficiently large medical expenditures may not be as able to pay tax as individuals without such expenditures. Table IV.2 shows adjustments, deductions, and credits in the current tax code and how these items might be treated under an income tax with a broader base. Items that are considered to be tax expenditures could be eliminated, while items that can be considered costs of earning income could be deductible. Other items, such as the standard deduction

⁴Several European countries that also tax net wealth have, at certain times, levied a tax on imputed rent by including a certain fraction of the assessed value of a house in the income tax base. See OECD Studies in Taxation, *The Personal Income Tax Base: A Comparative Survey* (Paris: 1990).

⁵U.S. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* Vol. 1 (1984), pp. viii-ix.

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Income Tax Reform Options

and the foreign tax credit, could be retained as a part of the overall structure of the income tax.

Table IV.2: Current Tax Code Adjustments, Deductions, and Credits for Individuals, Tax Year 1993, and Possible Treatment Under a Reformed Income Tax

Item	Millions of individual returns reporting item	Possible treatment under reformed income tax
Adjustments		
IRA deduction	5.8	Eliminated
Deductions for self-employment retirement plans (Keogh and simplified employee pension plans)	0.9	Eliminated
Deduction for self-employment tax	12.5	Possibly deductible
Self-employment health insurance	2.9	Eliminated
Deductions		
Standard deduction	80.8	Retained
Additional standard deduction for age 65 or blindness	10.5	Eliminated
Itemized deductions:	32.8	
Medical and dental expense	5.5	Eliminated
Taxes paid	32.3	Eliminated
Mortgage interest paid	27.2	Deduction retained, adjusted for inflation if income from owner-occupied housing is taxed; otherwise, deduction eliminated
Investment interest	1.5	Deduction retained, adjusted for inflation
Charitable contributions	29.8	Eliminated
Unreimbursed employee business expenses	9.3	Retained
Credits		
Earned income	15.1	Possibly eliminated
Child care	6.1	Possibly deductible
Elderly or disabled	0.2	Eliminated

(continued)

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Item	Millions of individual returns reporting item	Possible treatment under reformed income tax
Foreign tax	1.3	Retained
General business	0.3	Eliminated
Alternative minimum tax	0.3	Eliminated

Sources: Data on number of returns with line item: IRS, Statistics of Income Division, Individual Income Tax Returns 1993. Possible changes from Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1997-2001 (JCS-11-96), Nov. 26, 1996; and Joint Committee on Taxation, Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax (JCS-4-96), Apr. 30, 1996; and Bradford (1986), pp. 33-34.

Indexing the Tax System for Inflation

The current tax code does not include explicit adjustments to take inflation into account in calculating business income. As several studies, including the Department of the Treasury's 1984 proposal for tax reform, have shown, without adjustments for inflation (indexing), taxable income could be overstated or understated relative to the real income of the taxpayer. That study and others have concluded that business income would be better measured if inventories, depreciation, interest income, interest expense, and capital gains were all indexed for inflation.⁶ Some analysts have stated that concern about added complexity was one reason why indexing was not adopted in the Tax Reform Act of 1986.⁷

An example can illustrate the income mismeasurement problem caused by inflation. Suppose a business bought equipment for \$1,000 in 1985. Suppose also that the equipment was expected to be used for 10 years, and the business was allowed a deduction for depreciation over the course of the 10 years. The total amount deducted over time would add up to \$1,000, the historical cost or purchase price of the equipment. Suppose further that the business could deduct \$100 in each of the 10 years for depreciation. With inflation, the value of the deduction for depreciation erodes over time because the \$1,000 is fixed in terms of 1985 dollars. In other words, a \$100-deduction in 1995 would understate the real economic

⁶For a more detailed analysis of indexing, see Shuldiner (1993); Bradford (1986), Ch. 3; Daniel Halperin and Eugene Steuerle, "Indexing the Tax System for Inflation," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C.: The Brookings Institution, 1988); and Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform* (Cambridge, Mass.: The MIT Press, 1996), Ch. 8. For information about foreign experience with indexation provisions, see Milka Casanegra de Jantscher, Isaias Coelho, and Arturo Fernandez, "Tax Administration and Inflation," in Richard M. Bird and Milka Casanegra de Jantscher, eds., *Improving Tax Administration in Developing Countries* (Washington, D.C.: International Monetary Fund, 1992).

⁷Shuldiner (1993), p. 598, and Slemrod and Bakija (1996), p. 238.

cost of operating the equipment because \$100 was not worth as much in 1995 as it was in 1985. Thus, the income of the business would be overstated because its costs as calculated would not represent the real costs to the business.

While inflation adjustments could correct this problem, the tax code has featured accelerated depreciation to indirectly offset inflation. If an inflation adjustment for the historical cost of the machine were made, the \$1,000 historical cost figure would be increased to reflect inflation each year, and the deduction for depreciation would therefore be increased so that it reflected the real economic cost of operating the equipment. Instead, the tax code has allowed accelerated depreciation (allowing relatively larger deductions in the first few years after the asset is purchased) but kept historical basis calculations. While it is possible to develop accelerated depreciation schedules that offset the effects of a given rate of inflation, depreciation schedules would have to be changed to prevent renewed overstatement or understatement of income if the rate of inflation changes.

A similar problem exists in the calculation of capital gains. As noted above, capital gains on the sale of assets are taxed when assets are sold. To calculate gain or loss, the sale price of the asset is compared to the price that was originally paid for the asset.⁸ Part of this gain may be the result of inflation. Assets that have lost value on an inflation-adjusted basis could show a gain when the effect of inflation is ignored. This problem is one justification for applying a preferential tax rate to capital gains income to, albeit imperfectly, offset the overstatement of income. However, having a preferential tax rate, in turn, creates incentives for taxpayers to structure transactions so that income is characterized as a capital gain rather than as ordinary income, and further rules are designed to prevent or limit this activity.⁹

Integrating the Corporate and Individual Income Tax

Another objective of income tax reform could be the integration of the corporate and individual income taxes.¹⁰ The differences in the current tax code between the tax treatment of corporations and noncorporate businesses, such as partnerships and sole proprietorships, have long been

⁸For depreciable assets, the calculation of gain or loss would also take into account depreciation deductions taken over time.

⁹See Treasury, pp. 180-81.

¹⁰For a comprehensive study of the issue of integration, see U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Jan. 1992).

criticized. Some forms of corporate income can be taxed twice, while income earned by noncorporate businesses is taxed once. Under the current tax, corporate income paid out as dividends to individual shareholders is taxed twice; it is first taxed in effect at the corporate level because dividend payments are not deductible, and it is generally taxed again when shareholders receive the dividend payment as income.

Table IV.3 details several options for integrating the corporate tax with the individual tax so that all business income, whether earned by a corporation or a noncorporate business, would be taxed once annually. Under all the income tax reform options, business income would be taxed at either the business level or the individual level, but the same income would not be taxed at both levels. In contrast to the consumption tax options that would allow an immediate deduction for investment spending, each income tax option would allow a deduction for depreciation of investment assets over time. The income tax options differ in the degree to which income would be taxed at the business level or the individual level.

**Appendix IV
Income Tax Reform Options**

Table IV.3: Overview of Alternative Income Tax Reform Options

Item	Current tax	Income VAT	CBIT	Integrated corporate income tax	Integrated individual income tax
Business level					
Included					
Sales of goods and services	•	•	•	•	
Interest, dividend income	•				•
Deducted					
Purchases of goods and services, except investment goods	•	•	•	•	
Depreciation on investment assets	•	•	•	•	
Wages	•		•	•	
Interest paid	•			•	
Dividends paid				•	
Individual level					
Included					
Wages	•		•	•	•
Interest income	•			•	•
Dividend income	•			•	•
Capital gains	•		•	•	•
Income from sole proprietorships, partnerships	•			•	•
Share of undistributed corporate income					•

Source: GAO analysis of alternative income tax reform options.

Integration Options That Tax Most Types of Income at the Individual Level

Two options would be similar to the current tax in that most types of income would be taxed at the individual level. Like the current income tax, the structure of these taxes would allow for any combination of rates and standard deductions and exemptions. Large standard deductions and a single rate would be possible, or the tax could feature graduated tax rates and subsidies such as the earned income credit. Family size and individual circumstances, such as being over 65 or blind, could be taken into account if desired.

Integrated Individual Income Tax. Under an integrated individual income tax, all corporate income would be taxed at the individual level at the individual's tax rate. As under the current tax, income earned by corporations and distributed to shareholders as dividends would be taxed at the individual level. Undistributed corporate income would be allocated to shareholders and taxable to them much as income earned by partnerships and S corporations is taxed currently. If the tax base was broadened, fringe benefits would be similarly allocated to the employees receiving the benefits.

Integrated Corporate Income Tax. An integrated corporate income tax would differ from the integrated individual tax in that undistributed corporate income would not be allocated to shareholders; rather, it would be taxed separately at the corporate level. Corporations would be allowed to deduct dividends paid to shareholders, and shareholders would pay tax on dividends they receive. Deductions for expenditures on fringe benefits could be disallowed, effectively taxing this income at the corporate level rather than as income to employees. Compared to the integrated individual tax, this option would tax more types of corporate income at the corporate level at the tax rate that applies to corporations rather than at the individual's tax rate.

Integration Options That Tax Most Types of Income at the Business Level

The other two options would move the taxation of most types of income to the business level. Many of the simplifications made in the consumption tax proposals come about because more of the tax base is taxed at the business level than at the individual level. For example, the national retail sales tax (RST) and value-added taxes (VAT) have no individual filing, and the flat tax reduces the number of items taxed at the individual level substantially. Taxing all or most of the tax base at the business level could also be done while maintaining an income tax, eliminating or substantially reducing the scope for individual filing. Any income or consumption tax that is levied primarily at the business level gains simplicity for individuals but sacrifices the ability to tax individuals according to their individual circumstances.

Income VAT. It would be possible to tax income with only a business-level tax by using an income VAT. The difference between an income VAT and the consumption VATs we describe in appendix VI is the treatment of purchases of capital assets. Under the consumption VATs, these investments are deducted immediately, or expensed. Under an income VAT, businesses would depreciate capital goods over time, as they now do under the income tax. Wages, interest, and dividends would not be

deductible, so these forms of income would effectively be taxed at source. Under such a system, as under a consumption VAT, individuals would not have to file returns themselves, and tax administration would be limited to business returns. Also, like a consumption VAT, individual characteristics could not be taken into account to make the tax more progressive or better reflect ability to pay.

Comprehensive Business Income Tax (CBIT). It would be possible to tax most types of income at the business level and have a simplified individual tax that included only a few income items. For example, one of the prototypes for corporate integration analyzed by the Treasury Department, the CBIT would not allow deductions at the business level for interest and dividends, essentially collecting tax on these forms of income at the business level. Under such a system, individuals would pay tax on only wages and certain capital gains.¹¹ The CBIT would modify the income VAT by allowing a deduction for wages at the business level and taxing wages at the individual level. Including personal exemptions, a standard deduction, and other features in the individual tax could then make the tax more progressive than an income VAT.

Potential Impact on Taxpayers' Compliance Burden

Table IV.4 summarizes some of the ways in which a reformed income tax could affect taxpayers, and a more detailed discussion follows.

¹¹“Certain capital gains” are increases in the value of stock that are unrelated to undistributed business income, which is already taxed at the business level under the CBIT. Such increases in the value of stock might result from anticipation of increases in future earnings or from increases in the value of assets owned by the business itself. See Treasury (1992) Ch. 8 for more details on how capital gains might be taxed under different corporate tax integration options.

**Appendix IV
Income Tax Reform Options**

Table IV.4: Summary of Some Key Potential Impacts of Income Tax Reform Options on Taxpayers

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of income tax reform options on taxpayers
	Burden on individual taxpayers	Impact on individual taxpayers
Return filing	116 million returns filed in 1995	Individual taxes: Broader base; more individuals possibly filing, depending on standard deduction amount and amounts of tax withheld CBIT: Limited base; fewer filers possible Income VAT: No individuals filing
Records kept	Records supporting tax returns supposed to be kept—e.g., receipts, proof of payment, and documentation supporting deductions and credits; burden alleviated by information reports given to individuals	Individual taxes: Records reduced by eliminating some deductions and credits; increased by adding other types of income to base CBIT: Reduced; many types of income no longer taxable Income VAT: Eliminated
Calculations made	Complicated calculations for some taxpayers included for provisions such as dependency tests and capital gains	Individual taxes: Calculations added by indexing, taxing accrued capital gains; reduced by eliminating deductions, credits CBIT: Made for certain capital gains only Income VAT: Eliminated
Complexity faced	Many pages of instructions involved and millions of supplemental forms and schedules filed—e.g., 33 million schedules of itemized deductions for tax year 1994; difficulties existing in defining and recognizing income; however, in actual practice, minimal complexity faced by millions of individuals	Individual taxes: Complexity increased by indexing, need to accrue capital gains taxes; reduced by treating income, expenses, and savings more uniformly CBIT: Capital gains complexity only Income VAT: Eliminated

(continued)

**Appendix IV
Income Tax Reform Options**

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of income tax reform options on taxpayers
	Burden on business taxpayers	Impact on business taxpayers
Return filing	24 million returns filed in 1995	All options: Returns filed by all businesses, either paying tax separately or allocating income to owners. Withholding on wages eliminated under income VAT
Records kept	Records supporting income and expenses supposed to be kept	All options: Records needed for revenues; expenses, including depreciation; fringe benefits—allocated or nondeductible Integrated individual: Added records for allocation of income to shareholders
Calculations made	Complicated calculations included for provisions such as depreciation, the alternative minimum tax, and the foreign tax credit	All options: Calculations added by indexation, reduced if AMT eliminated
Complexity faced	Detailed rules involved; complexity reflected in areas such as depreciation, the alternative minimum tax, and the foreign tax credit; difficulties existing in defining and recognizing income	All options: Income measurement, international issues remain; AMT possibly eliminated, debt versus equity distinctions not as important

(continued)

**Appendix IV
Income Tax Reform Options**

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of income tax reform options on taxpayers
Requirement to furnish information returns	1.1 billion information and withholding documents filed	Integrated individual tax: Possible need for returns showing allocation of corporate income, fringe benefits CBIT: No need for returns on dividends, interest Income VAT: None related to individuals

Source: GAO analysis of available information about alternative income tax reform options.

Number of Tax Returns

Under the individual tax options, as under the current income tax, both businesses and individuals might file returns. Under current law, individuals must file returns if their gross income exceeds certain thresholds. These thresholds vary according to filing status and are determined by the amount of the applicable standard deduction and the value of personal exemptions. If individuals with gross income below these thresholds have had tax withheld during the year, they can file a return to claim a refund. If these thresholds were unchanged by tax reform and the income tax were broadened to include more types of income, more individual returns might be filed. For example, individuals who have small amounts of wage income and some tax-exempt interest income might not have to file a return under current law; these individuals might have to file a return under the individual income tax options because all interest income would be taxable. However, if the additional revenue acquired from broadening the tax base were used to increase standard deduction or personal exemption amounts, the number of filers might be reduced.

Business filing under these options could be similar to the current system. Sole-proprietorship income could be included with individual tax returns. Partnerships could continue to file information returns, and partners would report their share of the income earned by the partnership on their individual returns. Depending on the type of corporate integration reform adopted, corporations would either pay tax separately or file

partnership-like information returns that allocate corporate income to shareholders.

The number of information returns would be greater than under the current system if such reporting were extended to newly taxable income. Currently, interest on tax-exempt bonds is not subject to information reporting like taxable interest income; information reporting might be extended to all forms of interest income. The value of fringe benefits received by employees and income earned in pension fund reserves could also be reported.

In contrast to the individual tax options, the number of individuals filing returns could fall under the CBIT. Rather than increasing the number of types of income subject to tax at the individual level, the CBIT would reduce the number of types of income reported by individuals to wages and certain capital gains, and other forms of income would be taxed at the business level. Therefore, individuals whose income is limited to interest, dividends, and small amounts of wage income would not have to file returns. If taxes continued to be withheld on wages, for many individuals the amount of tax withheld could very closely match their annual tax liability. As under the flat tax, a return-free filing system would be more feasible.

Under the CBIT, all businesses, including sole proprietorships, would have to file tax returns, withhold tax on wages paid to employees, and file certain information returns. If interest on bonds issued by governments and nonprofit organizations were made taxable, these entities would have to file returns and remit tax on interest on any debt they had issued. Governments and nonprofit organizations would also have to withhold tax on wages paid to employees. However, businesses, governments, and nonprofit organizations would not have to file information returns for interest or dividend income.

An income VAT could reduce the number of tax returns still further. Businesses, governments, and nonprofit organizations would remit tax and file returns, but no individual filing would be required. As a consequence, information returns related to individuals' receipt of interest or dividends would not be needed.

Recordkeeping

Under either of the individual income tax reform options, broadening the tax base would both increase the need for recordkeeping in some areas

and possibly decrease it in other areas. Eliminating various tax credits and deductions in the current tax code would reduce individuals' need to keep records on these items. For example, broadening the tax base by eliminating deductions for state and local taxes, charitable contributions, health insurance payments, and large medical expenditures would eliminate the need for taxpayers who now itemize deductions to keep records on these expenditures.

However, broadening the tax base by taxing additional types of income could lead to additional recordkeeping. For example, records might have to be kept by individuals for interest income that is currently tax-exempt, pension earnings, fringe benefits, and government benefits, particularly if information reporting is not extended to these types of income. If owners of assets were required to pay capital gains tax on increases in the value of an asset, regardless of whether it was sold, they would have to obtain information to determine or estimate the value of the asset. This requirement would increase burden relative to the current tax, but the need to keep records over long periods of time might be reduced because capital gains from prior years would have already been subject to tax.

In some areas, however, including additional types of income might eliminate the need to distinguish between different types of income, reducing the need for recordkeeping. For example, currently taxpayers must use separate accounts for IRAs and other saving. A reformed income tax could treat savings more uniformly, eliminating the need for separate accounts and the associated recordkeeping. Similarly, under current law, interest expenses must be characterized according to many different rules to prevent taxpayers from deducting interest expense from debt used to generate tax-exempt income. A more uniform treatment of income may in turn allow for a simpler, more uniform treatment of interest expense.

Although a more uniform treatment of all forms of income might require more complicated rules for some forms of income, it might also reduce incentives for tax planning and reduce the number of transactions undertaken for tax reasons. For example, the Tax Reform Act of 1986 instituted some complex rules to reduce the attractiveness of tax shelters. While complying with these rules may be burdensome and costly, if they succeed in reducing the amount of resources used in structuring tax shelters, the result might be that overall, fewer resources will be used complying with the tax code and attempting to minimize tax liability.

If many of the tax preferences in the current tax code were eliminated and if tax rules measured economic income more accurately, Congress might conclude that the corporate or individual alternative minimum taxes (AMT) were no longer needed. Under the AMT, taxpayers must account for a number of items differently than they do for regular tax or financial statement purposes. The requirements to keep two or more sets of records for certain items and make special calculations might be eliminated if Congress decided that an AMT was no longer needed after income tax reform.¹²

The need for individuals and businesses to keep records under a reformed income tax would also depend on the option chosen. For the individual taxes, the integrated individual tax would require corporations to allocate all their income to shareholders. This would likely lead to additional recordkeeping, especially for widely held corporations whose shareholders may have owned stock only briefly during a year. Integrating the corporate tax by allowing a deduction for dividends might not significantly complicate the tax system. Both integration plans would reduce the need to distinguish between debt (for which interest payments are currently deductible) and equity (for which dividend payments are currently not deductible).

The CBIT option would reduce recordkeeping requirements for individuals. Since taxes on wages could continue to be withheld, other forms of compensation would be in effect taxed at the business level, and interest and dividend income would not be taxable to individuals, individuals' recordkeeping responsibilities would be limited to certain capital gains. If the income tax base was also broadened to include fringe benefits, businesses would need to keep records that identified business expenditures that could be considered nonwage compensation of employees because these expenses would not be deductible. The distinction between debt and equity would not have to be made under the CBIT because neither interest nor dividends would be deductible.

The income VAT would eliminate all recordkeeping for individuals. If the tax base was broadened, all compensation would be nondeductible for businesses, so records would not have to distinguish between forms of compensation for income tax purposes. However, businesses would have to distinguish between compensation and other expenses that would be

¹²Under the reformed income options that include a business-level tax and indexing, taxable income as measured by tax rules would be different from income reported on financial statements. Congress would need to decide whether an AMT was needed to ensure that corporations that reported income to shareholders in a particular year also paid tax in that year.

deductible. Businesses would not be required to withhold income tax on wages; however, withholding for payroll taxes would still have to be done unless the payroll tax was eliminated as a part of tax reform.

Calculations Required

Both the introduction of indexing the tax base for inflation and taxing capital gains on an accrual basis would affect the calculations required for computing income tax liability. Under all the tax reform options we are discussing, depreciation and inventories could be indexed. For the options that tax capital gains or interest income at the individual level, these items could be indexed as well. For individuals, indexation would make the calculation of capital gains more complicated, and adopting a system of taxing capital gains as they accrue could increase the frequency with which capital gains calculations would need to be made. Indexing interest income might add to individuals' calculations unless it was actually done for individuals by businesses or financial institutions. For businesses, indexation would also increase the number of calculations required for depreciation and inventories, and under some options for interest expense deductions and interest income. These calculations are not done for financial reporting purposes.

Under the CBIT option, individuals would have to make capital gains calculations, but since interest income would not be taxable for individuals, no indexing calculations would have to be made for interest income. For businesses, inflation adjustments would be needed for depreciation and inventories, but inflation adjustments for interest expenses would not be needed because neither real nor nominal interest expense would be deductible.

The income VAT would eliminate taxes on individuals, so no calculations would have to be made by individuals. Businesses would also have fewer calculations. The calculations for computing tax liability would be similar to those for the CBIT except that calculations related to deductions for wages and withholding tax on wages would not be needed for income tax purposes.

Effects of Income Tax Reform on Compliance Costs

Joel Slemrod recently estimated potential compliance cost savings from a reformed income tax similar to the integrated corporate income tax option.¹³ The reformed income tax he described would simplify the income tax base by eliminating itemized deductions except for the

¹³See Slemrod (1996), pp. 377-80, for further details.

mortgage interest deduction; restricting business deductions for fringe benefits; and ending the child care and elderly credit, the tax-exempt status for interest on state and local government bonds, and savings incentive programs like IRAs and Keogh plans. AMTs would be eliminated, and a dividend credit would be established to integrate the corporate and individual taxes. A 10-percent tax rate would apply to about 75 percent of individual taxpayers, and withholding would be extended to interest payments, making tax return filing unnecessary for many taxpayers. Slemrod estimated that such reforms could reduce individual compliance costs by at most 15 percent and business compliance costs by about 5 percent.

Potential Impact on Tax Administrators

Table IV.5 shows some of the effects that various income tax options could have on tax administrators, and a more detailed discussion of those effects follows.

Table IV.5: Summary of Some Key Potential Impacts of Income Tax Reform Options on Tax Administrators

Item	Current income tax	Income tax reform options
Impact on number of returns processed	Hundreds of millions of returns and other materials received	Individual taxes: Possibly similar to current tax, increased number of information returns CBIT: Fewer individual returns and information returns Income VAT: No individual returns or information returns related to individuals
Impact on refund processing	92 million refunds issued in fiscal year 1995	Individual taxes: Possibly increased if no withholding on other forms of income CBIT: Possibly fewer refunds with more accurate withholding Income VAT: Individual refunds eliminated

(continued)

**Appendix IV
Income Tax Reform Options**

Item	Current income tax	Income tax reform options
Impact on examination approach	Tax returns matched with information returns; fiscal year 1995 examination coverage at 1.36 percent, with corporate audits taking longer than individuals' audits	Individual taxes: Similar to current system; audits and matching information returns with individual returns CBIT: Scope of individual examinations, matching reduced Income VAT: Examination of businesses only
Continuation of old compliance problems	Compliance problems related to income definition, unreported income, and more specific issues identified in areas such as transfer pricing, depreciation, deductibility of business expenses, small businesses, independent contractors, and the underground economy	All options: Compliance problems continued with unreported business income, deductibility of business expenses, depreciation, small businesses, transfer pricing
Resolution of old compliance problems	Not applicable	All options: Compliance issues for some deductions, credits eliminated; debt versus equity distinction reduced in importance
Creation of new compliance problems	Not applicable	All options: Indexing calculations Individual taxes: Accrual of capital gains, reporting of additional income items CBIT: Capital gains only
Impact on collections from tax delinquents	Millions of taxpayer delinquent investigations and accounts disposed of, with most of the latter being for individuals and most business dispositions covering employment taxes	Individual options: Possibly increased if more balance-due returns CBIT: Fewer delinquent accounts for individuals Income VAT: Individual accounts eliminated

(continued)

Appendix IV
Income Tax Reform Options

Item	Current income tax	Income tax reform options
Impact on individuals' questions received	Millions of taxpayer inquiries fielded, covering a wide variety of questions	Individual taxes: Most questions continued and new questions added CBIT: Many questions no longer applicable Income VAT: Only questions related to business remain

Source: GAO analysis of available information about income tax options.

Processing of Returns

The individual tax reform options, combined with a broadened income tax base, would have several effects on the need to process returns. Broadening the tax base by adding income items would lead to some additional line items and perhaps some additional schedules and more information returns. These changes would, by themselves, increase returns processing workloads. However, the elimination of some deductions, adjustments, and tax credits would eliminate some line items, reducing the workload. In addition, if added revenue from a broadened tax base were used to increase the standard deduction, the number of taxpayers required to file could decrease, which would also reduce the processing workload.

The CBIT option would be more likely to reduce returns processing workload because the number of individual tax returns could be reduced, the individual tax return would contain fewer line items, and fewer information returns might be needed. While taxing additional types of income, such as accrued capital gains, could generate additional schedules and information returns as mentioned above, other types of income, such as interest and dividends, would no longer be reported on individual returns. Information returns for these types of income would not be needed, so the need to process them and match them with tax returns would be eliminated.

An income VAT would have the most significant impact on the returns processing workload because individual returns and most information returns would be eliminated. Returns would need to be processed for businesses (approximately 24 million in 1995) and nonprofit organizations and government entities.

**Noncompliance and
Enforcement**

Income tax reform, like the other tax reform alternatives, could resolve some compliance and enforcement issues, create some new issues, and leave some issues unresolved. In general, issues concerning the measurement of income from saving and investment would remain because the reforms would continue to tax this income. As under the consumption tax alternatives, unreported sales or income would remain an issue for tax administration, as would separating deductible business expense from personal consumption in areas like automobile use and meals and entertainment deductions. Issues involving differential treatment of some types of capital income would be resolved, although the added calculations used to uniformly measure capital income would have to be checked.

Under any of the income tax options, a broadened tax base would eliminate some administrative tasks but create others. The elimination of some credits and deductions would simplify administration. Because mortgage interest is the only deduction currently covered by information reporting, the elimination of other deductions would not reduce the need to match information returns with tax returns, but would reduce the need to audit tax returns. However, taxing some additional types of income would increase administrative tasks. Some types of income such as currently tax-exempt interest income and pension income could be subject to information reporting, so the identification of underreporting of these types of income could result from matching. To identify unreported or underreported accrued capital gains, audits would be necessary unless information returns were filed for owners of assets, not just for the sellers of assets as is done currently.

As under the current tax, issues involving the calculation of income from saving and investment would remain because the tax base would include these types of income. The capitalization or deductibility of business expenses, contentious in cases where it is difficult to determine whether a business expenditure creates an asset for the business, would likely remain an issue for tax administration. However, issues that arise because of differences in the tax treatment of certain types of income from saving and investment may be reduced because this income would be treated more uniformly. For example, checking that the rules and limitations on IRA, 401(k), and pension accounts had been followed would not be necessary.

Under all the income tax options, as well as all the alternative consumption taxes, identifying unreported or underreported amounts

would remain a major concern for tax administration. Issues involving consumption in a business, as under consumption taxes, also would continue under any reformed income tax.

The CBIT and income VAT options would simplify examination by eliminating the need to verify many types of income for individuals. Under the CBIT, the compliance of individuals could be checked largely through information return matching on wages. Identification of certain capital gain income would also be necessary, as would the verification of filing status and the proper number of dependents. However, the identification of other forms of income and verification of deductions would not be needed, and administrators could focus relatively more attention on business returns. Under an income VAT, clearly all examination and compliance efforts would involve business returns.

Collections

As under the current income tax, under any of the reform options, there would likely be taxpayers who do not file returns or who file but do not pay the correct amount of tax. Under the individual income tax options, the number of such balance-due or delinquent accounts might increase for two reasons. First, if withholding is generally limited to wages as it is currently, the amount withheld might not be as close to the actual tax liability because additional types of income would be subject to tax. Second, some of the types of income that might be taxed under a reformed income tax, such as accrued capital gains, are not received as cash. Unless individuals carefully adjusted their withholding to take this additional income into account, more individuals might have to pay tax when they filed. These individuals might not pay the correct amount or might not file if they do not have cash available to pay the tax. However, if a broadened income tax was accompanied by lower tax rates, some individuals who have difficulty paying their tax liability currently might be able to pay the tax they owe.

Collections activity might fall under the CBIT option simply because fewer individuals would be liable for tax and, for individuals, fewer types of income would be subject to tax. As noted in appendix II, in 1995, about two-thirds of delinquent accounts were individual accounts. Under the CBIT option, tax withheld on wages might closely match actual tax liability, especially for taxpayers without capital gains income. An income VAT would do away with individual payments; businesses would be responsible for remitting all tax. Therefore, collections activity would be focused on business tax liability.

Taxpayer Services

In terms of taxpayer calls to IRS for assistance, most calls now received concern procedural issues, refunds, notices, and other account information. Additional calls concern filing status, dependents, and exemptions. The extent to which this assistance would still be needed under the various reform options would depend on the number of individual taxpayers filing returns under each option.

The tax reform options would likely generate additional demand for taxpayer services and education in the areas of indexation (how to make adjustments for inflation) and calculations of accrued capital gains. On the other hand, some currently asked questions concerning pensions and deferred compensation and individual adjustments and deductions might no longer be asked if the tax base was broadened to tax income more uniformly.

Other Issues

Transition Issues

While transition issues would likely arise from any type of tax reform, some issues that could be particularly significant in a transition from the current tax to a consumption tax might not be as significant under income tax reform. The tax treatment of existing business assets, a significant issue in transition to a consumption tax, would not be as significant an issue for income tax reform. For example, indexing depreciation deductions for inflation would be a less significant change than adopting expensing as under most of the consumption taxes. Existing business net operating loss carryforwards could continue with a new system.

Some other transition issues raised by income tax reform could be significant and could create administrative problems. If pension income were made taxable and if the old treatment was maintained for existing pension assets, taxpayers would have to segregate old from new accounts, and administrators would have to check these accounts. Individuals receiving dividends could receive a windfall gain if dividend taxes were eliminated or if dividend deductibility was granted; again maintaining the old system for current equity shares would be difficult. Under the CBIT option, ending the deduction for interest at the corporate level and ending the taxation of interest at the personal level is an issue that could be handled through tax rules or might be ignored if it was thought that the private sector would renegotiate the terms of the debt.

Federal/State Issues

Currently, 38 states and the District of Columbia levy income taxes that conform to some degree with the federal income tax. Many states also rely on federal enforcement efforts and information to administer their income taxes.¹⁴ If the federal income tax were changed, the states could make adjustments in their income taxes to conform to the reformed federal tax. Under the income tax options that include an individual-level tax, the states that now follow the federal tax could continue to tax individual income and rely on federal administration efforts. The inclusion of additional income items could expand state and local income tax bases if those governments chose to conform with the federal tax base. On the other hand, under the CBIT or income VAT, the ability of states to tax individual income would be reduced, as would be the case with the VAT, national RST, or flat tax, because much of the information, such as information returns, that are currently used to administer the federal individual income tax would no longer be available.

International Issues

Under the current income tax, the income of U.S. citizens and corporations is subject to tax wherever it is earned—that is, income is taxed on a worldwide basis. Income earned abroad may also be taxed by foreign governments, so the United States provides a limited credit for foreign income taxes paid (the foreign tax credit) to prevent double taxation. Income earned in the United States by foreign corporations and foreign residents is also taxed, and withholding taxes are levied on certain interest and dividends paid to foreign investors. These withholding taxes are commonly reduced through income tax treaties with foreign governments.¹⁵

Under current law, income earned abroad by U.S. corporations may not be subject to U.S. tax until it is distributed to the United States (repatriated). However, taxpayers' ability to defer tax by retaining income abroad is limited for some types of income by the so-called subpart F rules. If income tax reform included taxing accrued capital gains for domestic assets, it would be consistent to tax all types of income earned abroad when they are earned rather than when repatriated. The current rules to limit deferral are considered complex, but extending these rules might reduce tax planning by treating different types of income uniformly, might

¹⁴Joint Committee on Taxation, Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax (JCS-4-96), Apr. 30, 1996, pp. 6-8.

¹⁵For a summary of U.S. international tax rules and policies, see Hugh J. Ault and David F. Bradford, "Taxing International Income: An Analysis of the U.S. System and Its Economic Premises," in Assaf Razin and Joel Slemrod, eds., Taxation in the Global Economy, (Chicago: University of Chicago Press, 1990).

simplify the foreign tax credit, and might reduce transfer pricing controversies for U.S. corporations with foreign operations.¹⁶

For foreign corporations operating in the United States, transfer pricing would likely continue to be a difficult area for taxpayers and tax administration as long as the U.S.-source income of these corporations is taxed. A related policy issue would arise regarding whether the benefits of corporate tax integration should be extended to foreign corporations and investors automatically or through treaty. The integrated individual tax option (by eliminating the corporate-level tax) and the integrated corporate tax (by allowing a deduction for dividends) would pass integration benefits to foreign shareholders automatically. On the other hand, the CBIT and income VAT options would retain a corporate-level tax and replace an explicit withholding tax on certain distributions to foreigners with implicit withholding through the nondeductibility of interest and dividends.¹⁷

¹⁶For further details, see U.S. Department of the Treasury, International Tax Reform: An Interim Report (Jan. 15, 1993).

¹⁷In its report on corporate tax integration, the Treasury recommended integration options that did not automatically pass benefits to foreigners because these provisions might simply transfer tax revenue from the United States to foreign governments. See Treasury (1992), Ch. 7, for a detailed discussion of international issues regarding corporate tax integration.

National Retail Sales Tax

Description

As the name implies, a retail sales tax (RST) is levied on the retail price of goods or services sold to final consumers. The tax is familiar to most Americans, originating in many states in the 1930s and now found in 45 states, the District of Columbia, and thousands of local tax jurisdictions. The federal government currently administers excise taxes, which are related to an RST, but differ from it in important respects.¹ Few industrialized countries have attempted to institute a nationwide RST, although many have adopted the related value-added tax (VAT).

Some proponents of a national RST have suggested that it should be administered primarily by the states. One reason for this is that states have already identified and registered many businesses selling to final consumers. In addition, they might be able to expand their existing systems with less effort devoted to fundamental retraining and systems development because of their experience in administering sales taxes. Even if states became the primary administrators, the federal government could be required to coordinate and audit the states' programs, administer any taxes not replaced by the national RST, and act as the primary administrator in the five states without sales tax systems and in other states that do not agree to be the primary administrator.

As illustrated in table V.1, a national RST would be a consumption tax because it is collected only on goods and services that are consumed. Only business elements are addressed because individuals generally have no filing responsibilities under an RST, although they typically pay the taxes collected by businesses on sales of goods and services.

¹Unlike an RST, excise taxes are levied on relatively few items; generally, they apply to preretail stages of production or distribution and do not exempt business purchasers in those cases where they are applied to retail sales (such as the communications services tax).

Appendix V
National Retail Sales Tax

Table V.1: Treatment of Businesses Under a National RST Compared With the Current Income Tax

Tax base element	Current income tax	National RST
Sales of goods and services	Included	Included (retail sales only)
Sales of business assets	Gain included	Not included
Sales of financial assets	Gain included	Not included
Loans and new stock issues	Not included	Not included
Purchases of goods and services for business use	Deducted	Not included
Purchases of capital goods	Depreciated over time	Not included
Wages paid	Deducted	Not included
Fringe benefits	Deducted	Not included
Interest paid	Deducted	Not included
Dividends paid	Not deducted	Not included

Source: GAO analysis of state and proposed national RSTs.

Based on recent proposals, a national RST might replace, rather than supplement, existing federal income, gift, estate, and excise taxes, which together yielded about \$805 billion in fiscal year 1995. Raising these revenues under a national RST would require a relatively high tax rate compared with state RST rates, which generally range from 3 to 7 percent, except for higher rates on selected items in some states.² Taxing most or all personal consumption, which totaled \$4.9 trillion in 1995, would tend to reduce the required tax rate. However, such a tax might encompass retail categories generally excluded under state systems, including housing, medical care, financial intermediation, and other services. A narrower tax base that excludes certain categories, transition rules to deal with preenactment savings, or tax rebates would tend to increase the required rate.

National RST Design Features

Administration of a national RST would be distinguished from the income tax by a fundamentally different tax collection mechanism. Under an RST, businesses collect taxes from retail consumers and periodically send their collections to the government. Unlike the income tax, individuals generally have no tax reporting responsibility, although, as with other taxes, they are the actual taxpayers. An RST's complexity and its impact on administrative and compliance burdens depend on the extent of its tax base exemptions and exclusions. One type of exemption—items purchased for use in a business—would be required to avoid the

²Proponents have suggested that a rate of 15 to 17 percent would be required in a national RST, assuming a broad-based tax.

unintended economic effects that result from taxing not only goods and services sold at retail but also the costs of producing those goods and services.

Without a mechanism to obtain information on individuals, a national RST could not incorporate exemptions or credits based on personal or family status.³ Ways of modifying an RST's tax base have instead included statutorily excluding or exempting certain goods and services or business, nonprofit, or government purchasers. Some states also levy reduced sales tax rates on certain goods or services, such as motor vehicles or certain production goods. As noted in Treasury's 1984 tax reform report, multiple rates introduce administrative complexities similar to those discussed below for exemptions.⁴ Another approach, using automatic rebates to in effect exclude a certain level of individual purchases, has been proposed at the national level.

Most states exempt designated goods and exclude sales of real estate and a wide range of services, including medical, legal, and financial services, although three states—New Mexico, South Dakota, and Hawaii—tax both goods and services broadly. Almost all states exempt certain business purchases, and most exempt sales to government and nonprofit organizations. Vendors apply exemptions at the point of sale based on their understanding of the exemption criteria for designated goods and services, or evidence, in the form of an exemption certificate, of a purchaser's exempt status.

In theory, according to various descriptions of sales taxes, RST systems need to exempt valid business purchases if they are to avoid the unintended economic effects of tax pyramiding and not tax capital income. Pyramiding occurs when a sales tax is applied to business purchases of items intended for resale or used in the production of retail products, and then applied again to the final retail sale. It results in a preretail tax component that is not visible to consumers and that varies, in an unintended manner, depending on how a product is developed. Total taxes applied to an item would increase with the number of intercompany transactions involved in its development, resulting in a competitive advantage for firms that consolidate production and distribution

³In theory, some personal exemptions could be administered under an RST using technology such as computerized identification cards, which might be encoded with an individual's age or disability status and applied at the point of sale.

⁴See U.S. Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 1 (1984), p. 217.

operations internally. Likewise, imported goods whose inputs are not taxed would have a tax advantage over domestically produced goods. State RSTs result in significant pyramiding because business exemptions are often limited to items purchased for resale or directly incorporated into final products. Other business and production costs—such as fuel, utilities, and various business services—are taxed in many states.

Another aspect of a national RST is that it would tax retail purchases by foreigners in this country and could also be assessed on U.S. citizens' foreign purchases that are used or consumed in this country. The latter feature would parallel "use" taxes under some state RSTs, which apply to out-of-state purchases used or consumed in the purchaser's state of residence.

National RST Versus VAT: Similarities and Differences

A national RST and credit VAT with the same tax base and a common rate would appear identical to final consumers, provided that both were itemized on sales invoices. Moreover, given identical compliance rates, they would yield the same amount of revenue. They differ primarily in their methods of avoiding tax pyramiding. An RST depends on the use of exemption certificates that businesses provide to their suppliers, whereas a VAT allows businesses to credit taxes paid on their purchases against the taxes collected on their sales. A VAT appears to offer an administrative advantage for exemption of business purchases because it requires businesses to maintain purchasing records supporting their claimed credits and thereby provides an audit trail for verifying these claims. Under a national RST, by contrast, auditors might need information from all of a business' suppliers, who retain exemption certificates to document their own tax-exempt sales.

An RST also concentrates the entire tax collection burden on businesses selling to final consumers, while a VAT spreads collections across a broader range of businesses. Some commentators maintain that a national RST would therefore be more susceptible to noncompliance because many vendors are small businesses, which have been relatively noncompliant under the current income tax. Enforcement efforts under a national RST, however, could be focused on a somewhat smaller population of filers, excluding businesses that do not sell at retail.

In addition, businesses under a credit VAT might be less likely to underreport their sales, knowing that another business is likely to keep records of the sale to support its claimed credits. However, this

“self-enforcing” mechanism, which does not exist in an RST, also does not apply to the retail sales stage of a VAT, since final consumers are not eligible for credits and are generally not required to keep records of their purchases. Another purported enforcement advantage of a credit VAT is that it provides greater incentives for businesses to file in order to claim credits on their purchases.⁵ However, this argument does not apply with equal weight to some businesses—such as some small service providers—who make minimal purchases from other businesses.

Potential Impact on Taxpayers’ Compliance Burden

A national RST replacing the income tax would reduce the number of entities filing returns. Compliance burdens would depend on the system’s design, particularly the extent of exemptions provided and degree of consolidation with state systems, and might in some circumstances fall on individuals as well as on business filers. Some of the ways in which an RST might affect businesses are summarized in table V.2, followed by additional information on these and other considerations.

⁵See Bruce Bartlett, “Replacing Federal Taxes With a Sales Tax,” *Tax Notes*, Vol. 68, No. 8 (Aug. 21, 1995), p. 1001; and Charles E. McLure, Jr., “State and Local Implications of a Federal Value-Added Tax,” *Tax Notes*, Vol. 38, No. 13 (Mar. 28, 1988), p. 1520.

Table V.2: Summary of Some Key Potential Impacts of a National RST on Business Taxpayers

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of a national RST on business taxpayers
Return filing	24 million returns filed in 1995	Vendors the only businesses to be included
Records kept	Records supporting income and expenses supposed to be kept	Records of sales and exemptions needed but not records for items such as depreciation
Calculations made	Complicated calculations included for provisions such as depreciation, the alternative minimum tax, and the foreign tax credit	Calculations for depreciation, alternative minimum tax, and the foreign tax credit not needed; state return forms require calculation of net taxable sales
Complexity faced	Detailed rules involved; complexity reflected in areas such as depreciation, the alternative minimum tax, and the foreign tax credit; difficulties existing in defining and recognizing income	Rules for characterization and timing of income, and items such as depreciation, the alternative minimum tax, and the foreign tax credit eliminated, but determining exemptions and multiple sales tax rates and harmonizing with state systems possibly added
Requirement to furnish information returns	1.1 billion information and withholding documents filed	Information returns generally eliminated

Source: GAO analysis of available information about state and proposed national RSTs.

Number of Tax Filers

A national RST that exempted business purchases would limit routine filing requirements to vendors—that is, entities selling to final consumers. Thus, the number of filers would be less than the 24 million businesses that filed income tax returns in 1995 and a fraction of total filers. Below this upper limit, the actual number of filers under a national system would depend on its design. The number would decrease to the extent that vendors in some industries are excluded from the tax base—for example, most states exclude many service providers. However, the number would increase somewhat if the system required a separate return from each outlet of multilocation retailers.⁶ Many states allow consolidated filing but require location-specific data.

⁶Census data indicate that the number of outlets of retail companies exceeded the number of retail companies by about 20 percent in 1992, although some of these additional outlets may already be filing separate returns.

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Estimation of potential filers under a national RST is also hampered by limited data on the number of businesses acting as vendors. IRS classifies business returns into one of nine industrial sectors based on their primary business activity, as shown in table V.3. However, the classification generally does not distinguish vendors from nonvendors, except in the retail sector, which is limited to vendors by definition, and the service sector, which primarily consists of vendors except for a “business services” subsector.⁷ Together, these sectors, excluding business services, represent roughly 10 million potential filers under a national RST. The number of retail vendors in other sectors is unknown but potentially large. The construction sector, for example, includes general contractors as well as self-employed plumbers and electricians who might serve either final consumers or businesses, or both. Even manufacturers might maintain retail outlets as a secondary activity not captured under IRS’ current classification system.

Table V.3: Income Tax Returns by Business and Industry Category as of 1993

In thousands

Industry group	Business category			Total
	Sole proprietorships	Corporations	Partnerships	
Retail goods	2,444	729	134	3,307
Services	7,718	1,158	256	9,132
[Business services subgroup]	[1,820]	[349]	[51]	[2,219]
Construction	1,927	417	62	2,406
Finance, insurance, and real estate	1,273	641	793	2,707
Transportation and utilities	711	176	21	908
Agriculture, forestry, and fishing	2,425 ^a	141	120	2,686
Mining	124	35	32	191
Wholesale trade	416	338	19	773
Manufacturing	472	307	25	805
Not allocable	265	21	7	293
Total	17,776	3,965	1,468	23,208

Note: Totals do not add because of rounding.

^aIncludes 1.9 million farmers filing Schedule F with their Form 1040.

Source: IRS Statistics of Income published data.

⁷The business services subsector includes advertising, janitorial, photocopying, and other services provided to business purchasers.

As with corporate tax revenue, most RST revenue could come from relatively few businesses. Based on IRS data, in 1992, corporations and partnerships took in about 86 percent of the business receipts in the retail and service sectors, and 80 percent of this amount was taken in by about 286,000 entities. In addition, as shown in table V.3, corporations and partnerships comprised only about 18 percent of the businesses in these sectors. This concentration is consistent with the states' experience—New York and California, for example, derive about 90 percent of their sales tax revenues from 10 percent of their filers.

Compliance Burdens

A national RST replacing the income tax could eliminate many existing recordkeeping and filing burdens and introduce a different set of requirements focused on vendors. Taxpayers would no longer need to cope with complex tax provisions such as those associated with the characterization and timing of income, depreciation of business assets, foreign tax credits, or calculation of the alternative minimum tax. And they presumably could dispense with filing most existing information returns. Under a national RST, vendors could be required to register as sales tax collectors, collect taxes and apply any exemption criteria, retain appropriate records, and file periodic sales tax returns. Except in some circumstances, individuals would not need to maintain records or file returns. Of course, taxpayer burdens would increase if a national RST supplemented rather than replaced existing income taxes.

Vendor Burdens

Vendors under a national RST would presumably face burdens similar in nature to those encountered under state RST systems. A vendor's initial burden in state systems is completing a registration form, which is generally one or two pages long and identifies the business, its nature, owners, and level of expected sales. Only registered vendors are permitted to act as the state's collection agents or, in some states, obtain the exemption certificates required to make tax-free business purchases. The states are about evenly split on allowing consolidated registration versus requiring each outlet of multilocation businesses to register separately.

One of a vendor's major compliance efforts is that needed to interpret and apply exemption criteria when collecting taxes at the point of sale. This task often falls on the cash register operator, who, for example, may need to distinguish the appropriate tax treatment of marshmallows in a state that exempts small marshmallows as food but taxes large marshmallows

as candy.⁸ The register operator must also obtain exemption certificates from exempt purchasers. In many states, vendors must check the reasonableness of claimed business exemptions to avoid liability for the uncollected taxes when exemption certificates are misused.

Vendors' recordkeeping requirements also depend on the extent of an RST's exemptions. To substantiate exempt and taxable sales, vendors must retain exemption certificates accepted in addition to sales invoices. Some states require vendors to use a system matching each exemption certificate to its related sales invoice.

Costs of complying with a national RST are unclear. Vendors' cost of complying with state systems in 1990 averaged about 3.5 percent of revenues collected, according to a study sponsored by the American Retail Education Foundation.⁹ Converting this percentage to dollars, adding an amount for compliance costs related to service transactions, and factoring in an increase in inflation-adjusted retail sales, one author estimated 1996 compliance costs for a particular national RST to be about \$8 billion.¹⁰ According to another author, because a national RST rate would have to be substantially higher than current state RST rates, incentives to evade taxes would increase. Retailers would have to be increasingly vigilant in distinguishing between taxable and exempt items and between retail sales and sales to companies.¹¹

The effort required to prepare sales tax returns is influenced by filing frequency and the type of information required. Filing intervals in most states depend on a vendor's sales volume, generally ranging from monthly for the largest to semiannually or annually for the smallest. Intervals are shorter for large filers to minimize forgone interest and the size of potential losses in delinquent accounts. Most states use one- or two-page return forms, although the number of line items on the forms ranges

⁸Scanning cash registers used by some businesses can be programmed to recognize exempt items and thereby reduce the burden on register operators.

⁹Price Waterhouse, Study to Estimate the Cost of Collecting State and Local Sales and Use Tax (Washington, D.C.: Aug. 30, 1990).

¹⁰See Arthur P. Hall, "Compliance Costs of Alternative Tax Systems," Tax Notes, Vol. 71, No. 8 (May 20, 1996), pp. 1088-89.

¹¹Joel Slemrod, "Which Is the Simplest Tax System of Them All?" in Henry J. Aaron and William G. Gale, eds., Economic Effects of Fundamental Tax Reform (Washington, D.C.: Brookings Institution Press, 1996), pp. 368-70.

widely, depending on whether itemization of exempt sales is required.¹² For example, Connecticut devoted 56 lines to itemizing nontaxable transactions in 1995. However, some states limit their return forms to 10 to 12 lines by summarizing exempt sales under one line item. Aside from address and subtotal lines, the following basic items are required on state returns:

- gross sales,
- total deductions,
- net taxable sales,
- tax due,
- penalty due, and
- interest due.

Some states have begun to implement electronic or telefiling systems, which could ease some filing burdens.

Added Difficulty of Complying With More Than One RST

A national RST would increase vendors' compliance burdens beyond those associated with state RSTs to the degree that state and federal tax bases and administrative requirements differed. The current difficulties associated with state exemptions would be compounded if the federal system introduced additional tax base exemptions or defined exempt categories differently. Differences in filing intervals, penalties, appeals, and other administrative procedures could also entail added confusion and compliance costs.

Potential Burdens on Individuals

Some compliance burdens could extend to individuals as well as businesses, depending on how a national RST is structured. For example, taxpayers may need to keep records in some circumstances if provisions are included to tax real estate or items purchased in foreign countries but consumed in the United States or to relieve sales taxes when savings already subjected to the income tax are spent on goods and services. Also, if instead of receiving automatic rebates as has been proposed at the national level, individuals had to apply for them, as has happened at the state level, they would face a new compliance burden.

Potential Impact on Tax Administration

The states' experience indicates the types of administrative processes and hurdles that might apply to a national RST. Administration in the states includes identifying and registering vendors and returns processing,

¹²Many lines are also allotted for local tax allocations in some states that collect taxes for local governments.

enforcement, collection, and taxpayer service functions. Within these functions, administrative procedures and potential hurdles differ somewhat from those of the income tax. Some key administrative differences are highlighted in table V.4, followed by additional information on these and other considerations.

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National Retail Sales Tax

Table V.4: Summary of Some Key Potential Impacts of a National RST on Tax Administrators

Item	Current income tax	National RST
Impact on number of returns processed	Hundreds of millions of returns and other materials received	Returns simplified and number of filers substantially reduced, although filing likely more frequent
Impact on refund processing	92 million refunds issued in fiscal year 1995	Refunding of overpayments required and possibly rebates to consumers
Impact on examination approach	Tax returns matched with information returns; fiscal year 1995 examination coverage at 1.36 percent, with corporate audits taking longer than individuals' audits	In states, verifying taxable and exempt sales emphasized
Continuation of old compliance problems	Compliance problems related to income definition, unreported income, and more specific issues identified in areas such as transfer pricing, depreciation, deductibility of business expenses, small businesses, independent contractors, and the underground economy	Compliance problems with business expenses, independent contractors, underreporting, and underground economy continued; small businesses problematic
Resolution of old compliance problems	Not applicable	Compliance problems with characterization and timing of income, depreciation, and transfer pricing resolved
Creation of new compliance problems	Not applicable	Noncompliance risk raised by possibility of high rates, lack of withholding and information reports, and exemptions
Impact on collections from tax delinquents	Millions of taxpayer delinquent investigations and accounts disposed of, with most of the latter being for individuals and most business dispositions covering employment taxes	Delinquencies problematic, particularly if rate relatively high and businesses tempted to use tax collections as working capital
Impact on individuals' questions received	Millions of taxpayer inquiries fielded, covering a wide variety of questions	Number of inquiries reduced by large reduction in number of filers

Source: GAO analysis of available information about state and proposed national RSTs.

Registration of Vendors

Administrators of a national RST might need to obtain certain information on millions of businesses to identify expected filers and their filing deadlines and those who file late or not at all. To this end, the states have required businesses to provide certain information in registration applications, as noted above. Many states attempt to identify unregistered businesses by matching their registration files against alternative business listings, such as telephone directories or local licensing records. Some states use the registration system to attempt to limit misuse of business exemption certificates. For example, New Mexico issues such certificates only to registered vendors who apply for them and includes vendor identification numbers on the certificates to provide a means for tracking their use.

National administrators might ground a database of potential vendors on state registration files and prior income tax records. However, the state information would omit many vendors—particularly in the service sector—that might be included in a national tax base, and federal income tax records might not provide enough information on the nature of a business to determine whether it makes retail sales.¹³ In any case, some mechanism would be required to identify and enlist new businesses arising in the future.

Processing of Returns

A national RST would presumably entail returns processing steps similar to those followed by the states. Some state administrators send return forms to registered vendors shortly before their filing deadlines, which can vary in frequency from monthly to annually depending on their sales volume. Other states provide an annual supply of forms in a return booklet. Typically, once returns are filed, selected return data—often only gross sales, total deductions, taxable sales, and tax paid—are transcribed into a computer database. Some states use optical scanning equipment to capture all return form details. The database is used to identify delinquent filers, create accounts receivable listings, and select accounts for audit. A few states have contracted with banks to receive returns and process checks. At least one state, New York, has also contracted out the transcribing of return data.

As with the income tax, significant administrative effort under a national RST could be required to resolve late or unfiled returns, underpayments, and other discrepancies. For example, according to a New York tax

¹³See Federation of Tax Administrators, *Sales Taxation of Services: An Update* (Washington, D.C.: 1994); and U.S. Department of the Treasury, IRS, "Application for Employer Identification Number," Form SS-4, revised Dec. 1995.

official, about 7 percent of New York's sales tax returns for tax year 1994 required administrative follow-up owing to discrepancies detected by computer checks.

Refunding of overpayments is also required, but less frequently than under the income tax, where excess wage withholdings are commonly refunded. Sales tax refunds in the states can result from inadvertent overpayments and amended returns. In Florida, according to its Department of Revenue, about 2 percent of returns received annually resulted in refundable credit balances, but almost all filers chose to apply the credit against their next tax liability.

A national RST could involve a much larger and fundamentally different refund program than is found in the states if, as has been proposed, the system provides for automatic tax rebates to consumers. As proposed, such rebates—designed to reduce the sales tax burden on low-income consumers—would generally be provided to all wage earners by adjusting the Social Security taxes withheld from their paychecks. Other provisions would have to be made for the unemployed.

Enforcement Efforts

The general audit procedures now used by the states could also apply at the national level. However, a national enforcement program could face noncompliance issues that differ somewhat in nature and severity from those encountered under either the federal income tax or state RSTs.

Audit Procedures

Compared to the income tax, audits under a national RST could be focused on a much smaller population, basically limited to businesses. State sales tax audits emphasize verification of a vendor's total taxable sales. According to state officials we contacted and sales taxation materials we reviewed, auditors typically compare reported sales against sales noted in a business' accounting records and verify that untaxed sales for resale are substantiated by exemption certificates obtained from purchasers. As a secondary check on reported sales, auditors sometimes review sales reported on income tax returns or use purchase records to estimate sales volume. Auditors might also try to verify the proper use of an exemption certificate, particularly if it appears questionable, by contacting the purchaser who used it. Substantial audit effort is also devoted to checking a vendor's remittance of "use" taxes and collection of local taxes.¹⁴ Auditors might need to address similar issues under a national RST—that is, vendors' remittance of use taxes on foreign purchases, if not considered

¹⁴Most states also administer sales taxes imposed by local governments.

exempt business purchases, and interstate vendors' allocation of state taxes. Those audited are selected based on a variety of criteria, including sales volume, compliance history, results of computer data matches, and random selection. In allocating audit resources, state administrators are faced with a sharp disconnect between the incidence of noncompliance—highest among small filers—and its potential revenue impact—greatest among large filers. Audits of small vendors are less resource-intensive, per audit, than those of large vendors, but they are more often complicated by the filer's failure to keep adequate tax records.

Enforcement Trade-Offs

A national RST could raise some additional enforcement hurdles, compared to the federal income tax, while reducing others. Because businesses would no longer have the compliance burden of income tax withholding and information reporting under a national RST, the absence of withholding could tend to increase evasion opportunities, and the lack of information reporting could tend to decrease the perceived risks of detection. In addition, businesses would generally be responsible for remitting to the government more tax revenue than currently if an RST replaced existing individual and corporate income taxes.¹⁵ Small businesses in particular have been relatively noncompliant under the current system and might be tempted to use their collections as a source of business capital.

A national RST—particularly one with few exemptions—could, however, be simpler than the current income tax because some existing sources of complexity, such as correctly measuring capital income, would be eliminated. A relatively simple tax could reduce intentional noncompliance by limiting opportunities for willful evaders to claim misunderstanding or ignorance of the rules. In that case, would-be evaders might be deterred by a greater risk of facing the stiffer penalties associated with intentional evasion. A simpler, clearer tax would also tend to reduce unintentional noncompliance resulting from misinterpretation of the rules. The income tax gap for large corporations, estimated at \$24 billion for tax year 1992, was largely attributable to tax code complexity and ambiguity and illustrates the impact of these factors on noncompliance. In addition, businesses under a national RST could face a greater likelihood of being audited, if audit resources now devoted to individual filers were applied to businesses.

The question of whether a national RST could be enforced to a greater degree than the current income tax on participants in the underground

¹⁵Some large retailers who have little or no income tax obligation currently could be responsible for collecting taxes on billions of dollars in retail sales under a national RST.

economy also requires careful consideration. The answer appears to depend on whether the registration system and associated enforcement efforts would be more effective than IRS' current nonfiler program at identifying and enlisting legal enterprises operating outside the tax system. Illegal enterprises, however, might tend to escape identification if, for example, their identification depended on cross-matching registration files against licensing records and business directories.

One argument holds that a national RST would inherently capture more underground revenue than the income tax, because underground vendors who pay no income taxes would at least pay taxes on their purchases. However, the tax collection point would switch from income to purchases under a national RST. Purchases from underground vendors would be untaxed under a national RST just as income from underground sales is untaxed now.

Potential Noncompliance Issues

The nature and severity of the noncompliance problems administrators might encounter under a national RST would depend on its design, particularly its tax rate and available exemptions. We found little data quantifying noncompliance in the states, either in terms of rate of occurrence or resulting revenue losses. Audit assessments, which do not measure total noncompliance, accounted for 1 to 3 percent of sales tax revenues in 22 of 28 states responding to a 1992 survey by the state of New York.¹⁶ Noncompliance issues encountered in state sales tax audits include those arising from a misunderstanding of system requirements as well as intentional evasion.

Based on our, Treasury, and academic analyses, it appears that a relatively high national RST rate would tend to increase evasion incentives and associated administrative difficulties beyond those arising under state RSTs, assuming the perceived risks of detection by administrators remained constant. An RST also lacks certain deterrents to evasion found in a credit VAT (see app. VI). Some commentators have suggested that the resulting evasion would completely undermine a national system.¹⁷ However, we found no data allowing a quantified estimate of the impact of higher RST rates on noncompliance. The impact on the incidence of noncompliance would depend largely on the behavior of the more

¹⁶New York State Department of Taxation and Finance, Survey of State Sales Tax Compliance Problems and Programs (Jan. 1993).

¹⁷See Joel B. Slemrod, "The Simplification Potential of Alternatives to the Income Tax," Tax Notes, Vol. 66, No. 9 (Feb. 27, 1995), p. 1332; and Bartlett, p. 997.

numerous small filers, while revenue effects would depend more on large filers, who account for most potential revenues, as noted above.

Exemptions, such as for food or medicine, would add complexity and ambiguity to a national RST and could lead to both unintentional and intentional noncompliance. Vendors might inadvertently misapply an exemption to an item that fell in a gray area under the statutory criteria. For example, cashiers might face a decision on how to identify products with medicinal value if nonprescription drugs were exempt. In other cases, some business purchasers have intentionally misused their exemption certificates to acquire items for personal use, and some sellers have falsified certificates to inflate their apparent exempt sales. A study by the state of Florida estimated that about 5 percent of tax-free business purchases involved abuse or misuse of business exemption certificates, based on a sample limited to selected business sectors.¹⁸

Under a national RST, a relatively high tax rate could increase incentives for business exemptions abuse. For example, according to the Florida Department of Revenue, “paper” businesses might be created solely as a means of obtaining business exemption certificates and avoiding taxes on purchases intended for personal use. Another potential difficulty is controlling the use of business exemptions for business purchases of services, as state experience indicates that distinguishing business purchases of services from personal purchases can be difficult. Also, business exemptions might be used to purchase tax-free fringe benefits for employees in lieu of an equivalent amount of wages, raising an issue now encountered under the income tax. This would tend to reduce the effective tax base inasmuch as the benefits would have been taxed if purchased directly by the employee.

While a broad-based national RST could limit the noncompliance associated with exemptions, it could also complicate administration by involving more service providers, including many independent contractors, who have been particularly noncompliant under the current income tax. State RSTs do not broadly tax service providers. However, small vendors, particularly those operating on a cash basis, account for a large share of the noncompliance incidents detected with some state RSTs. Noncompliance among small vendors may be associated with state findings that they more often fail to keep adequate records of their taxable and exempt sales. Small vendors have also been known to use their tax

¹⁸Florida Department of Revenue, Examination of Resale Abuse/Misuse: Summary of Findings (June 1994).

collections as a source of business capital, even though the amount held in trust currently is relatively small compared with what it would be under a higher national rate. They may then go bankrupt or otherwise fail to repay the “borrowed” collections.

Although small vendors could be responsible for a relatively small share of total taxable sales, their noncompliance might nonetheless cause significant revenue losses if it occurred frequently enough. Under the current system, IRS estimated in 1996 that noncompliant sole proprietorships were responsible for about \$29 billion of the gross individual tax gap for tax year 1992. Further, IRS estimated in 1993 that sole proprietorships for tax year 1987 paid less than half their self-employment tax liabilities.

Some administrative and compliance burdens, however, could be reduced under a broad-based national RST that included the service sector. For example, the requirement in many states to distinguish between untaxed repair labor and taxable repair parts would not apply at the federal level if repair services were taxed the same as repair parts.

Another potential noncompliance problem under a national RST could mirror, at the international level, difficulties states have experienced with their interstate use taxes. The states have often been unable to enforce use taxes on sales to their residents from out-of-state vendors, including mail order sales. Similar problems could arise under a national RST. For example, absent an additional enforcement mechanism, residents could escape the U.S. sales tax by shopping in other countries, such as Canada or Mexico. Taxation of services obtained from foreign vendors through the Internet or other electronic media could raise another enforcement problem.

Finally, special provisions in a national RST could raise additional enforcement considerations. For example, provisions to either limit taxation when previously taxed preenactment savings are consumed, exempt some level of foreign purchases, or rebate certain amounts to individuals could all have enforcement consequences. These consequences would depend on a specific proposal’s design. For instance, if individuals had to apply for rebates, the tax administrator would have to devise a mechanism to reduce the number of fraudulent applications.

Collections

Based on the states' experience, collection of late, miscalculated, and underpaid liabilities could require a major administrative effort under a national RST. At least one delinquency notice is required for about 13 percent of the returns due each filing period, on average, based on data limited to 38 states and the period 1989 through 1991.¹⁹ Most states issue two or three notices of increasing sternness before initiating collection action, which can take the form of a lien against the delinquent's assets. About 10 percent of the sales tax returns processed by Florida in 1995 required assessment notices. Collection efforts in some states have reportedly been complicated by instances where businesses "borrow" sales tax collections when they are short of cash and are later unable to pay their tax liabilities—a problem that could worsen under a higher tax rate.

Taxpayer Services

Taxpayer assistance under a national RST would focus on businesses, as individuals would generally not file returns. Nonetheless, a significant education effort may be required under a national RST owing to an infusion of new filers—if services are taxed broadly—and the potential confusion arising if state and federal requirements differ or special transition provisions are introduced. Sales tax filers in the states, particularly small businesses, require assistance to interpret exemption criteria and understand other system requirements. Assistance is provided through state programs to educate new filers and through toll-free telephone help lines.

Other Issues

Other aspects of a national RST could raise additional administrative issues. These include potential transition mechanisms, the system's impact on state taxes, and international considerations.

Transition Issues

Moving to a consumption tax, such as a national RST, could result in unintended consequences for taxpayers, and if transition rules intended to limit these effects were adopted, they could entail added administrative burdens. For example, as a by-product of the transition to a national RST, savings accrued from after-tax dollars under the income tax might be taxed again when spent under a national RST, while savings accrued after enactment of the RST would be taxed only when spent. Other transition concerns might include unintended business losses owing to the

¹⁹John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, 2nd ed. (Washington, D.C.: The Urban Institute Press, 1994), p. 187.

discontinuation of existing provisions, such as allowances for business depreciation and net operating losses carried forward from prior years. Transition rules designed to mitigate these effects could eliminate a substantial portion of the RST's tax base, thereby increasing the required rate and the evasion incentive noted above.

Aside from these structural changes, the transition to a national RST could also involve technical changes, such as requirements for new forms or different data processing systems, which would entail added administrative effort initially. These potential requirements are discussed in more detail in appendix VI. Some requirements might not apply in the same degree to a national RST if states are the administrators and are able to adapt their existing systems to the requirements of a national RST.

Potential Impact on the States

Replacing the federal income tax with a national RST could effectively force states to abandon their own income tax systems because they depend on the federal tax infrastructure. For example, states depend on IRS' information reporting, use income reported on federal returns as a starting point on state returns, and generally rely on federal definitions.²⁰ If these states were forced to depend more on their sales tax revenues after abandoning their income taxes, the combined federal-state rate would be higher than otherwise, exacerbating any compliance and administrative problems. However, if states maintained their own income tax systems without a federal lead, multistate businesses might face growing differences among the states' laws, regulations, and policies.

Obviously, the states would face additional hurdles if they were to administer the federal RST. These added burdens would be minimized to the degree that federal and state tax bases and/or administrative systems were consolidated. Even in a consolidated approach, taxpayers in different states could be treated differently—more or less aggressively—depending on each state's enforcement policies.

Federal oversight might be required to minimize these differences. The federal government, or a neighboring state, might also have to administer a

²⁰Without federal information reporting, states attempting to develop their own systems may have no legal basis for requiring information returns from out-of-state entities generating income for state residents.

national RST in the five states that have no sales tax of their own or in other states that do not agree to be the primary administrator.²¹

A national RST could also have some positive effects on state tax administration. If federal and state systems were consolidated, the result would be greater uniformity among state systems, reducing the compliance burdens of businesses collecting taxes in multiple states. Also, coordinating the administration of a national RST with existing state RSTs might lead to resolution of current interstate tax allocation problems, as in the case of mail-order sales.

International Issues

A national RST, limited to taxing final consumption, would tax imports when sold at retail in this country and would not tax exports. Foreign income would not need to be defined. As a result, the existing tax code's rules for sourcing the income of multinational businesses and for allocating expenses against this income, could be eliminated. Also, rules to credit taxes remitted in foreign countries—currently a source of substantial complexity—would be unnecessary. Enforcement problems stemming from noncompliance with these rules, such as transfer pricing abuses, would also be eliminated in this country.²²

Under an RST that eliminated tax pyramiding, the border adjustments required under a VAT as described in appendix VI would not be needed. If pyramiding was eliminated, businesses would not pay taxes on their inputs and, therefore, there would be no need to remove the cost of these taxes from exports as under a VAT. However, to the degree that pyramiding occurs in a national RST, exports would tend to carry embedded sales tax costs, which would be difficult to quantify and extract at the border.

Most provisions of bilateral U.S. tax treaties apply only to income taxes. If the United States eliminated its income tax, the future of these treaties would be unclear.

²¹Alaska, Delaware, Montana, New Hampshire, and Oregon do not have state sales taxes and in some cases have rejected such taxes by popular vote. Together, these states contain about 2 percent of the U.S. population.

²²However, eliminating the U.S. income tax could aggravate transfer pricing problems in other countries by creating an incentive for multinational firms to shift more of their income into the United States for tax purposes.

Credit and Subtraction Value-Added Taxes

Description

Value-added taxes (VAT) are consumption taxes in which taxes are paid on the value a business adds to a product. Two forms of VAT are commonly discussed, the credit-invoice (or credit) VAT and the subtraction VAT, which refer to different methods for calculating the amount of tax owed. With either the credit or subtraction VAT, a business pays tax only on the value added at its stage in the production or distribution process. The credit VAT is used as a major revenue source by most industrialized countries.

With either the credit or subtraction VAT, businesses of all kinds would be responsible for reporting and remitting the tax to the tax agency, and most tax revenue would be remitted by only a relatively few taxpayers. If a VAT replaces the income tax, individual taxpayers would not be responsible for reporting or remitting taxes to the government. However, individuals generally would end up paying the tax, passed on to them by business.

With a credit VAT, the tax is calculated on the difference between the tax the business collected on its sales and the tax it paid on business purchases, including capital goods. The business, which sold the goods, pays tax on its purchases and remits the difference to the tax agency. Thus, the business' records of the taxes collected on each transaction, or alternatively on gross receipts, form the basis from which it can calculate the tax collected. The business would also need its records of the taxes it paid on transactions with other businesses.

With a subtraction VAT, the tax is calculated on the aggregate value of a business' transactions, rather than on the individual transactions. That is, the business that bought and sold goods calculates the tax on the difference between its total receipts from sales and total purchases of goods and services (including expenditures for investment or capital purchases), rather than on the individual transactions.

A comparison of the base under a VAT with the business tax base under the current business income tax is shown in table VI.1. VATs are paid only at the business level, so the individual-level elements that apply to other taxes do not apply here. Both credit-invoice and subtraction VATs are consumption taxes because (1) they are paid only on goods and services that are consumed and (2) businesses' capital investment is expensed when it is purchased, rather than depreciated over time.

Table VI.1: Key Elements of VATs

Business-level item	Current income tax	Credit and subtraction VATs
Sales of goods and services	Included	Included
Sales of business assets	Gain included	Included
Sales of financial assets	Gain included	Not included
Loans and new stock issues	Not included	Not included
Purchases of goods and services for business purposes	Deducted	Deducted
Purchase of capital goods	Depreciated over time	Deducted immediately (expensed)
Wages paid	Deducted	Not deducted
Fringe benefits	Deducted	Not deducted
Interest paid	Deducted	Not deducted
Dividends paid	Not deducted	Not deducted

Source: Joint Committee on Taxation and GAO analysis of VATs.

The two VATs, though similar in appearance, can be quite different in practice. For this reason, we address the credit and subtraction VATs separately. If a simple, single-rate, broad-based VAT includes all businesses and all goods and services, there should be little or no difference between the credit and the subtraction methods of calculation in their economic effects or their administration. However, if a VAT base is narrowed to exclude some businesses or goods and services or more rates are added, the credit and subtraction VATs are quite different in both economic effects and ease of administration. In this report, we concentrate on the administration issues.

Regressivity, Exemptions, and Rates

Because a VAT is remitted by businesses rather than individuals, it cannot readily include the type of standard deduction or personal allowance that is available with an income tax to alleviate the tax burden on the low-income taxpayer, and policymakers may feel the problem of regressivity should be addressed.¹ International experience indicates that in most countries, exemptions or lower rates for specific goods and services are given to offset the regressivity; regressivity can also be

¹Regressivity in a tax system means low-income taxpayers pay a disproportionate share of their income in taxes. The perceived need to address regressivity assumes the VAT is a replacement tax for the income tax. If an income tax is retained, a variety of ways to address regressivity are available.

countered, as in Canada, by direct payments to those with low income.² If the VAT is complicated by exemptions or multiple rates, there can be substantial differences between the credit and subtraction VATs. A significant distinction between them is that only the credit VAT has the flexibility to readily accommodate a variety of rates or exemptions commonly used to offset regressivity, and even with the credit VAT, compliance and administration costs escalate if multiple rates or exemptions are used.

Credits to individuals, such as the earned income credit, which is intended to offset taxes paid by the low-income working population, are not viable within either VAT system—if either replaces the current income tax system. A mechanism would have to be in place to process claims, verify eligibility, and issue the credit. In some countries, the income tax serves this purpose. In the United States, the employment tax could be used by giving a credit to offset employment taxes to be paid, although another mechanism would be needed for those not working.

Methods commonly used internationally for eliminating taxation on businesses or on specific goods under a VAT are a business exemption and exemption by zero-rating. A business exemption eliminates the tax by categorizing the business as exempt. However, if taxes have been paid by the exempt business to other businesses in the production and distribution chain, the business would not have a way to recover them. This problem is addressed through a mechanism known as zero-rating, which allows these businesses to be refunded the taxes they paid to others. Zero-rating removes the tax by charging a zero rate—that is, no tax—on the business' sales and still allows the business to claim credit for taxes it paid on goods and services used in the business' production or distribution.

Three ways used for tax exemption with VATs are as follows:

- exemption by zero-rating specific goods and services at the retail or final level, such as food or medical services;

²In our analysis, we used data about international VATs from the Organization of Economic Cooperation and Development and information from the International Monetary Fund and international tax specialists. See also *Tax Policy: Value-Added Tax: Administrative Costs Vary With Complexity and Number of Businesses* (GAO/GGD-93-78, May 3, 1993); *Tax Policy: State Tax Officials Have Concerns About a Federal Consumption Tax* (GAO/GGD-90-50, Mar. 21, 1990); *Tax Policy: Value-Added Tax Issues for U.S. Tax Policymakers* (GAO/GGD-89-125BR, Sept. 15, 1989); *Tax Policy: Tax-Credit and Subtraction Methods of Calculating a Value-Added Tax* (GAO/GGD-89-87, June 20, 1989); *Tax Policy: Choosing Among Consumption Taxes* (GAO/GGD-86-91, Aug. 20, 1986); *The Value-Added Tax—What Else Should We Know About It?* (GAO/PAD-81-60, Mar. 3, 1981); and *The Value-Added Tax in the European Economic Community* (GAO/ID-81-2, Dec. 5, 1980).

- exemption for a specific size of business, such as businesses with less than a certain amount in gross receipts per year; and
- exemption by zero-rating goods that are exported.

The first of these exemptions is feasible with either the credit or subtraction VAT if (1) it is applied at the retail or final level or (2) all of a firm's sales are zero-rated. It is practical with the credit VAT even if taxes are applied only to some of a firm's sales. Because a credit VAT is collected at the point where value is added in the production chain, businesses or goods or services can be omitted from the tax at any point in the chain without loss of revenue. A subtraction VAT is much less flexible for making such adjustments except at the retail level, where an item simply can be untaxed.³

As we pointed out in 1993, the second type of exemption commonly used may eliminate the burden for small businesses and lessen the cost of administration.⁴ Most European VATs were established with small business exemptions. Typically, in countries with these VATs, small businesses do not have to file returns or remit tax if their gross receipts are low, for example, less than \$25,000 per year. They may, however, have to register with a tax agency. Exempt small businesses in these countries also lose the opportunity to claim the credit for the tax they pay to other businesses in the production and distribution chain. The same kind of exemption may be used to exempt a particular type of business, such as banks, from a VAT. In some cases, however, businesses have joined the system, if the option is available, preferring to pay the tax so they can take the credit for taxes paid to other businesses.

An important feature of a VAT is border adjustments for exports, the third type of exemption. Taxing items at their place of use, rather than their place of production, is known as the destination principle. Under this principle, taxes are imposed on imports and rebated on exports. Under either a credit or a subtraction VAT, businesses that export goods can claim credit for taxes they paid on these goods by zero-rating the exported goods. If the taxes paid on the inputs to exported goods exceed the value of the taxes collected on domestic sales, the business can be entitled to a credit or refund.

³See Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (New York: American Institute of Certified Public Accountants, Dec. 1995), pp. 35, 36.

⁴See [GAO/GGD-93-78](#), p. 61.

In 1996, the standard VAT rates in most of the world's industrialized countries ranged between 15 and 25 percent.⁵ Most of these countries had different rates for necessities and/or luxuries. Most of these countries also relied on an income tax, as well as the credit VAT, for their revenues.

If the United States were to enact a VAT, it might draw on the experience of these countries. However, if a VAT fully replaced U.S. income taxes, and perhaps employment taxes, a higher rate than those of other countries might be necessary to produce the amount of revenue currently generated by those taxes. Furthermore, in most states, a VAT would be added to the state and local sales taxes, making the combined rates still higher. For this reason, other countries' experiences may be less applicable in predicting future U.S. experience with such things as tax evasion, tax collection, or fraud. If a VAT was administered along with an income tax, the burden on both the taxpayers and the tax agency would increase, although it probably would not double the current level.⁶

Services, which now represent more than 50 percent of the U.S. economy, can present special taxation problems. While most services probably would be taxed with a credit VAT, international experience shows that some services escape taxation. Because of the complexity of establishing value for such things as life insurance premiums or financial intermediation services, they generally are not in the system. Various ways to accommodate these items have been considered by tax policymakers, but during our review most countries exempted them.

Other Issues

Transition Issues

If a transition were thought desirable, problems with transitioning to a VAT could arise, as with any consumption tax. For example, since individuals would pay the tax when they spend money, the portion of their savings, which was taxed as income before conversion to the VAT, would be taxed again. Special transition rules might be designed to take into account individuals' interest and dividends, which otherwise would be taxed doubly, first as income (earlier), and later as consumption.

⁵The exceptions were Canada, with a rate of 7 percent; Switzerland, with 6.5 percent; and New Zealand, with a rate of 12.5 percent on a very broad base. Japan had a subtraction VAT, which is gradually being changed and more closely resembles a credit VAT, with a rate of 3 percent, rising to 5 percent in 1997.

⁶See [GAO/GGD-93-78](#).

Also, businesses that are taking depreciation under the income tax system would not have the opportunity to continue depreciating their capital goods unless special provisions were made to continue it under a VAT. Similarly, problems could arise with businesses' carrying forward net operating losses and recovering unclaimed tax credits.

Transition to any new tax would require both time and government resources. Educating businesses would be important for future compliance, and time for educating the public and the resources to do it would be needed.

The transition effort needed for a VAT may include education of the public about the impact at the retail level, of businesses about the legal aspects and compliance procedures necessary, and of tax preparers. In addition to designing new educational programs, some estimates would be needed of the support services required once the tax took effect. Seminars, telephone assistance, publications, and media advertisements would likely be used to reach the public. Enlisting private trade associations and professional groups and taking advantage of free public service announcements and programs to assist in the education effort could help.

Federal/State Issues

The interaction between federal and state governments is an important aspect of a VAT, particularly the credit VAT. First of all, the credit VAT is a transaction tax that appears at the retail level, which states traditionally have considered to be their domain for tax purposes.⁷ Second, many of the state income tax systems are built upon the federal system and rely on the income tax information reported to the federal government. If a VAT replaced the income tax, the states would lose this source of information. Third, five states currently do not have a retail sales tax (RST) and might not cooperate in the administration of a VAT. (For a more complete discussion of federal/state issues, see app. V on the national RST.)

International Issues

Destination-basis VATs use border adjustments to create a level playing field internationally for imports and exports. Border adjustments—taxing imports and refunding taxes paid on exports—could be included in a U.S.

⁷The VAT may or may not be visible to the customer, depending on the way it is established, but the effect would be evident.

VAT.⁸ Various concerns with administering border adjustments are discussed in the enforcement area of this appendix.

Since VATs are not levied on individuals, problems of taxing individuals' foreign-source income or of establishing U.S. residency of foreigners are eliminated. For businesses, some current complex laws governing U.S. and foreign corporations operating outside their country would no longer be necessary. The complexities of transfer pricing problems would disappear, as well as the need for foreign tax credits.

Other problems and tax avoidance issues could be created, such as identifying nondeductible foreign services since domestic service is deductible. Mechanisms would be needed, as they were in Europe, to counteract incentives to buy certain foreign, as opposed to domestic, services to avoid paying VAT. Further, moving to a VAT, or other consumption tax, could make the future of U.S. bilateral income tax treaties unclear.

Credit VAT

Description

The credit VAT is used throughout the world, although most developed countries also rely on an income tax. Adopting a credit VAT would either move our tax system to a consumption type, transaction-based system or, if an income tax was retained, to more of a hybrid tax system. In this appendix, we discuss the tax alternatives as replacing the current income tax system.

As with all consumption taxes, a credit VAT would not tax saving until spent, and it would eliminate the portions of the individual income tax that are designed to encourage saving (IRAs and 401(k) plans). The current business income tax, in which assets can be depreciated over a period, would change to allow immediate expensing of all asset investments. Tax preferences could be built into a credit VAT by imposing different rates for different goods; this is more difficult to do with a subtraction VAT.

A credit VAT and an RST are similar in appearance—for individuals, they are both taxes that they pay on transactions at the retail level. Certain features

⁸Many economists think the border adjustments would not affect the trade balance in the long run due to the adjustment of exchange rates; however, as noted by Sullivan, p. 63, there could be a differential impact across industries.

of a credit VAT are useful tax mechanisms. These features are (1) the VAT's crediting mechanism, whereby the tax paid is based on a cross-check of the sales of goods or services with the records of the purchasers; (2) the dispersion of tax collection throughout all business levels rather than collection only by retailers, who are typically small and may go in and out of business quickly; and (3) the ability of the credit VAT to exempt from taxation small businesses, which are more likely to try to evade taxes, as opposed to the RST, in which so much of the revenue is collected from small businesses.

Credit VATs in foreign countries are imposed on the sale of taxable goods and services by businesses. A broad-based tax may include food, housing, medical and pharmaceutical sales and services, and educational sales. Typically, several tax rates—a standard one, plus at least one for necessities and one for luxury goods—are used to counter concerns about fairness. Having only one rate, however, eases the burdens of compliance and administration. New Zealand's VAT is often cited by tax experts as an exemplary tax because it is a simple VAT with a single tax rate imposed on a very broad base of goods and services.

To offset the impact of the tax on low-income persons, some countries exempt or zero-rate some of these items. With a credit VAT, narrowing the base by excluding items from the tax has several effects: (1) a higher tax rate on the remaining items is necessary to raise a given amount of money, (2) it becomes more complex for both the taxpayer and the tax administrator because definitional distinctions might have to be made,⁹ and (3) the intended population may not be the only group sharing in the benefits.

Issues arise with a credit VAT that are not a concern with the current income tax, such as how to tax a broad range of services. While a credit VAT can be very broad-based, including virtually all goods and services, some items, such as financial intermediation services, which are difficult to tax, may or may not be included even in a broad tax base. In recent years, issues about the taxation of international services have taken on more importance because of the increasingly global nature of economic interaction. Tax policymakers have been considering whether and how international services—for example, architectural services or telecommunications—should be taxed. Consideration of a credit VAT in the United States might include such concerns.

⁹For example, distinctions might have to be made between food that is candy and food used for home cooking.

Potential Impact on Taxpayers' Compliance Burden

A summary of some potential impacts of a credit VAT on business taxpayers is shown in table VI.2 and elaborated on afterward.

Table VI.2: Summary of Some Key Potential Impacts of a Credit VAT on Business Taxpayers

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of the credit VAT on business taxpayers
Return filing	24 million returns filed in 1995	All businesses included unless specifically exempted
Records kept	Records supporting income and expenses supposed to be kept	Records of taxes paid to other businesses and collected from them required; records for items such as depreciation not needed except for possible transition
Calculations made	Complicated calculations included for provisions such as depreciation, the alternative minimum tax, and the foreign tax credit	Fewer calculations, such as for depreciation, required
Complexity faced	Detailed rules involved; complexity reflected in areas such as depreciation, the alternative minimum tax, and the foreign tax credit; difficulties existing in defining and recognizing income	Complexity possibly reduced by simpler tax but added by exemptions or multiple rates; base harmonization with state sales taxes needed
Requirement to furnish information returns	1.1 billion information and withholding documents filed	Information returns eliminated

Source: GAO analysis of available information about credit VATs.

Number of Taxpayers

A credit VAT taxes all businesses, which in 1995 included about 24 million corporations, partnerships, and sole proprietors filing returns. This is substantially less than the 122 million taxpayers—businesses and individuals—who recorded information and filed tax returns with IRS in 1995.

If the United States followed the lead of many other industrialized countries and created an exemption for small businesses, the number remitting tax could be substantially smaller, while the dollars collected would decrease very little because the largest corporations remit most of the tax. For example, as described in appendix II, with the current corporate income tax structure, 96 percent of income year 1993 corporate revenues came from only 2 percent of the corporations. However, because most small businesses at the retail level in the United States are familiar with remitting state and local RSTs, small businesses may not need special treatment under a U.S. VAT.

**Information Reported and
Filing Frequency**

With a credit VAT, the following information is needed by a registered business to calculate and file its VAT return and by the tax agency to verify the accuracy of the amount remitted:

- VAT paid on purchases of goods and services (inputs), including capital goods, investment, and imports;
- VAT received on sales;
- amount of goods and services exported (assuming destination principle);
- any credits carried forward; and
- credits for adjustments on purchases from the previous period.

A broad-based, single-rate credit VAT replacing the current income tax should alleviate some burden on businesses by requiring fewer records, calculations, and information returns, whether or not small businesses are exempted. A business paying a credit VAT would be required to maintain sales transaction records (or records of its gross sales from which it could figure the taxes collected) and the records of taxes it paid to other businesses for its purchases, including investment and capital goods purchases. The difference (i.e., taxes collected on sales minus taxes paid on purchases) would be remitted to the tax agency, and a tax return and accompanying records would be kept relating to that difference. In practice, transactions between businesses would likely be aggregated over a period (e.g., week or month) as with current billing procedures so that one invoice might cover many transactions. In cases in which small businesses have been required to file returns under a VAT, countries have used simpler systems than for larger firms to try to ease compliance burden.

Calculations of items such as depreciation, alternative minimum tax, foreign-source income, and foreign tax credits, and accrual accounting methods would not be necessary for a VAT. However, complexities could

be created if there was a period of transition in which calculations for both a VAT and an income tax would be required.

If a credit VAT replaced the current income tax, businesses, particularly in the retail sector, might be responsible for collecting more “over-the-counter” tax dollars than they currently do, increasing the attendant liability and accountability, particularly for small firms. In contrast to an RST, however, the credit VAT would spread the collection of the tax dollars over a much broader spectrum of businesses that buy or sell goods or services, so some of the concerns about an RST are not as valid with a VAT.

State RSTs likely would continue to be collected by retailers, and if the bases of the federal and state taxes were not harmonized, that is, if the same goods and services were not given equivalent tax treatment, retailers could be dealing with two separate taxes—each, perhaps, with its own rates and base. The confusion could escalate the burden for both businesses and consumers, and proper recordkeeping and reporting could be difficult; thus, state and federal harmonization of tax bases would be desirable. Zero-rating of goods would seem to be a bit easier to handle, although here, also, distinctions between goods that are taxed at the state level and goods that escape taxation at the federal level (or vice versa) could be confusing and burdensome.

How often a business remits a VAT could vary with the size of business and the amount of tax owed, ranging from annually to monthly to, perhaps, more often for very large corporations. The form for filing a very simple credit VAT might have only 16 lines of tax information on it, and as described in the next section, filing might be more automated than it is now. Filing of returns could be required on a less frequent timetable, similar to current requirements, with estimated amounts to be sent between filings. New businesses could be required to file more frequently until a basis for estimating the tax due has been established.

Credit VAT Compliance Costs

The experience of other countries with credit VATs provides some information about their compliance costs.¹⁰ However, studies of compliance costs, in general, have limitations similar to those discussed in appendix III, and those mentioned here vary widely in their approach and methodology, as well as the years they cover. The costs compared here are based on a percentage of revenue, but a limitation of this approach is that

¹⁰Cedric Sandford, ed., *Tax Compliance Costs: Measurement and Policy*, (Perrymead, England: Fiscal Publications in association with the Institute for Fiscal Studies, 1995).

at higher tax rates, compliance costs should be a lower percentage of revenue, unless noncompliance rises accordingly. Because VATs are collected by businesses, individuals do not have to file, thus eliminating their compliance burden. Some estimates of compliance costs for businesses are 2.5 percent of tax revenue in Sweden, 3.7 percent in the United Kingdom, and 4 percent in the Netherlands. The European VATs, however, have multiple rates and are less simple and more costly to operate than an ideal VAT. The Congressional Budget Office estimated costs for a U.S. VAT designed with a single low rate to be a similar share of revenue as European VATs.¹¹ However, comparing costs with the current, complex U.S. income tax is difficult. As with any consumption tax, costs of compliance would vary depending on whether regressivity is addressed and whether some form of an income tax is retained for a transition period or longer.

A recurring finding of these and other studies is that compliance costs for VATs are regressive—small businesses bear a much heavier burden than large businesses. A 1986-87 study of United Kingdom costs showed compliance costs for the smallest firms to be more than 200 times the compliance costs for the largest firms.¹²

Potential Impact on Tax Administrators

A summary of some potential impacts of a credit VAT on tax administrators is shown in table VI.3 and elaborated on afterward.

Table VI.3: Summary of Some Key Potential Impacts of a Credit VAT on Tax Administrators

Item	Current income tax	Credit VAT
Impact on number of returns processed	Hundreds of millions of returns and other materials received	Returns simplified; only businesses included, and information returns unneeded; if a small business threshold, large number of businesses excluded
Impact on refund processing	92 million refunds issued in fiscal year 1995	Refunds for excess estimated remittances required; verification needed for refunds of taxes paid on exports and for taxes paid exceeding taxes credited

(continued)

¹¹Joel Slemrod, "Which Is the Simplest Tax of Them All?" in Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (Washington, D.C.: Brookings Institution Press, 1996), p. 374, citing the Congressional Budget Office.

¹²Cedric Sandford, "The Administrative and Compliance Costs of the United Kingdom's Value-Added Tax," *Canadian Tax Journal*, Vol. 38, No. 1 (Jan./Feb. 1990), pp. 10-12.

Appendix VI
Credit and Subtraction Value-Added Taxes

Item	Current income tax	Credit VAT
Impact on examination approach	Tax returns matched with information returns; fiscal year 1995 examination coverage at 1.36 percent, with corporate audits taking longer than individuals' audits	Self-enforcing mechanism encouraging compliance; audits probably shorter and more frequent
Continuation of old compliance problems	Compliance problems related to income definition, unreported income, and more specific issues identified in areas such as transfer pricing, depreciation, deductibility of business expenses, small businesses, independent contractors, and the underground economy	Compliance problems continued with business and personal expense distinctions, independent contractors, unreported receipts, and underground economy; small business possibly exempt or audits increased
Resolution of old compliance problems	Not applicable	Compliance problems with transfer pricing and depreciation eliminated
Creation of new compliance problems	Not applicable	Compliance complicated if there are exemptions and multiple rates and for verifying export claims
Impact on collections from tax delinquents	Millions of taxpayer delinquent investigations and accounts disposed of, with most of the latter being for individuals and most business dispositions covering employment taxes	Collections complicated if high rates put large cash amounts in hands of small businesses, unless exempted; small business problems possibly mirroring current employment tax collection problems
Impact on individuals' questions received	Millions of taxpayer inquiries fielded, covering a wide variety of questions	Individuals not responsible for filing returns

Source: GAO analysis of available information about credit VATs.

Tax Rates

If a credit VAT, collected at the various stages of production and distribution (including retail), replaced the income and employment taxes, the rate could be as high or higher than the common rates of 15 to 25 percent currently in effect in industrialized countries.¹³ The rate assessed with a credit VAT could have a major bearing on the administrative burden. High VAT rates could complicate administration because high rates generally raise incentives to avoid taxes, and businesses would more likely handle large amounts of tax money that could be diverted to their own cash flow needs. This could make tax

¹³See Sullivan, pp. 88-89, and Organization for Economic Cooperation and Development, Consumption Tax Trends (Paris: 1995), p. 16.

collection more difficult for the agency.¹⁴ However, unlike an RST, in which collection of all tax dollars falls on the retailer, the collection points are distributed along the production and distribution chain, and thus the amount of taxes owed to the government is spread among more entities.

Most commonly, countries impose different rates on luxury goods than on necessities. Multiple tax rates—that is, different rates for different goods and services—are used in many countries to address the problem of regressivity. However, having more than one rate complicates tax administration and increases administrative costs, because verifications have to be made of the taxes paid on goods and services taxed at varying rates.

Processing of Returns

If the VAT replaced the current income tax, fewer tax returns would need processing, and this would relieve the burden on the tax agency because only about 24 million businesses—and no individuals—would file returns. This would be approximately 98 million fewer filers than with the current system. Initial registration of most of these businesses probably could be accomplished through current tax records, but additional effort would be required to register new businesses and any others, such as nonprofit organizations, not in the current system but included under a VAT. Cooperation with the states could be very useful, since they may work in concert with local governments that license businesses.

The number of returns and remittances to be processed would depend on the number of taxpayers and how often businesses were required to file or remit. As we noted in 1993, if small businesses with less than \$25,000 in annual gross receipts were exempt from the VAT, about 50-percent fewer businesses would remit the VAT, thus alleviating both taxpayer and tax agency burden and costs.¹⁵ Many countries establish a threshold for small businesses but allow them the option of joining the system by filing and remitting the VAT in order to receive the tax credits or refunds on taxes they paid on purchases of goods and services. These credits or refunds, as well as any refunds for excess estimated remittances, could require processing and monitoring for verification of the amounts claimed, however.

Reporting of information by the taxpayer to the tax agency could be done less frequently than the remittance of taxes. Reporting for smaller businesses might be done annually, as it is now with the individual income

¹⁴See [GAO/GGD-93-78](#).

¹⁵[GAO/GGD-93-78](#), p. 67.

tax, while remittance frequency would likely depend on the size of business and tax owed, similar to the current system. Higher tax rates with a VAT and more revenues being collected by businesses might result in more frequent remittances being required than with the current income tax. A purpose of this would be to capture tax revenues quickly to allay the temptation for a business to use the money to bolster its cash flow. This would affect the administrative burden, but the estimate of 24 million business taxpayers would seem to result in a much lighter agency processing load than under the current system.

A tax agency collecting the VAT could use the same general process now used for income tax returns, although it presumably could rely more on automation. Because filers of a VAT are limited to businesses, they may be able to accommodate automated systems. In Canada, a one-time allowance was given to cover the additional cost to small businesses for necessary equipment purchases. Special rules, such as a requirement for electronic filing, might be enacted to expedite relatively error-free processing, and scanning equipment might enter the data into the computer system. The status of the tax systems modernization effort at the time a new tax is put in place could have a major bearing on a tax agency's ability to institute and assess the tax.

Most information returns, which now are used to report earnings and also savings and investment returns to taxpayers, would no longer be necessary with a credit VAT since these income items would not be taxed. This means that the processing of hundreds of millions of documents, mostly electronic and some paper, would be eliminated.

A tax agency would also have to be prepared to process refunds and credit claims. With a VAT, these are likely to be for exports (discussed in a later section on these claims). If an earned income credit or other similar credit was used to refund taxes to the low-income population, some mechanism to do this would need to be in place.

Enforcement—Audit

Enforcement with a credit VAT would be quite different from enforcement with the current income tax. With a VAT, the taxes collected by businesses minus those paid to other businesses are remitted to the tax agency; however, with an income tax, business taxes are based on profits and losses, rather than on sales and purchases. The difference makes the joint enforcement of the taxes more problematic if both were in effect, though for large corporations, auditing the two taxes together might be done using information derived from auditing one to verify the other. Of course,

certain elements of the income tax, such as depreciation, give rise to specialized audit problems. Some issues, such as differentiating between business and personal expenses, might be the same, while others, such as transfer pricing issues, would disappear for the United States with a border-adjustable VAT.¹⁶

As we mentioned in 1993, a simple VAT, with a broad base and one rate, or very few, and without exemptions, is by far the easiest to enforce. Efforts to offset the regressivity of a credit VAT by having a tier of rates or by exempting goods and services will escalate the costs to administer the VAT.¹⁷

The chain of tax payment and tax receipt, available only in the credit VAT, creates a mechanism thought by some to encourage or force compliance with the tax system.¹⁸ Because each business is required to provide receipts for taxes paid on its sales and the business making the purchase needs these receipts to verify that it paid the taxes, there seems to be a self-enforcing mechanism within the system. However, there is not general agreement in the tax literature as to the effectiveness of this approach in preventing noncompliance. Theoretically, a tax agency could require that all pertinent documents be turned over to it for audit purposes, but the sheer volume of data makes it unlikely that a tax agency would attempt to match documents. Nevertheless, businesses would need to retain gross receipts records and records of transactions on taxes paid on purchases of goods and services. Even Japan, which started its own unique version of a VAT in 1989 without substantial recordkeeping requirements, recently has started requiring businesses to maintain records that substantiate their claims for credits.¹⁹

As we pointed out in 1993, other countries' experiences with a credit VAT indicate that auditing would require less time but more frequent visits by auditors to businesses than with an income tax.²⁰ Also, other countries' experiences indicate that while VAT audits may be done very quickly, the

¹⁶See Joint Committee on Taxation, Impact on Small Business of Replacing the Federal Income Tax (JCS-3-96), Apr. 23, 1996, p. 79; and Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," National Tax Journal, Vol. XLVIII, No. 4 (Dec. 1995), p. 637.

¹⁷See [GAO/GGD-93-78](#), pp. 79-80.

¹⁸For discussion of this concept, see [GAO/GGD-93-78](#), p. 44, and Sullivan, p. 24.

¹⁹See Alan Schenk, "Japanese Consumption Tax After Six Years: A Unique VAT Matures," Tax Notes, Vol. 69, No. 7 (Nov. 13, 1995), pp. 899-911.

²⁰See [GAO/GGD-93-78](#), pp. 42 and 46.

time required increases if any complexity is introduced. Frequent auditors' visits to businesses may be used to quickly capture taxes due and to discourage businesses from using the tax funds in their cash flow. The number and frequency of audits of small businesses, who have proven to be the most noncompliant under the current system, might be increased by a tax agency. Further, specially trained people may be needed for fraud detection, particularly for verification of exports for border tax adjustments.

The United Kingdom's planned audit rate of VAT taxpayers was 6.5 percent (in 1992), compared with IRS' corporate income tax audit rate of 2.0 percent (in fiscal year 1995). Time for a VAT audit is highly variable, depending on the size of the business. IRS' experience with the income tax indicates that larger firms employ tax specialists and are less likely to make basic errors than are smaller firms.

Other Issues in Enforcement

Underground Economy. No easy formula seems to exist to solve the problem of collecting taxes from the underground economy. With a VAT, some taxes still would escape collection, including the tax on the value added by the labor of sole proprietors who, as mentioned in appendix II, have had extremely poor compliance histories. A Canadian study reports the potential for "skimming" (underreporting) or nonreporting of legitimate business receipts with the Canadian VAT is greatest in the service sector, similar to the U.S. income tax.²¹ Similarly, illegal goods and services would likely continue to escape taxation with a VAT, although the amount of these is unknown.

The credit VAT has the advantage of creating incentives for businesses to file in order to get credit for taxes they have paid. With a credit VAT, even if sole proprietors do not file, they probably would pay some tax on goods and services they purchase for business use.

As with the current system, the tax agency likely would want to develop methods of audit selection, such as the scheme currently used for income tax returns. The resulting selection might be quite different from those now used with the income tax, and it would require some years of experience with a U.S. VAT to develop and refine the patterns and indicators of noncompliance.

²¹Statistics Canada, National Accounts and Environment Division, "The Size of the Underground Economy: A Statistics Canada View," Discussion Paper, Feb. 1994.

Credits/Refunds. Because a new business' initial costs of starting up would probably exceed its sales for some time, it would likely have larger claims for credits than an established business would. In this situation, the business could claim a substantial amount of money to be refunded. Some countries handle these claims as credits that are carried forward to be used with the next tax due, but new businesses may need the money quickly for operating funds. A credit or refund mechanism would need to be established to address these possible cash flow problems, but the tax agency would be burdened with the necessity of checking the validity of these claims before refunding large amounts. Fraudulent claims could be a problem for the tax agency when there are requests for speedy refunds.

As we described in 1993, border adjustments, done by zero-rating exported goods, require special attention from auditors to ensure that the credits claimed for exports are correct.²² Auditing, verifying, and processing these claims so that the businesses receive their refunds in a timely manner adds to the cost of administering a VAT. For a tax agency to make adjustments for taxes paid on inputs to exported goods, verification of claims would be required to ensure that the goods were, in fact, exported and that the claim for taxes paid was correct. Most companies export only a portion of the goods they produce, complicating the tax for the company and the agency, because records must separate the goods sold domestically from the goods exported to establish the proper claim for credit. Other countries' experiences indicate that fraudulent claims could be a big problem because they might generate large dollar refund claims. Furthermore, quick payment of these claims could relieve the exporter of cash flow problems, but these claims would have to be verified before payment. An enforcement mechanism would be needed that prevents or exposes fraudulent claims. Transaction records available with a credit VAT would provide the needed verification, but an economy dominated by exporters could require significant tax agency resources. The potential for businesses to overstate claims of exports to obtain credits would have to be addressed. The burden for this may or may not fall entirely on the tax agency, and in the United States, the Customs Service, which currently administers import duties, might assume that role in cooperation with the tax agency.

Enforcement—Collections

Collection functions may not change significantly from those required for the current income tax, and whether delinquencies would increase or decrease with a VAT is unclear. However, if a VAT replaced the income tax, the relatively high tax rates necessary for revenue neutrality could involve

²²See GAO/GGD-93-78, p. 46.

businesses' handling more tax revenues than they do now and, therefore, make the collection functions more important. The temptation would exist for businesses—as it does now with employment taxes—to divert taxes collected to working capital, especially in times of business downturn. Businesses, particularly smaller ones, could either move or close to escape the tax collector and, with high rates, the benefits of doing so could be attractive. Collections could be time-consuming and costly, and a collecting agency may need more resources for these functions than with the current business income tax. As described in appendix II, the most problematic business taxes under the current collection process are employment taxes—taxes that are collected in a way similar to how a VAT would be collected.

Taxpayer Services

Relieving individuals of the responsibility for filing returns would greatly decrease the number of entities requiring taxpayer services but would increase the administration burden for ensuring compliance by businesses. Tax agency efforts during the transition to a credit VAT would be needed to educate current taxpayers as well as new businesses, and continuing educational services would be needed for new businesses even after the transition. Taxpayer education programs for VATs in other countries include such techniques as seminars, special publications targeted to various business sectors, and automated or personal assistance through taxpayer inquiries via telecommunications. Personal attention with visits to individual businesses was thought to be effective in some other countries' transition to a credit VAT.

If special rules were used to avoid large gains or losses in the transition between the old and new systems, such as continuing to allow depreciation for a number of years, the tax would be complicated and would require more extensive taxpayer education and services.

Subtraction VAT

Description

A subtraction VAT is a tax on consumption, remitted to the government by businesses; it is similar to a credit VAT but is calculated on the difference between the total receipts from sales and total purchases of goods and services from other businesses, including expenditures for capital purchases. The VAT rate is then applied to this difference to determine the tax owed.

Even though a subtraction VAT would be levied on businesses at each stage of production and distribution, it is the consumer who would ultimately pay the tax. A subtraction VAT might not be as visible to the consumer as the credit VAT because each transaction would not have to be tracked at the retail level; but it would likely be reflected in the price charged, nonetheless.

A subtraction VAT would be imposed on the sale of taxable goods and services by businesses, and unlike a credit VAT, the base would have to be very broad to be administrable. To facilitate its administration, there should be no multiple rates nor any exemptions of goods and services before the retail level, even for such a purpose as offsetting regressivity. Although using multiple rates and exemptions with a credit VAT is possible, it would be difficult administratively with a subtraction VAT. (Some think this is an advantage because, at least theoretically, it could keep a subtraction VAT from being subject to added complexities.) If exemptions existed at the retail level, the tax would become more like current RSTs, and some of the same problems, such as making definitional distinctions between similar items with different tax rates, could be troublesome.

To be administrable, a subtraction VAT should have only one rate. Although multiple rates add complexity to a credit VAT, with a subtraction VAT businesses simply could not keep track of the rates paid at the intermediate production stages. If more than one rate applied, the net difference between sales and purchases could not be the basis for calculating the tax. Further, if multiple rates were used with a subtraction VAT, the tax agency administering the tax would have no reliable way to confirm a business' claims for the volume of goods sold at lower rates, since the business, itself, would furnish the audit information.

A credit VAT, because it relies on records of transactions, is adaptable for the taxation of small retail services, such as automobile mechanics or hairdressers, which are labor-intensive. With a subtraction VAT, however, it would be easy to understate the value added in labor for the service provided, because the amounts reported are based on the business' own records, and there is no checking mechanism in the system as there is with a credit VAT.

Enforcement advantages of a credit VAT are not present with a subtraction VAT: (1) checks and balances of a credit VAT are not available and (2) businesses do not have the incentive to enter the system to receive credits for taxes paid as with a credit VAT.

As discussed in appendix III, financial intermediation services may be difficult to include in any consumption tax, including a subtraction VAT. Treatment of housing is a concern with any consumption tax, and international VATs generally tax the sale of new housing. As mentioned, any narrowing of the base of a VAT complicates the tax and raises the cost to both the taxpayer and tax administrator.

Consumption taxes generally tax fringe benefits by not including them in the items that can be deducted as business purchases.²³ However, any business purchases that are used for personal consumption, such as large gifts to employees that could be considered fringe benefits, would escape taxation with the subtraction VAT. Business purchases might readily be abused by claims for tax credits for items used for personal purposes. Identifying these items in an audit could be time-consuming.

**Potential Impact on
Taxpayers' Compliance
Burden**

A summary of some impacts of a subtraction VAT on business taxpayers is shown in table VI.4 and elaborated on afterward.

²³A flat tax can tax fringe benefits through the individual or through the business, depending on the way it is set up.

Table VI.4: Summary of Some Key Potential Impacts of a Subtraction VAT on Business Taxpayers

Item	Characteristics of taxpayer compliance burden under the current income tax	Impact of the subtraction VAT on business taxpayers
Return filing	24 million returns filed in 1995	All businesses included
Records kept	Records supporting income and expenses supposed to be kept	Reliance on normal business recordkeeping; records for items like depreciation not needed except for possible transition
Calculations made	Complicated calculations included for provisions such as depreciation, the alternative minimum tax, and the foreign tax credit	Fewer calculations, such as for depreciation, required
Complexity faced	Complexity reflected in areas such as depreciation, the alternative minimum tax, and the foreign tax credit; difficulties existing in defining and recognizing income	Without exemptions and multiple rates, which are unsuitable, tax simplified
Requirement to furnish information returns	1.1 billion information and withholding documents filed	Information returns eliminated

Source: GAO analysis of available information about subtraction VATs.

Number of Taxpayers

A subtraction VAT taxing all businesses would include many fewer than the 122 million taxpayers (all types of businesses and individuals) that filed in 1995. As we described in a 1989 report, an exemption for small businesses could be used with the subtraction VAT if the tax agency could be certain the businesses indeed qualified as small.²⁴

Information Reported and Documents Retained

Under a subtraction VAT, a business would likely need to keep fewer records than with either the current income tax system or a credit VAT requiring transaction records. With a subtraction VAT, a business would need records for the following:

- gross receipts from sales;
- gross amount of purchases of goods and services (inputs), including capital investment;
- amount of exports (assuming destination principle);
- any credits carried forward; and

²⁴See [GAO/GGD-89-87](#), pp. 35-37.

- credits for adjustments on purchases from previous period.

The tax reported and remitted would be calculated by a business on the difference between the gross receipts from sales minus the cost of goods and services purchased, including capital investment.²⁵ With a subtraction VAT, a business with good, standard accounting practices should be able to rely on its normal cash flow recordkeeping for its tax calculations and records and would not have to do accrual accounting calculations for tax purposes. However, the business would have to distinguish between purchases from other businesses, which would be deductible, and its own internal costs, which would not be deductible. Some items would be critical to a taxpayer's records, specifically proof of the business' domestic versus foreign sales. These would be necessary for claiming refund credits for exports and would be a likely target if the business were audited.

With a subtraction VAT, calculations no longer would be necessary for such things as depreciation, alternative minimum tax, foreign operations, and passive investment activity, unless they were required during a transition period. A form for reporting to a tax agency might be similar to that of a credit VAT, which is optimally no longer than 16 lines of tax information.

At least one study notes that a subtraction VAT would be less burdensome to the taxpayer than a credit VAT, although "this simplification . . . comes at the cost of increased potential for evasion and less flexibility."²⁶ Fiscal responsibility would be required, particularly of a retail business taxpayer, inasmuch as tax liability could get high very quickly if tax rates are high; seasonally sensitive businesses could be especially subject to difficulties.

Frequency of remittance and filing would likely be similar to the current system in which the schedules may vary from annually to semiweekly, based on the size of a business' liability and the type of tax. As with a credit VAT, filing methods might be limited to electronic, since only businesses are subject to the tax. Tax remittances probably would be estimated and made more often than returns filed. Whether or not higher tax rates prevailed, businesses would likely be handling more money, creating more liability for themselves, and the filing and remittance burdens could be more demanding than with the current income tax. Some sole proprietors and partnerships who currently file income tax returns and remit annually might be interacting with the tax agency more

²⁵As with a credit VAT, interest and income from other financial flows between businesses would not be taxed.

²⁶Sullivan, p. 35.

frequently, similar to the current employment tax, although without an individual income tax, businesses' requirements for information returns would decline.

A transition period to the new tax could add to businesses' recordkeeping and tax calculations and the administrative burden and costs. If an income tax were in effect in addition to the subtraction VAT, the recordkeeping burden would escalate somewhat, but current accounting methods likely could be the basis for both and be supplemented to make VAT distinctions.

Subtraction VAT Compliance Costs

As opposed to the credit VAT, which is widely used, no country except Japan has tried a subtraction VAT,²⁷ and little information is available to judge compliance burden and costs with any precision. Since individuals would not file returns with a subtraction VAT, they would not deal with compliance or experience the associated costs. Similarities between the subtraction VAT and the business tax under the flat tax indicate their compliance costs for businesses could be similar. Based on a major reduction in paperwork over the current system, the time necessary for compliance would be greatly reduced, according to one estimate based on the Arthur D. Little study, which has limitations as described in appendix II.²⁸

Impact on Tax Administrators

A summary of some impacts of a subtraction VAT on tax administrators is shown in table VI.5 and elaborated on afterward.

Table VI.5: Summary of Some Key Potential Impacts of a Subtraction VAT on Tax Administrators

Item	Current income tax	Subtraction VAT
Impact on number of returns processed	Hundreds of millions of returns and other materials received	Returns simplified; only businesses included, and information returns unneeded; if a small business threshold, large number of businesses excluded
Impact on refund processing	92 million refunds issued in fiscal year 1995	Refunds for excess estimated remittance required; verification needed for refunds relating to exports and costs exceeding sales

(continued)

²⁷Japan's VAT has variations that make it unlike the alternatives we consider; also, recent changes are moving it toward a credit VAT.

²⁸Arthur P. Hall, "Compliance Costs of Alternative Tax Systems," *Tax Notes*, Vol. 71, No. 8 (May 20, 1996), pp. 1087-88.

Appendix VI
Credit and Subtraction Value-Added Taxes

Item	Current income tax	Subtraction VAT
Impact on examination approach	Tax returns matched with information returns; fiscal year 1995 examination coverage at 1.36 percent, with corporate audits taking longer than individuals' audits	Self-enforcing mechanism not available, making audits of business' own records more complicated than for credit VAT; audit frequency possibly increased
Continuation of old compliance problems	Compliance problems related to income definition, unreported income, and more specific issues identified in areas such as transfer pricing, depreciation, deductibility of business expenses, small businesses, independent contractors, and the underground economy	Compliance problems with business and personal expense distinctions, independent contractors, unreported receipts, and underground economy continued; collections from small businesses problematic but less than under retail sales tax
Resolution of old compliance problems	Not applicable	Compliance problems with transfer pricing and depreciation eliminated
Creation of new compliance problems	Not applicable	Compliance complicated by underreported sales and for verifying export claims; administration difficulties increased if exemptions or multiple rates used
Impact on collections from tax delinquents	Millions of taxpayer delinquent investigations and accounts closed, with most of the latter being for individuals and most business dispositions covering employment taxes	Collections complicated if high rates put large cash amounts in hands of small businesses; small business problems possibly mirroring employment tax collection problems
Impact on individuals' questions received	Millions of taxpayer inquiries fielded, covering a wide variety of questions	Individuals not responsible for filing returns

Source: GAO analysis of available information about subtraction VATs.

Tax Rates

As with other consumption taxes, the tax rate with a subtraction VAT probably would be determined by the amount of revenue needed to be raised. If a subtraction VAT replaced the current income and employment taxes, the tax rate necessary to obtain a given level of revenue would be greater than if it were imposed in addition to the income and/or employment taxes. The rates, which might be levied in addition to the state sales taxes, could complicate administration of the tax, in part

because small businesses, such as retailers and sole proprietors handling large amounts of tax money, could be tempted to dip into them for their own cash flow purposes.

Multiple rates, frequently used with a credit VAT to address regressivity by imposing a variety of tax rates on such things as necessities and luxuries, could not readily be used with a subtraction VAT except at the retail level because it would be virtually impossible for a tax agency to administer them. With a subtraction VAT, businesses would not be required to keep detailed records of purchases, and if a business' goods and services were purchased at varying tax rates, tax administrators could find it very difficult to ascertain the accuracy of the apportionment of the purchases to the differing rates. Some tax policymakers think a subtraction VAT that did not have a variety of rates would have a distinct advantage over a credit VAT or other consumption tax that did because the tax would not be as complex. If a lower tax rate resulted from the broader base and rate structure, the administrative burden might be eased.

Number of Taxpayers

About 24 million taxpayers—all taxpayers filing as corporations, partnerships, and sole proprietors in 1995—would be subject to the subtraction VAT. This number could be reduced if small businesses were exempted, but administering a subtraction VAT that attempted to exempt small businesses could be time-consuming and costly if the auditor had to review an inordinate number of records to confirm the validity of the exemption. Also, small businesses could spring up if larger companies split up their firms for tax avoidance purposes.

Processing of Returns

Processing of tax returns and remittances for 24 million businesses of all types should require far fewer resources than the processing required for the 122 million individual and business taxpayers in the tax system in 1995. Because the many items that have entered the current tax code for social and economic reasons would not be required to be reported or itemized in a subtraction VAT, the tax would be much simpler. However, more frequent filing and certainly more frequent remittance, probably through estimated remittances, could be required because more dollars would be collected by even small businesses. (Quickly retrieving tax dollars from businesses is important when much money is at stake.) Much simpler returns would make generally accurate data entry into the computer system possible with scanning equipment and electronic filing since all taxpayers would be businesses. Automated systems such as these should reduce costs and increase the speed for processing the returns, so that auditors could receive the necessary information in a timely manner.

Currently, hundreds of millions of information documents (Forms W-2 and 1099) reporting wages and investment income are submitted to IRS, mostly electronically and through other nonpaper means but also by paper, and subsequently processed. This information reporting and processing would not be necessary with a subtraction VAT, since these items would no longer be used in tax calculations.

Similar to a credit VAT, if refunds and credits were given, a method for processing them would have to be designed. And as with a credit VAT, registration would be especially important for new businesses, in order to get them into the tax system, and for others that are not now in the tax system but that would be included under a VAT. Incentives to register, however, would be lacking.

**Enforcement—Audit/
Collections**

With a subtraction VAT, auditing a business with adequate records could be similar to auditing a credit VAT, depending on the simplicity or complexity of the tax design. Records of receipts or payment invoices might have to be checked to ascertain the validity of the amounts reported. Without multiple rates or exemptions, the tax agency burden should be limited to straightforward verification of business records. Since these are the audited business' own records, as opposed to the credit VAT's tax receipts from other businesses, their validity may be questioned, lengthening the audit and raising audit costs compared with those of a credit VAT.

With multiple rates or exemptions, a business could calculate the tax to be remitted, but verification could be difficult because the records the business used to determine its taxes would be its own accounts of purchases and deductions. (While this also happens with the business side of the current income tax, a much smaller proportion of tax revenues is derived from that tax, and so the problem is not as perilous.) Tax evasion, which appears to be easy to do with a subtraction VAT having multiple rates or exemptions, could jeopardize large amounts of tax dollars.

Auditing a subtraction VAT with a broad base and a single rate would probably be simpler than auditing the current income tax and its complexities. As with the credit VAT, auditing could be less time-consuming and done more often than with the current income tax. The importance of having auditors visit businesses frequently to identify any problems before large amounts of taxes become due would be similar with both the subtraction and credit VATs. Fraud detection would require diligence with a subtraction VAT, particularly in identifying underreported or unreported income that could be readily hidden in a business' books.

Also, distinguishing between business and personal expenses would still be a problem.²⁹

A new system would need to be developed for audit selection. Some years of experience with a subtraction VAT might be necessary before patterns of noncompliance could be identified, developed, and refined, particularly since no country now has experience with one.

A subtraction VAT could have problems with businesses that do not record their sales or that understate them. With a credit VAT, because these businesses may want to claim the credits due them, they may record both their sales and their purchases; however, with a subtraction VAT, there would be little to prevent a business from ignoring or understating sales. With a credit VAT, businesses making retail sales would be the ones chiefly at risk of not remitting the VAT, since the businesses at the prior level in the production or distribution chain would want to claim the credit for their purchases and therefore would report them.

As with a credit VAT, the collection of a subtraction VAT would not fall entirely onto the retailer, and thus the burden and liability would be spread through all businesses. This would be a distinct advantage over a national RST in which there are so many small retailers whose records may be difficult to check or who may go out of business or otherwise evade taxation. As described in appendix II, small businesses have had significant compliance problems.

Other Issues Under Enforcement

Underground economy. The underground economy should escape taxation about as well with the subtraction VAT as with other systems; in other words, there is no obvious reason that chances of collecting from the underground economy are better here than with most tax systems. In fact, since there is no incentive to register, as there is with the credit VAT, it might be more difficult to collect the tax from that segment of the economy.

Credits/Refunds. As with a credit VAT, border adjustments, which tax imports of goods and services and refund exports by zero-rating exported goods, could be a source of particular concern for administrators. To make these adjustments, a mechanism would be needed for crediting or refunding businesses with taxes paid on exports; in the United States, the Customs Service might have responsibility for administering some of it. Businesses that are large exporters probably would need cash refunds,

²⁹See Joint Committee on Taxation, p. 79.

rather than credits, promptly disbursed, complicating administration. Fraudulent claims for amounts of goods sold have presented difficulties for other countries to identify before they paid out refunds. Auditors would have to ensure that credits claimed by exporters were correct, including claims made by companies who sell both domestically and internationally, to ensure that the VAT credit claimed for the exports was not inflated.

If a business remitted more tax than was due, a system for carrying forward the credit or paying the refund would be needed. Large credits or refunds claimed by new businesses to offset startup costs or claims of capital investment costs exceeding sales would have to be verified before payment. These claims could pose problems for a tax agency, since the timeliness of the validation would be critical. Likewise, an exemption for small businesses could be used with the subtraction VAT only if the tax agency could be certain the businesses, indeed, qualified as small, which probably would be difficult for an audit agency to pursue.

Enforcement—Collections

Collections functions with a subtraction VAT might be similar to those for the current income tax, and it is unclear whether delinquencies would increase. However, collections could mirror current collections for employment taxes, rather than the current income tax, because the processes seem similar. If this were the case, collection problems and costs could escalate, particularly with some businesses, such as sole proprietors, who are difficult to collect from. Furthermore, noncompliance with employment taxes was relatively low except in the self-employment area. Collections might be more problematic because, with the high tax rates likely needed to achieve revenue neutrality, businesses likely would be handling more tax dollars than they currently do. Small retail businesses, known to have a short life expectancy, could be tempted to avoid remitting the tax and to use the funds for other purposes.

Taxpayer Services

A new tax system is likely to require significant resources for educating the public, but probably less so with a simple subtraction VAT than with the credit VAT or more complicated tax. With a subtraction VAT, more effort would be devoted to educating businesses than the general public, and business associations might be enlisted to help with the effort. A tax agency would likely target businesses through seminars and electronic and other means. There still would be some education necessary for the general public so that they would know what to expect at the retail level. Measures designed to improve the transition to a subtraction VAT, such as

Appendix VI
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extension of depreciation, could complicate the taxpayer services effort and escalate its costs.

Flat Tax

Description

The term “flat tax” as used in the current tax environment may refer to a single, or “flat,” tax rate with either an income or a consumption tax base. The single rate does not include what is, in effect, a zero tax rate in the form of a standard deduction and exemption allowances. In this report, flat tax refers to the type of tax outlined by Hall and Rabushka.¹ This version taxes individuals and businesses at a single rate and eliminates many specific deductions and credits. Although the individual flat tax may appear to resemble an income tax because individuals file and pay taxes, the flat tax is a type of consumption tax because returns on savings and investment are not taxed and business’ investment is expensed. Unlike the credit value-added tax (VAT) or the retail sales tax (RST), the flat tax is not collected on individual transactions.²

The individual flat tax is a wage tax, which taxes only wages, salaries, and pension and retirement income. Fringe benefits received by individuals would be taxed at the business level because the employer would not be allowed to deduct them. This type of flat tax has no tax credits and no deductions for specific items, such as home mortgages and charitable contributions. Instead, regressivity is addressed through personal allowances based on the individual’s filing status and additional deductions for dependents.

The business side of the flat tax would be remitted by businesses on their total receipts from sales of goods and services, minus total purchases of goods and services from other businesses, and expenditures for capital purchases, minus wages, salaries, and pension and retirement benefits. Fringe benefits paid to workers, other than pension and retirement benefits, would not be deductible to businesses, and thus they would be taxed. All businesses, including all corporations, sole proprietorships, and partnerships, would remit the business tax. The business flat tax resembles a subtraction VAT, as described in appendix VI, except that the taxation of wages and salaries is shifted to the individual. Therefore, many of the effects of a flat tax on businesses and on the tax administration of those businesses also resemble the effects of a subtraction VAT.³

¹Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, Calif.: Hoover Press, 1995).

²Variations of the Hall-Rabushka flat tax model include the “X-tax” proposed by David Bradford. The base of both the individual and business taxes is the same with both models, but the X-tax would have graduated rates for individuals and the tax rate for businesses would equal the top rate for individuals. Certain deductions and credits for individual taxes could be retained. See David F. Bradford, “On the Incidence of Consumption Taxes,” in Charles E. Walker and Mark A. Bloomfield, eds., *The Consumption Tax: A Better Alternative?* (Cambridge, Mass.: Ballinger Publishing Company, 1987).

³The flat tax also resembles the business cash flow consumption tax described in appendix III, except that with the cash flow tax, new borrowing is taxed and wages are not taxed at the business level.

**Appendix VII
Flat Tax**

A comparison of the base under a flat tax with the base under the current income tax is shown in table VII.1. Because a business' investment purchases are expensed, rather than depreciated over time, this flat tax is a consumption tax. It is a flat tax because there is only one rate applied to all levels of both the personal and business tax base.

Table VII.1: Key Elements of the Flat Tax

Item	Current income tax	Flat tax
Personal level		
Wages	Included	Included
Interest income received	Included	Not included
Dividends received	Included	Not included
Pension income	Included when received	Included when received
Loan proceeds	Not included	Not included
Sales of assets	Capital gain included	Not included
New saving	Generally not deducted	Not deducted
Fringe benefits	Not included	Not included
Job expenses	Certain costs deducted by itemizers	Not deducted
Business level		
Sales of goods and services	Included	Included
Sales of business assets	Gain included	Included
Sales of financial assets	Gain included	Not included
Loans and new stock issues	Not included	Not included
Purchases of goods and services for business purposes	Deducted	Deducted
Purchase of capital goods	Depreciated over time	Deducted immediately (expensed)
Wages paid	Deducted	Deducted
Fringe benefits	Deducted	Not deducted
Interest paid	Deducted	Not deducted
Dividends paid	Not deducted	Not deducted

Source: Joint Committee on Taxation and GAO analysis of the flat tax outlined by Hall and Rabushka.

Taxation of Individual Taxpayers and Potential Impact on Individual Taxpayers' Compliance Burden

A summary of some of the potential impacts of the flat tax on individual taxpayers is shown in table VII.2 and elaborated on afterward.

Table VII.2: Summary of Some Key Potential Impacts of a Flat Tax on Individual Taxpayers

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of the flat tax on individual taxpayers
Return filing	116 million returns filed in 1995	Assuming withholding still required, number possibly lower than now, depending on personal deductions or allowances; separate individual and business returns possibly filed by self-employed individuals
Records kept	Records supporting tax returns supposed to be kept—e.g., receipts, proof of payment, and documentation supporting deductions and credits; burden alleviated by information reports given to individuals	Information returns kept as primary source of information for wages but not needed for savings; individuals responsible if companies do not furnish information
Calculations made	Complicated calculations for some taxpayers included for provisions such as dependency tests and capital gains	Dependency calculations still needed but computations for eliminated items, such as capital gains, not needed
Complexity faced	Many pages of instructions involved and millions of supplemental forms and schedules filed—e.g., 33 million schedules of itemized deductions for tax year 1994; difficulties existing in defining and recognizing income; however, in actual practice, minimal complexity faced by millions of individuals	Complexity reduced because many income and all itemized deduction items eliminated; complexity added if broad range of fringe benefits taxed at individual level; difficulties in defining and recognizing income reduced

Source: GAO analysis of available information about the Hall-Rabushka flat tax.

Tax Base

The principal differences in the base of the individual flat tax and the base of the individual income tax are that the Hall-Rabushka flat tax (1) eliminates taxation of savings and investment earnings at the individual level, including interest, dividends, and capital gains; and (2) excludes deductions or credits, such as those for home mortgage interest, charitable contributions, and child and dependent care.⁴ The reduction in complexity of the tax base resulting from eliminating the itemization of income items and deductions should relieve the burden on some individual taxpayers by ridding the system of complex rules and supplemental forms accompanying the eliminated items.

Hall and Rabushka advocate taxing all types of nonsavings income, particularly all fringe benefits including the employer's Social Security contribution, in order to have the lowest possible tax rates. The Hall-Rabushka approach accomplishes this by not allowing a deduction for fringe benefits at the business level. However, Hall and Rabushka advocate that fringe benefits other than retirement benefits no longer be furnished by businesses but, instead, be purchased by individuals. Whether the individual's compensation would be increased to offset this is not clear, but Hall and Rabushka assert that "Were the tax system neutral, with equal taxes on fringes and cash, workers would rather take their income in cash and make their own decisions about health and life insurance, parking, exercise facilities, and all the other things they now get from their employers without much choice."⁵ There are, however, reasons why businesses may want to provide fringe benefits, and whether the many varieties of fringe benefits would, in fact, be eliminated or taxed at the business level under a flat tax is uncertain.

Administration of these fringe benefits under the Hall-Rabushka tax could be problematic. Tax-exempt entities might have to remit tax on the value of employees' fringe benefits, or if an approach not advocated by Hall and Rabushka were adopted and the employee paid the tax on fringe benefits, businesses could have to report their value to both the tax agency and the taxpayer. In this report, we identify areas where the treatment of fringe benefits might be troublesome for the taxpayer or the tax administrator.

⁴Fringe benefits are taxed in the Hall-Rabushka flat tax, but not at the individual level.

⁵Hall and Rabushka, p. 63. Also, one tax preparer—Vernon Hoven, "Flat Tax As Seen by a Tax Preparer," *Tax Notes*, Vol. 68, No. 6 (Aug. 7, 1995), pp. 747-55—cites as an example of the difficulties that might be involved a parking lot purchased for use by employees—the land, which may be deductible as a business expense, might no longer be deductible because it becomes a fringe benefit. The question, then, could be whether the employees would be required to pay tax on the fringe benefit, in which case their burden, as well as the burden for the business, which would have to calculate and report the value to the individuals, and the burden for the tax administrators would be increased.

Number of Individual Taxpayers

The individual side of the flat tax likely would include no more than the number of individuals reporting under the current income tax—a maximum of 116 million taxpayers (in 1995 terms), depending on the threshold level for personal deductions and allowances. Some of these individuals might report as businesses—sole proprietorships, partnerships, and S corporations—under the flat tax, but they also might want to report some part of their income as wages to obtain the personal allowances. The individual tax could be set up so that only those with income above a threshold level (including deductions and personal allowances) or who are due a refund would be required to file and pay the tax, similar to the current system. The Hall-Rabushka flat tax framework has personal allowances of \$16,500 for married couples filing jointly, \$9,500 for single filers, \$14,000 for single heads of household, and a \$4,500-deduction for each dependent.⁶ All are higher than the current allowances. In 1993, the likely maximum number of filers would have been 65 million with the Hall-Rabushka allowances, based on the number of taxpayers who had wage or pension income above the personal allowance levels that year.

Information Reported and Filing Frequency

Unlike the RST and the VAT, the flat tax would require individuals to keep records, file returns, and pay taxes. However, the form for individuals could be much simpler than the current income tax form, assuming no specific deductions were introduced, but individuals would be required to do the calculations necessary to claim deductions and personal allowances. Because, however, individuals would not have to report earnings from interest, dividends, and capital gains, their difficulties in defining and recognizing income would be reduced. With a flat tax, an individual would report the following:

- wages,
- salaries,
- pension income, and
- retirement benefits when received.

Retirement benefits would be included in the wage tax, but other fringe benefits probably would be taxed under the business tax. However, if contrary to the apparent Hall-Rabushka approach, a variety of fringe benefits were included in individual taxes, individual taxpayers would have to report them to the tax agency, increasing their burden and the

⁶Hall and Rabushka, p. 59.

burden for businesses, which would probably be required to provide taxpayer information to the taxpayer and the tax agency.

Information reporting by employers, which is currently done with duplicate records of the amounts paid being sent to the taxpayer and the government, likely would alleviate the need for further recordkeeping for most individual taxpayers. With a flat tax of this type, a return-free filing system possibly could be designed so that some individuals might have only limited contact with the tax agency.

Filing and payment of a flat tax likely could be on a schedule much similar to the current income tax—filing annually and paying through payroll deduction or quarterly estimated taxes. With automated information reporting by employers to individuals, probably few documents would need to be retained. And if individuals filed simpler forms, greater possibilities for automation advancements, such as telefile, might follow.

Tax Rates

A single tax rate would be applied to all individuals having incomes above levels of personal allowances and deductions for dependents. Individuals would be required to make the calculations to determine deductions, and thus, properly claiming dependents, which has proven troublesome in the current system, would continue as a problem area.

The one rate necessary to raise the same amount of revenue as the current multiple-rate income tax coupled with the tax base changes could result in considerable change for some individual taxpayers.⁷ However, as the Congressional Research Service has alluded to, there would be little compliance burden change for those individuals who currently take the standard deduction and pay no tax or are taxed at the 15-percent rate.⁸ Evasion incentives would vary, depending on the impact of the changes, but the simplicity of the tax plus information reporting of wages might deter some evasion.

Credits/Refunds

Under the Hall-Rabushka flat tax, refunds would be available for those whose personal allowances and deductions exceed their income. For those tax filers with salary and wage income, refunds may not be difficult for the tax agency to verify if information returns reflect both the wages and the taxes withheld.

⁷Hall and Rabushka suggested a rate of 19 percent. Other proposals range from 17 to 20 percent.

⁸Congressional Research Service, Flat Taxes: Simplification and Compliance Issues (May 10, 1996).

Taxation of Business Taxpayers and Potential Impact on Business Taxpayers' Compliance Burden

A summary of some of the potential impacts of a flat tax on business taxpayers is shown in table VII.3 and elaborated on afterward.

Table VII.3: Summary of Some Key Potential Impacts of a Flat Tax on Business Taxpayers

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of the flat tax on business taxpayers
Return filing	24 million returns filed in 1995	All businesses included
Records kept	Records supporting income and expenses supposed to be kept	Businesses responsible for wage reporting to individuals; records for items such as depreciation not needed except for possible transition
Calculations made	Complicated calculations included for provisions such as depreciation, the alternative minimum tax, and the foreign tax credit	Fewer calculations, such as for depreciation and multiple rates, required; possible fringe benefit calculations
Complexity faced	Detailed rules involved; complexity reflected in areas such as depreciation, the alternative minimum tax, and the foreign tax credit; difficulties existing in defining and recognizing income	Without exemptions and multiple rates, tax simplified; fringe benefits calculations complicated, if broad range taxed at individual level
Requirement to furnish information returns	1.1 billion information and withholding documents filed	Returns still needed for wages, but not for investment earnings; withholding possibly still required

Source: GAO analysis of available information about the Hall-Rabushka flat tax.

Tax Base

A business remitting a flat tax would calculate, report, and remit taxes on its gross receipts (or sales) minus the cost of goods and services (or

purchases), including investments for capital goods, minus wages, salaries, and pensions and retirement benefits.

Number of Business Taxpayers

A maximum of about 24 million taxpayers (as of 1995) would be included in the business flat tax if all corporations, partnerships, and nonfarm and farm sole proprietors remitted as businesses. Sole proprietors might want to pay themselves a wage in order to take the personal allowance deductions available with the individual tax, and they might take all income earned as commissions, for example, as personal wages. Nevertheless, most would probably file as businesses to deduct their expenses—that is, purchases of goods and services, purchases of capital equipment, and wages paid.

Information Reporting and Filing Frequency

With a Hall-Rabushka style of flat tax, a business would need records for the following:

- gross receipts from sales;
- gross amount of purchases or inputs (goods and services), including capital investment;
- amount of employee wages and salaries; and
- amount of employee pensions and retirement benefits.

Businesses likely would be required to submit to both their employees and the tax agency information returns, similar to the present W-2 forms, showing employees' wages and salaries. In addition, pensions and retirement benefits (and perhaps other fringe benefits) would have to be calculated and reported. With a flat tax, preparation of Forms 1099 for investments could be eliminated for returns from savings and investments. Furthermore, calculations of items such as depreciation, alternative minimum tax, and foreign-source income and foreign tax credits would be eliminated, unless there was a period of transition in which calculations for both a flat tax and an income tax would be required. Businesses, of course, might continue to calculate depreciation for their own financial statements or other business reasons.

Accounting methods for a flat tax could mirror current standard accounting methods and accrual accounting would not be required for tax purposes. Even for self-employed individuals, reporting of the above items would seem to duplicate information businesses should keep on hand. However, if contrary to Hall and Rabushka, fringe benefits were taxed on

the individual level, estimating and reporting their value could be difficult for companies, as well as tax-exempt entities, providing a wide array of employee benefits, such as insurance, stock options, gym facilities, parking privileges, cafeteria plans, and other items that are difficult to evaluate.

Businesses probably would be required to file tax returns and make tax remittances on schedules similar to the current business income and employment tax schedules, which vary based on the type and amount of tax. Special rules might apply to new businesses until a basis for the amount of tax due is determined.

Tax Rates

With a flat tax, one tax rate other than a zero rate would apply to both individuals and businesses, making it generally futile for either type of taxpayer to attempt to shift income. Businesses, however, would have an incentive to shift income to individuals in the form of wages so the individuals could take advantage of personal allowances.

Credits/Refunds

Businesses starting or expanding operations would likely have large capital investment expenditures deductible from their gross receipts, which could put them into negative tax situations. Under the Hall-Rabushka flat tax, no refunds would be given when a business' start-up costs exceed its income, but the losses could be carried forward indefinitely and a market rate of interest would be paid on them by the government. End-of-year purchases of inventory also could reduce taxes and create refund carryover situations. The tax agency would have the burden of administering these carryover credits.

The Hall-Rabushka model is an origin-based tax, which taxes only a business' domestic operations and provides no border adjustments for exports as is done now with VATs. While this does not address the concerns of major exporters who wish to recover their export taxes, it relieves the tax agency from administering border adjustments, a cost saving to the administrator. (See app. VI for a discussion of administering border adjustments with a VAT.)

Flat Tax Compliance Costs

A flat tax requiring both businesses and individuals to file returns would not have as great an impact on alleviating the compliance burden as would a tax, such as a VAT, which requires only businesses to comply. If all

individuals were required to file, if only to establish personal deductions for tax exemption, a certain amount of compliance burden would be continued. Nevertheless, a flat tax, unencumbered by exemptions and multiple rates, by virtue of its simplicity would offer the possibility of substantial reduction from the current income tax in compliance burden for both individuals and businesses—some of which might also be possible with simplification of the current tax.

No reliable data exist with which to evaluate with any precision the compliance burden of a potential flat tax. Slemrod estimated the compliance costs overall at about half of his rough estimate for the current system—cutting business compliance costs by about one-third and personal compliance costs by 70 percent.⁹ Hall estimated a lower cost than Slemrod, using the model developed for IRS, which had the limitations described in appendix II.¹⁰

The treatment of fringe benefits—whether or not a business or individual has to determine the value of fringe benefits in order to pay tax on them—would affect the degree of simplicity and costs of compliance with a flat tax. Another concern that would influence compliance costs is the type of transition, if any, from an income tax to a flat tax. While individuals might not be affected by double taxation of existing savings, which could occur with some consumption taxes, a transition period might be needed to shelter existing capital assets of businesses. If there were a transition period, many businesses could find themselves complying with both a new flat tax and the remaining elements of the existing income tax.

Potential Impact on Tax Administrators

A summary of some of the potential impacts of a flat tax on tax administrators is shown in table VII.4 and elaborated on afterward.

⁹See Joel Slemrod, "Which Is the Simplest Tax System of Them All?" in Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (Washington, D.C.: Brookings Institution Press, 1996), pp. 374-75.

¹⁰See Arthur P. Hall, "Compliance Costs of Alternative Tax Systems," *Tax Notes*, Vol. 71, No. 8 (May 20, 1996), pp. 1088-89.

**Appendix VII
Flat Tax**

Table VII.4: Summary of Some Key Potential Impacts of a Flat Tax on Tax Administrators

Item	Current income tax	Flat tax
Impact on number of returns processed	Hundreds of millions of returns and other materials received	Returns simplified; assuming withholding still required, number of tax returns possibly almost the same, but number of information returns needed much lower because interest and dividends not taxed
Impact on refund processing	92 million refunds issued in fiscal year 1995	Refunds for excess payment required for individuals; verification needed
Impact on examination approach	Tax returns matched with information returns; fiscal year 1995 examination coverage at 1.36 percent, with corporate audits taking longer than individuals' audits	Verifying individuals' taxes simplified, but auditing business' own records still needed
Continuation of old compliance problems	Compliance problems related to income definition, unreported income, and more specific issues identified in other areas such as transfer pricing, depreciation, deductibility of business expenses, small businesses, independent contractors, and the underground economy	Compliance problems with transfer pricing, business and personal expense distinctions, independent contractors, small businesses, unreported income, and underground economy continued
Resolution of old compliance problems	Not applicable	Compliance problems with depreciation and related to income definition eliminated
Creation of new compliance problems	Not applicable	Tax avoidance encouraged for employees paid in ways other than cash and sales characterized as interest received; possible fringe benefits audits complicated
Impact on collections from tax delinquents	Millions of taxpayer delinquent investigations and accounts disposed of, with most of the latter being for individuals and most business dispositions covering employment taxes	Need for collection follow-up for individual taxpayers reduced by less information matching and elimination of audit issues; small business problems possibly mirroring current employment tax collection problems
Impact on individuals' questions received	Millions of taxpayer inquiries fielded, covering a wide variety of questions	Some types of taxpayer questions eliminated when income and deduction items eliminated

Source: GAO analysis of available information about the Hall-Rabushka flat tax.

Processing of Returns

With a flat tax, a tax agency might process almost the same number of tax returns as the 122 million in the current system (in 1995), since both individuals and businesses would continue to file returns and remit taxes; however, the level of personal allowances and deductions available could affect that number considerably. Filing and remittance schedules could mirror the present system, with filing required annually and remittance at intervals, depending on the type of taxpayer and amount of tax to be remitted. Forms, such as W-2s submitted by businesses for each employee, would require processing and document matching. However, the information now reported on Form 1099 would not be needed by the tax agency because savings and investment earnings would not be taxed.

Eliminating the many deductions now itemized by some taxpayers simplifies the return so that individual taxpayers would only submit a form with about 12 lines, and businesses only 10 lines. Return processing should be simpler as a result. Any variations from the Hall-Rabushka flat tax design, by introducing other deductions or credits, could complicate the administration of the tax.

The large numbers of taxpayers and returns would require retaining the current emphasis on such uses of automation as scanning and electronic filing. The much simpler form would seem to facilitate automation of data entry and document matching, making the process less error-prone and costly and providing timely data for auditors. As with other tax proposals, the status of IRS' Tax Systems Modernization at the time of the inception of a new tax would be critical for its administration. Hall and Rabushka do not suggest exempting small businesses from tax, as is done in some countries' VAT systems to alleviate taxpayer and tax agency burden. Claims for credits might not be a significant processing item, but as discussed above, other types of refunds or credits might be claimed by both individuals and businesses.

Audit/Examination

Given the current success in collecting taxes through withholding, tax avoidance would seem to be difficult for individual wage earners whose companies reported earnings and taxes withheld, thus performing a compliance function the government would have to do otherwise. The personal allowances and dependent deductions would seem to have less room for cheating if Social Security numbers were required for claiming dependents, as is done now with the income tax. Auditing could get complicated, however, depending on the extent that the system was

circumvented by paying employees in ways other than cash or by transforming payments into savings or investments.

Verification of businesses' records of sales and purchases and their payments to employees probably would be the largest component of a tax agency's audit effort. As in the current system, these records are kept by the businesses themselves, and the opportunity for erroneous reporting is present. Checking for such things as underreported sales or overreported purchases can be time-consuming and difficult for a tax agency to audit. As the 1995 study published by the American Institute of Certified Public Accountants pointed out, claims of business expenses (deductible) may be difficult to separate from personal expenses (nondeductible), similar to the current situation.¹¹ Validity of these expense claims has been one of IRS' ongoing audit and post-audit problems and probably would not be improved with a flat tax. Depending on the prevailing tax rate, such problems could be exacerbated. For self-employed individuals, the self-reporting of earnings could be problematic. Reporting by sole proprietors has been shown to be particularly troublesome in the current system.

A scoring system, such as IRS has now for identifying which returns to audit by looking at audit potential, would probably have to be developed for a flat tax. Since no country has tried a flat tax similar to the Hall-Rabushka model, the United States has no other experience to rely upon beyond the current income tax system, and it could take some time to fully develop a scoring system.

From a tax administration viewpoint, any complications through multiple rates or further deductions to address regressivity or other concerns are likely to be costly and very difficult to administer with a flat tax, similar to a subtraction VAT, which we previously said would not function properly with multiple rates.¹² Excluding individuals with incomes below specified levels from paying taxes, receiving refunds, and filing returns alleviates taxpayer burdens and reduces the number of returns to be processed; however, tax administrators may still need to verify claims for exclusion. Conversely, if any programs such as the earned income credit were administered, they might be delivered to low-income recipients through the tax system, as is done here and internationally through income tax

¹¹Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (New York: American Institute of Certified Public Accountants, Dec. 1995), p. 111.

¹²See *Tax Policy: Tax-Credit and Subtraction Methods of Calculating a Value-Added Tax* (GAO/GGD-89-87, June 20, 1989), p. 5.

systems, increasing the number and complexity of returns filed as well as the cost of administration. Similarly, small businesses might be excluded from a flat tax, as is done with international consumption taxes, but administratively, ascertaining the validity of a business' claim for exemption could be very difficult, similar to a subtraction VAT. None of these variations is in the Hall-Rabushka tax design.

Enforcement efforts probably would still need to emphasize many of the current areas of noncompliance. There is no credit/invoice system, such as exists with a credit VAT, to give at least an appearance of automatic enforcement. Issues of noncompliance, such as with sole proprietors/independent contractors, now troublesome to IRS, would not likely change much with a flat tax, and there is nothing apparent in this tax system that would solve the current problems with underreported or unreported income, particularly of small businesses. Abusive transfer pricing, long an enforcement concern for IRS, also would continue to be a problem with the flat tax, as Grubert and Newlon have noted.¹³ Abusive transfer pricing occurs when prices claimed for transactions between related companies operating in different jurisdictions are set too high or too low, and income is, in effect, shifted from one jurisdiction to another, resulting in tax underremittance.

New noncompliance problems could arise, similar to those found in other consumption tax situations. For example, as alluded to in the 1996 Economic Report of the President, an incentive would exist for businesses to characterize part of their sales as interest payments payable by buyers by reducing the sales price (taxable) and offsetting this by raising the interest paid (nontaxable to the businesses). Shifting sales to interest payments would give the business a tax advantage, and detecting this through enforcement efforts could be difficult.

An underground economy would seem to be able to operate in much the same way with a flat tax as with the current system, because no obvious deterrent would seem to be available to prevent both legal and illegal transactions from occurring outside the tax system. It is difficult to determine the impact any consumption tax would have on the underground economy.

¹³Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal*, Vol. XLVIII, No. 4 (Dec. 1995), p. 637.

Credits/Refunds

With a flat tax, as with VATS, new businesses could have purchases and employee compensation costs exceeding sales. This could put the new business into a negative cash flow situation, potentially detrimental to the business' future. Not only would the business need to be able to claim a refund, but, as we assumed in an earlier study, it would also likely prefer the refund to be in cash, rather than as a carry-forward credit as specified by Hall and Rabushka.¹⁴ If, contrary to Hall and Rabushka, refunds were allowed, a tax agency would need to have a system that could rebate the money quickly without jeopardizing government funds.

Unlike VATS used internationally, the flat tax as outlined by Hall and Rabushka would not include border adjustments to tax imports and rebate taxes on exports. This would eliminate a potentially difficult administrative responsibility, including identifying fraudulent claims of exports that we pointed out in our 1993 VAT study.¹⁵ However, transfer pricing, mentioned above as a large audit issue in the current system, would remain.

Collections

Collection efforts might change somewhat with a flat tax. If information reports of earnings from savings and investments (Forms 1099) were no longer necessary and if audit issues associated with capital gains and itemized deductions disappeared, matches with taxpayer data and related audit issues and findings should also decline. This, in turn, would affect the need for collection follow-up with individuals, where most of the collection issues have arisen.

Taxpayer Services

As with any new system, taxpayer services would require an initial education period, with additional resources required for publications, assistance through telephones and other telecommunications, and taxpayer education programs. The individual component of the flat tax, however, would appear to be simple enough in many ways so that taxpayers could have less difficulty understanding it than the current income tax. Entire areas of questions, such as those for capital gains and losses and medical expenses, might virtually disappear, although others, such as those for dependents and filing status, would likely continue.

¹⁴See Tax Policy: Value-Added Tax: Administrative Costs Vary With Complexity and Number of Businesses (GAO/GGD-93-78, May 3, 1993), p. 115.

¹⁵See GAO/GGD-93-78, pp. 33 and 57.

Information about IRS' current taxpayer services effort, discussed in appendix II, shows that about 10 percent of the tax law questions received by IRS' technical support staff concerned the dependent or exemption or filing status of taxpayers. Many of these questions would likely continue with the flat tax. Some frequent stumbling blocks, such as inquiries about capital gains and losses, could be eliminated by the flat tax.

The business part of the tax could require initial education effort and auditor time for some period to ensure maximum clarity and, hopefully, compliance. Education is thought by many to be the key to compliance, and efforts along these lines should not be undervalued for any tax change.

The transition to a flat tax likely would require taxpayer education because a flat tax would change the way such things as capital investment would be treated—that is, by expensing on a current basis rather than depreciating over a longer period. If the transition occurred while features of the income tax were still operative, taxpayers might have to comply with both systems for a period of time and likely would require more extensive taxpayer education and services.

Other Issues

Transition

The familiarity of taxpayers with the current tax system should ease a transition to a flat tax if a transition were desired. Nevertheless, accounting and reporting requirements with a flat tax would require time for businesses to convert to the new system. Furthermore, some portions of the current system might be continued during a transition period. For example, businesses that under the current system had been depreciating their capital expenditures would be subject to immediate expensing with a flat tax. However, the negative ramifications of this might be offset by continuing to depreciate assets during a transition period, making the transition more difficult and lengthy for the business taxpayer and complicating auditing and collections for the tax administrator. A transition to a flat tax also could be designed to continue carrying forward existing net operating losses, and existing tax credits could be phased out during a transition period. Even though earnings from savings are not taxed with a flat tax, moving to a consumption tax could result in some individuals' preenactment savings being taxed when earned (as income),

and also when spent (as consumption) under the flat tax unless some special provisions were designed for this. Such adjustments could occur during transition.

The tax agency would need some time and resources for educating the public about the changes, particularly for business taxpayers. If, as proposed, wages and pensions were generally the only items taxed to individuals, transition for individuals would be much simplified. Overall, the flat tax, with one rate and no exemptions, would seem to be less cumbersome to introduce than would a more complicated tax system.

Federal/State Issues

Because a flat tax would operate much like the current tax system, it probably would cause fewer areas of uncertainty than a more drastic change to a transaction tax, such as a credit VAT, discussed in appendix VI, or a national RST, discussed in appendix V. However, the base of the individual tax, with only wages and pensions, would affect the amount of collections in states that based their taxes on the current broad base of the federal system unless they adjusted their rates to compensate for the loss. States could devise ways to accommodate the new system, such as by adjusting their income tax base to conform with the flat tax and raising the rate to compensate for the narrower base.

International Issues

In Hall and Rabushka's opinion, the flat tax would be desirable because their proposed "low" tax rate of 19 percent would attract international businesses, even though overseas earnings of American workers and businesses would not be taxed.¹⁶ Although Hall and Rabushka would not tax the foreign earnings of Americans, all earnings from work in the United States would be taxed, regardless of the worker's citizenship.

The flat tax, as envisioned by Hall and Rabushka, uses the origin principle for international taxation, rather than the destination principle now used widely with VATs. Under the origin principle, imports are exempt from taxes and exports are taxable; thus, transfer pricing problems would continue. However, problems administering the foreign tax credit would disappear. The future of U.S. bilateral income tax treaties would be unclear, and other countries might consider changing their own international taxation rules.

¹⁶Hall and Rabushka, p. 77.

Personal Consumption Tax

Description

Of the proposals that would replace the income tax with a consumption tax, a personal consumption tax would look most like the current personal income tax. In general, under a personal consumption tax, taxpayers add up all the funds they have received during the year and then deduct the amount they saved. The remaining amount is a measure of the taxpayer's spending on goods and services for consumption over the year, and this amount is subject to tax.

Table VIII.1 shows some of the principal similarities and differences between a personal consumption tax and the current individual income tax. The most basic similarity is that both are individual taxes, so both can include features such as a standard deduction, personal exemptions, and graduated tax rates. The two taxes are also similar in that many types of income now included under the current tax would also be included in the personal consumption tax base. In particular, wages, pension income, and interest and dividend income would be taxed under a personal consumption tax.¹

¹For additional details on personal consumption taxes, see U.S. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Ch. 9, "Consumed Income Tax," Vol. I (1984); David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2nd ed., revised (Arlington, Va.: Tax Analysts, 1984); The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (London: George Allen and Unwin, 1978); Henry J. Aaron and Harvey Galper, *Assessing Tax Reform* (Washington, D.C.: The Brookings Institution, 1985); David F. Bradford, *Untangling the Income Tax*, Ch. 5, "Personal Consumption Taxes" (Cambridge, Mass.: Harvard University Press, 1986); and Michael J. Graetz, "Expenditure Tax Design," in Joseph A. Pechman, ed., *What Should Be Taxed: Income or Expenditure?* (Washington, D.C.: The Brookings Institution, 1980).

**Appendix VIII
Personal Consumption Tax**

Table VIII.1: Comparison of the Current Income Tax With a Personal Consumption Tax

Item	Current income tax	Personal consumption tax
Personal level		
Wages	Included	Included
Interest income received	Included	Included
Dividends received	Included	Included
Pension income	Included when received	Included when received
Loan proceeds	Not included	Included
Sales of assets	Capital gain included	Proceeds included
New saving (purchases of assets, deposits in qualified accounts, loan repayments)	Generally not deducted	Deducted
Job expenses (cost of earning income)	Certain costs deducted by itemizers	Deducted
Fringe benefits	Not included	Allocated to individuals by business (if no separate business tax)

Source: GAO analysis of a personal consumption tax.

The major difference between the two taxes lies in the treatment of saving. Under the current income tax, saving is generally not deductible, and borrowed funds are not taxed. Under a personal consumption tax, new saving would generally be deductible. For example, amounts deposited in savings accounts or used to purchase corporate stock or bonds could be deducted. In addition, the repayment of principal and the payment of interest on borrowed funds would be deductible as saving. However, under most personal consumption tax proposals, borrowed funds would be taxable because they could be used for consumption. Similarly, upon the sale of an asset, the entire proceeds of the sale would be taxable rather than the gain (or loss) from the sale as under an income tax.

Business purchases of consumer goods and services could pose problems for a personal consumption tax, as they do under an income tax.² For example, business purchases of automobiles, meals, entertainment, and fringe benefits could represent consumption by the employees or owners of the business and not really represent a cost of operating a business. Without some rules, there would be an incentive for businesses to purchase these kinds of goods and services for their owners and employees in order to avoid tax under the personal consumption tax.

²See Aaron and Galper, p. 79.

This potential problem could be handled in two ways. First, businesses could be required to allocate spending on such consumption items to the individuals receiving the benefits, and the individuals could report this amount on their consumption tax returns. The tax rate applied to this form of consumption would then depend on the individual's tax bracket. This type of tax treatment is reflected in the last line of table VIII.1 for fringe benefits.

Alternatively, all businesses could be made subject to a cash flow tax for which consumption-type expenditures would not be deductible.³ Under a cash flow tax, inflows of cash would generally be taxable and outflows of cash would generally be deductible. Inflows would include business receipts, proceeds of sales of assets, and borrowing. As under a consumption value-added tax (VAT), business purchases of goods and services used for business purposes would be deductible, and purchases of investment goods, such as plant and equipment, would be deductible immediately rather than depreciated over time. In addition, wages, dividends, and payments for interest and repayment of borrowed funds would also be deductible. However, business purchases of consumption goods without a business purpose would not be deductible, so consumption done at the business level would effectively be taxed at the business' tax rate.⁴

Table VIII.2 compares a personal consumption tax and business cash flow tax with the current income tax for both individuals and businesses. As under the personal consumption tax, and unlike an income tax, the cash flow tax would include borrowed funds and all the proceeds from asset sales rather than only capital gain or loss. Like the VAT and flat tax, and unlike an income tax, the purchase of investment goods would be deductible immediately rather than depreciated over time.

³For noncorporate businesses, the business cash flow tax rules could be reflected in the individual tax return. For example, sole proprietorships could include the receipts and expenditures of the business in their personal return, much like sole proprietors now report their income on Schedule C of their personal income tax return. Alternatively, the business tax could be kept separate from the individual tax. All businesses (corporate and noncorporate) would pay a cash flow tax and file separate returns, as under the flat tax.

⁴A business cash flow tax could serve several additional purposes. First, if transition rules are desired in converting to a consumption tax, the business-level cash flow tax could allow businesses to claim currently unused tax credits and deduct depreciation on existing assets and net operating losses. Second, the tax would tax extraordinary returns to investment. Third, the tax could be used to tax U.S.-source activity of foreign corporations operating in the United States.

**Appendix VIII
Personal Consumption Tax**

Table VIII.2: Comparison of the Current Income Tax With a Personal Consumption Tax and Business Cash Flow Tax System

Item	Current income tax	Personal consumption tax and business cash flow tax
Business level		
Sales of goods and services	Included	Included
Sales of assets	Gain included	Proceeds included
Loan proceeds	Not included	Included
Purchases of goods and services	Deducted	Deducted
Purchase of capital goods	Depreciated over time	Deducted immediately
Wages paid	Deducted	Deducted
Fringe benefits	Deducted	Not deducted
Interest paid	Deducted	Deducted
Dividends paid	Not deducted	Not deducted ^a
Personal level		
Wages	Included	Included
Interest income received	Included	Included
Dividends received	Included	Included
Pension income	Included when received	Included when received
Loan proceeds	Not included	Included
Sales of assets	Capital gain included	Proceeds included
New saving (purchases of assets, deposits in qualified accounts, loan repayments)	Generally not deducted	Deducted
Job expenses (cost of earning income)	Certain costs deducted by itemizers	Deducted
Fringe benefits	Not included	Not included

^aAlternatively, the business cash flow tax could include proceeds from new stock issues and allow a deduction for dividends paid.

Source: GAO analysis of a personal consumption tax and business cash flow tax.

Potential Impact on Taxpayers' Compliance Burden

Table VIII.3 summarizes how a personal consumption/business cash flow tax could affect taxpayers, and a more detailed discussion follows.

**Appendix VIII
Personal Consumption Tax**

Table VIII.3: Summary of Some Key Potential Impacts of a Personal Consumption and Business Cash Flow Tax on Taxpayers

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of the personal consumption and business cash flow tax on taxpayers
	Burden on individual taxpayers	Impact on individual taxpayers
Return filing	116 million returns filed in 1995	Number of returns possibly increased with borrowing included in the tax base
Records kept	Records supporting tax returns supposed to be kept—e.g., receipts, proof of payment, and documentation supporting deductions and credits; burden alleviated by information reports given to individuals	Additional records needed on amounts borrowed and amounts saved
Calculations made	Complicated calculations for some taxpayers included for provisions such as dependency tests and capital gains	Calculations of capital gains eliminated
Complexity faced	Many pages of instructions involved and millions of supplemental forms and schedules filed—e.g., 33 million schedules of itemized deductions for tax year 1994; difficulties existing in defining and recognizing income; however, in actual practice, minimal complexity faced by millions of individuals	New rules required for saving deduction and inclusion of borrowing; measurement of capital income simplified
	Burden on business taxpayers	Impact on business taxpayers
Return filing	24 million returns filed in 1995	Similar number of returns, filing frequency the same
Records kept	Records supporting income and expenses supposed to be kept	Accrual accounting and depreciation records eliminated for tax purposes; additional records needed for borrowing and lending
Calculations made	Complicated calculations included for provisions such as depreciation, the alternative minimum tax, and the foreign tax credit	Accrual accounting and depreciation calculations eliminated for tax purposes

(continued)

Burden	Characteristics of taxpayer compliance burden under the current income tax	Impact of the personal consumption and business cash flow tax on taxpayers
Complexity faced	Detailed rules involved; complexity reflected in areas such as depreciation, the alternative minimum tax, and the foreign tax credit; difficulties existing in defining and recognizing income	Accrual accounting and depreciation eliminated for tax purposes; alternative minimum tax and foreign tax credit eliminated
Requirement to furnish information returns	1.1 billion information and withholding documents filed	Reporting possibly more extensive

Source: GAO analysis of available information about a personal consumption and business cash flow tax.

Filing Requirements

Under the current income tax system, filing requirements are reflected in rules regarding filing status, the size of the standard deduction, and personal exemptions. The number of returns filed depends on these rules and the extent of withholding. Currently, taxpayers file returns based on their filing status, which can be single; head of household; married, filing jointly; married, filing separately; or qualifying widow(er) with dependent child. Taxpayers are not required to file a return if they received less gross income than the applicable standard deduction amount plus the value of the minimum number of allowed personal exemptions. However, taxpayers with less income than these thresholds may still file a return to claim a refund if taxes have been withheld during the year or if they are eligible for a refundable credit such as the earned income tax credit.

Filing requirements for individual taxpayers under a personal consumption tax could be very similar to current requirements. For example, the rules regarding filing status could remain the same as under current law. Similarly, taxpayers reporting less consumption (or gross income) than the standard deduction and the value of personal exemptions could be excused from annual filing. In general, the larger the standard deduction and value of personal exemptions, the greater the number of taxpayers who could arrange to have no tax withheld and would therefore not need to file. However, taxpayers who would not otherwise have to file could still find it advantageous to file if a refundable credit program like the earned income credit was retained.

Apart from possible changes in the size of the standard deduction or personal exemptions, a change in the tax base from income to consumption could have an effect on the number of taxpayers filing returns unless changes in withholding were also made. For taxpayers with primarily wage income who do little saving or borrowing, the likelihood that they would have to file and the size of any remaining tax payment or refund might not be very different than under the current system. However, as the Department of the Treasury pointed out in its 1984 report on tax reform, for taxpayers who sold assets or borrowed funds for consumption, withholding tax on wages alone might not match their annual tax liability as closely as under the current system.⁵ Unless taxpayers adjusted the amount of tax withheld, they might be more likely to have to file returns or pay estimated taxes during the year. Other taxpayers who saved significant portions of their wage income could be entitled to relatively large refunds and therefore might have to file. This situation could be addressed by extending withholding to asset sales and borrowing, but this approach would put additional burden on the businesses that would have to withhold tax.

**Recordkeeping
Requirements**

Moving from the current income tax to a personal consumption tax could lead to additional recordkeeping requirements for some financial assets, reduce some requirements to maintain records over time, and leave recordkeeping requirements for certain deductions essentially unchanged. Moving to a business cash flow tax could substantially change how businesses keep records for tax purposes.

Financial Assets and Liabilities

Many analysts believe that individual taxpayers would have to keep more records under a personal consumption tax than under the current system.⁶ Unless information reporting was expanded, taxpayers would need to keep records on amounts borrowed and saved during the year. Taxpayers do not have to keep records for these items under the current system.

Some discussions of potential personal consumption taxes have suggested that for compliance reasons, only saving done through qualified accounts

⁵Treasury, pp. 202-03.

⁶See Treasury, p. 201; Harvey S. Rosen, *Public Finance*, 3rd. ed., Ch. 20, "Taxes on Consumption and Wealth" (Burr Ridge, Ill.: Irwin, 1992), p. 509; and Charles E. McLure, Jr., and George R. Zodrow, "Administrative Advantages of the Individual Tax Prepayment Approach to the Direct Taxation of Consumption," in Manfred Rose, ed., *Heidelberg Congress on Taxing Consumption* (June 28-30, 1989), p. 347.

in financial institutions should qualify for deductions.⁷ Qualified accounts would be similar to IRA accounts under current law. Other forms of saving, such as direct loans to other individuals, would not be deductible, but repayments of such saving would not be taxed. If this approach was used, individuals might be required to keep separate records on qualified and nonqualified assets and liabilities.

However, as Treasury noted in 1984, the need for taxpayers to keep some records for long periods may decrease.⁸ Under current law, individuals must keep records on the original purchase price of assets in order to calculate capital gains tax when assets are sold. Under a consumption tax, the original purchase price of an asset is irrelevant for tax calculations because all sale proceeds are subject to tax, so records related to the original purchase would not have to be kept.

Housing

One of the more difficult issues for consumption taxation is the taxation of consumer durable goods.⁹ These goods can serve both as consumption goods and as a form of saving. A significant example of this type of good is owner-occupied housing, which generates consumption services for the owner and is a major investment for many individuals. If housing was treated like other saving or investment under a personal consumption tax, the purchase of the house would be deductible as saving and the income from the investment would then be taxable. In the case of owner-occupied housing, the income from the investment is the value of the consumption services received by the owner—the amount the owner would pay to rent the house. However, since there is no rent transaction for owner-occupied housing, a value would have to be imputed either through appraisals or through some approximation method.¹⁰ Allowing a deduction for the purchase of housing and ignoring the rental value of housing would undertax owner-occupied housing relative to rental housing and other forms of consumption.¹¹

Most discussions of personal consumption taxes have supported a “tax prepayment” treatment for owner-occupied housing, or a modified version

⁷Treasury, p. 194.

⁸Treasury, p. 196.

⁹See Graetz, p. 184 and Rosen, p. 506.

¹⁰The same difficulty in taxing the return from owner-occupied housing arises in the income tax. (See app. IV.)

¹¹See Aaron and Galper, pp. 90-91.

of this approach.¹² Under the tax prepayment approach, consumption tax would be paid when the house is purchased because the amount borrowed for the mortgage and the funds withdrawn from accounts for a down payment would be taxable. The imputed rental value of the housing services would not be taxed, and only the capital gain rather than the entire sale price of the house would be taxable if the house was sold. While this approach may be easier to administer than taxing imputed rent, it would require a large one-time tax payment. A modification of this approach would levy tax only on the down payment, but not allow a deduction for repayment of mortgage principal or interest, reducing the one-time tax payment. However, this modification would treat mortgage debt and interest payments differently than other debt and interest, and rules to define different types of debt would be necessary, as under current law.

Before 1997 changes to the income tax, more homeowners than afterward were required to keep records on their purchases and sales of homes over their lifetime in order to calculate any capital gains tax they may have had upon sale. Recordkeeping requirements under a personal consumption tax would depend on the approach taken. If the modification of the prepayment approach was chosen, recordkeeping requirements for owner-occupied housing could be similar to those in effect before the recent changes in the law.

Job and Business Expenses

Some items that currently require detailed taxpayer recordkeeping would remain issues because they concern determining whether certain expenditures are legitimate business expenses or personal consumption. For example, deductions for job expenses, business entertainment expenses, moving expenses, and business use of automobiles would likely remain issues under a personal consumption tax.

Cash Flow Business Tax

Like some of the other consumption tax proposals, a cash flow tax might simplify recordkeeping for business taxpayers. For example, businesses would not have to keep records according to accrual accounting principles for tax purposes. Like other purchases of goods and services, investments in business plant and equipment or inventories would be deducted immediately, rather than depreciated over time or deducted when sold as under the income tax. Thus, taxpayers would not have to distinguish between expenditures that can be deducted immediately and those that must be capitalized and depreciated over time. However, businesses

¹²See Graetz, pp. 193-97; Aaron and Galper, pp. 90-91; and Laurence S. Seidman, "The USA Tax: A Friendly Critique of Its Design," *Tax Notes*, Vol. 73, No. 7 (Nov. 18, 1996), pp. 834-37 for discussions of this treatment.

would probably still calculate depreciation on capital assets for financial statements and other business purposes.

However, unlike the VAT or the business tax component of the flat tax, a cash flow tax would include financial transactions in the base of the tax. Borrowed funds would be included and repayments of loans and interest would be deductible. A VAT would be simpler than a cash flow tax in this sense because fewer transactions would have to be accounted for in computing tax liability. However, to accomplish this simplification, rules would have to be written to differentiate purely financial transactions from the sale of goods and services.¹³ A cash flow tax would include more transactions in its base but not require such rules.

Calculations Needed to Compute Tax Liability

While, as mentioned above, the need for recordkeeping may expand in some areas under a personal consumption tax, the need for taxpayers to do calculations may decrease in others. For example, although the need to compute net savings would be introduced, calculating capital gain or loss from the sale of an asset would no longer be necessary. Taxpayers who sell assets would have to keep records on the proceeds of the sale, but all the proceeds of the sale would be taxable, not only capital gain or loss.

More generally, businesses and individuals would not have to differentiate between the return of capital (original amounts invested or saved) and the return on capital (income earned from saving or investment). Under an income tax, the return of capital is not taxed, but the income earned from capital is taxed. Under a consumption tax, this distinction is not necessary because saving and investment is deducted immediately and both the return of capital and the return on capital are subject to tax.

One area in which a personal consumption tax would be simpler than a reformed income tax involves the need to make adjustments for inflation. Many analysts believe that inflation adjustments should be made in the income tax because the measurement of income can be significantly distorted when inflation is high. The current income tax does not have such adjustments explicitly and requiring them might significantly complicate the income tax. In contrast, a personal consumption tax would not need to include inflation adjustments.¹⁴ Therefore, consumption tax

¹³Transactions involving interest payments, installment sales, and leases can feature both an exchange of goods and services and borrowing and lending funds between the parties.

¹⁴See McLure and Zodrow, pp. 344-45 and Treasury, p. 197.

proponents argue that relative to an income tax that measures income correctly, the consumption tax would require far fewer calculations.

Potential Impact on Tax Administrators

Table VIII.4 summarizes some of the ways in which a personal consumption and business cash flow tax could affect tax administrators, and a more detailed discussion follows.

Table VIII.4: Summary of Some Key Potential Impacts of a Personal Consumption and Business Cash Flow Tax on Tax Administrators

Item	Current income tax	Personal consumption and business cash flow tax
Impact on number of returns processed	Hundreds of millions of returns and other materials received	Possibly more individual, information returns
Impact on refund processing	92 million refunds issued in fiscal year 1995	If withholding done only on wages, savers more likely to get refunds, borrowers less likely to get refunds
Impact on examination approach	Tax returns matched with information returns; fiscal year 1995 examination coverage at 1.36 percent, with corporate audits taking longer than individuals' audits	Potentially expanded matching of tax returns with information returns; auditing cash flow calculations possibly easier than auditing accrued income; more focus on identifying unreported income
Continuation of old compliance problems	Compliance problems related to income definition, unreported income, and more specific issues identified in areas such as transfer pricing, depreciation, deductibility of business expenses, small businesses, independent contractors, and the underground economy	Compliance problems continued with certain business expenses, unreported income or receipts
Resolution of old compliance problems	Not applicable	Disputes concerning deduction or capitalization of business purchases eliminated, identification of nonfilers improved if expanded information reporting
Creation of new compliance problems	Not applicable	Increased incentive to not report asset sales, incentives created to not report borrowing and to overstate amounts saved

(continued)

**Appendix VIII
Personal Consumption Tax**

Item	Current income tax	Personal consumption and business cash flow tax
Impact on collections from tax delinquents	Millions of taxpayer delinquent investigations and accounts disposed of, with most of the latter being for individuals and most business dispositions covering employment taxes	More delinquent taxpayers possibly identified by more information reporting and matching
Impact on individuals' questions received	Millions of taxpayer inquiries fielded, covering a wide variety of questions	Most issues generating questions continued; new questions concerning deduction of saving and inclusion of borrowing likely; capital gains no longer relevant

Source: GAO analysis of available information about a personal consumption and business cash flow tax.

Processing of Returns

As under the current tax administration system, the tax agency would need to process returns from individuals and businesses under a personal consumption tax and business cash flow tax. Since individuals would continue to file returns, moving to all-electronic filing and processing would be more difficult than for a business-only tax. The other core tasks of returns processing, such as sorting returns, transcribing return information to taxpayer accounts, and maintaining those accounts, could remain the same as under the current system.

The number of information returns could increase because the tax base for a personal consumption tax includes many of the items now subject to information reporting and also includes some additional items. First, expanding information reporting to include loans may be necessary since loans would be included in the tax base. Second, funds that are saved would also generate a deduction, so it may also be useful for compliance reasons to require information reporting on amounts saved. However, additional information returns would add to the processing workload and would add to the compliance burden of the businesses completing and filing the returns.

Enforcement and Compliance

Unlike the VAT and the retail sales tax, little direct evidence on compliance with a personal consumption tax exists because neither the United States

nor any other country currently uses this tax. However, some relevant evidence does exist from experience with the current income tax because it shares many features with a personal consumption tax. For example, the proper reporting of sales of assets would be a major concern because the incentive to underreport sales is much less under the income tax than it would be under the personal consumption tax. Under the consumption tax, the entire proceeds of the sale would be subject to tax, not just the gain. In its 1984 review of a consumption tax, the Treasury Department (citing IRS estimates) reported that 40 percent of capital gains transactions were not reported.¹⁵

Because many types of income now subject to tax and information reporting would also be taxed under a personal consumption tax, information reporting and the matching of information returns with tax returns could continue to be a major activity for tax administration. To ensure sufficient compliance, information reporting could be expanded to include borrowed funds and amounts saved in qualified accounts. While information reporting would reduce the need to audit for underreported borrowing and overreported deductions for saving, an expansion in the number of information returns would clearly increase administration costs.

Such expanded information reporting might improve the identification of delinquent nonfilers. Self-employed individuals without interest or dividend income are less likely to be identified to IRS now through information returns, and therefore, information returns on borrowed funds and repayment of debt could identify these individuals. This could create more taxpayer delinquent accounts and investigations for the tax administrator, but it could also decrease the number of delinquent nonfilers and increase amounts collected from nonfilers.

The personal consumption tax and the business cash flow tax would offer some simplifications that would ease enforcement relative to the current tax. For example, (1) ascertaining whether repayment of debt is principal or interest, (2) determining whether business purchases of goods and services should be deductible or represent the acquisition of an asset that should be depreciated over time, or (3) determining the type of interest expense may not be necessary. As a result of these simplifications, audit focus under a personal consumption tax can concentrate on the underreporting of cash inflows and overstatement of deductions.

¹⁵See Treasury, p. 203.

As mentioned above, determining whether certain expenditures are legitimate business expenses or personal consumption would remain issues under a consumption tax. For example, deductions for job expenses, business entertainment expenses, moving expenses, and business use of a car would likely remain audit issues under a personal consumption tax.

Taxpayer Services

IRS data on the questions asked of an IRS official over the telephone are not detailed enough to show clearly how the taxpayer assistance workload would change if a personal consumption tax was adopted. However, the data that do exist indicate that about 17 percent of the workload may be affected by the change since these questions deal with income definition and calculation issues. Seventy-nine percent of the questions involve procedural questions, refunds, notices, and other account issues, and 4 percent concern filing information and filing status and rules for dependents and other exemptions. Questions concerning capital gains and pensions, representing 4 percent of the workload, might no longer be relevant. Individuals would likely have additional questions about the calculation of the deduction for net saving.

IRS has more detailed data from its Tele-tax telephone assistance service, which provides recorded telephone information on about 150 tax topics. While some topics would no longer be relevant if a consumption tax replaced the income tax, many of the questions asked now would still be relevant because they concern the mechanics of filing returns, IRS procedures, or the types of income that might still be difficult items under a consumption tax. For example, often-asked questions on (1) medical and dental expenses, (2) the earned income credit, (3) business entertainment expenses, (4) moving expenses, (5) child and dependent care credits, and (6) business use of automobiles all might still be issues under a personal consumption tax.

Several analyses of consumption taxes have pointed out that additional taxpayer education would probably be needed, especially concerning the inclusion of loans in the tax base and the deduction for saving.¹⁶ The inclusion of loans and the sales proceeds of assets in the tax base are very different from current practice, and taxpayers would probably have to be instructed to think in terms of consumption taxation rather than income taxation.

¹⁶See McLure and Zodrow, p. 347; Graetz, p. 183; and Treasury, p. 201.

Other Issues

Transition Issues

The transition from the current income tax to a personal consumption tax would likely raise difficult policy and administrative issues. For the personal consumption tax and business cash flow tax, issues would arise regarding the treatment of existing saving, capital gains, borrowing, and deductions for existing assets.

If a personal consumption tax was enacted without transition rules, any saving done before the switch would be taxed twice, once when funds were originally saved and again when they are used for consumption. For example, individuals who saved by depositing funds in bank or other accounts would pay consumption tax on all funds when they are withdrawn. Individuals who saved by purchasing stock or other assets and who sold the assets after the consumption tax was implemented would have to pay tax on all sale proceeds, rather than only the gain from the sale. Individuals who saved by lending funds to others or purchasing bonds would have to pay consumption tax on both principal and interest income paid to them by borrowers. If an income tax were retained, these savers would not have to pay income tax on the original amounts deposited, used to purchase assets, or lent. Thus, a consumption tax could be particularly burdensome for individuals who saved before the switch from the income tax to the consumption tax.¹⁷ In contrast, borrowers would be able to deduct repayments for many types of loans in full under the consumption tax; if the income tax was retained, they could not deduct repayments of principal and might not be able to deduct payments of interest.

If policymakers want to limit such windfall gains and losses, transition rules would have to be devised and administered so that saving done before the switch was treated as it would have been treated under the income tax. Under such rules, distinctions between the return to saving (taxed) and the return of saving (not taxed) would have to continue to be made. In addition, the forms of saving that are granted preferential tax treatment under the current tax (certain IRA accounts and pensions) would have to be separately tracked. All distributions from these accounts should be subject to tax because contributions were originally deducted. Similar

¹⁷As Treasury pointed out, taxpayers would have an incentive to attempt to avoid double taxation by selling assets and hoarding cash until the consumption tax became effective. To prevent this, a new system of money and foreign exchange controls might be necessary. See Treasury, pp. 210-11, for a discussion of transition problems and options.

distinctions for debt issued before and after the switch would have to be made, and administrators would have to be able to track assets shifted among different accounts.

Businesses with assets that have not been fully depreciated and with other unused tax deductions and credits could stand to lose substantially without transition rules. Since all businesses file returns under a cash flow tax, the tax could be used for transition. One option would be to allow businesses to continue to deduct depreciation on existing assets as they would have under the income tax. This would require the continuation of recordkeeping and auditing that is done currently. However, businesses would still face a windfall loss because the value of existing assets would fall relative to new assets, which could be deducted immediately. This situation creates incentives for the current owners of assets to sell; new owners could deduct the full cost immediately as new investment. Developing rules to prevent this and administering them could be difficult.

Another option would be to allow businesses to deduct the remaining value of their not fully depreciated assets immediately or over a few years. This type of transition would limit the incentive to sell assets and eliminate the need to keep depreciation records and audit this issue in the future. However, the revenue loss from this type of transition might be substantial. If tax rates have to be substantially higher to raise sufficient revenue, noncompliance might be increased in other areas.

Federal/State Issues

The states could follow the federal government and replace their income taxes with a personal consumption tax and a business cash flow tax. Such a state tax should be administrable because expanded information reporting required at the federal level could be relied upon by the states, and federal tax audits would cover similar issues. States would be free to choose a rate structure and add other features if they desired.

It would be difficult for states to stay with an income tax base without effectively imposing potentially large compliance burdens on businesses. Much of the simplification achieved by switching from the federal income tax to a cash flow tax would be negated if businesses continued to be required to compute income for state tax purposes. In addition, states would not be able to benefit from federal tax audits concerning capital income issues because of the change in the federal tax base.

International Issues

As an individual-based tax, the personal consumption tax would apply to U.S. residents or citizens. This would mean that foreigners “consuming” in the United States (tourists, for example) would not be taxed. The tax would probably be formulated to tax the consumption of U.S. residents wherever it takes place. Unlike a value-added tax or retail sales tax, individuals could be taxed on their consumption regardless of whether it is done domestically or overseas.

To do this, cash flows from abroad (income from investments and proceeds from asset sales) would be subject to tax, and funds saved or invested abroad would be deductible. In contrast to the current income tax, complex rules to account for income earned abroad but not repatriated (brought back to the United States) might not be as important if unrepatriated income could not be readily used for consumption. In such a system, foreign taxes would implicitly become deductible, and the foreign tax credit would be eliminated.¹⁸

For compliance purposes, tax administrators would need to be able to identify instances where borrowing was done abroad. Without such information, individuals who redeposited funds would be able to get a deduction for saving and might be able to deduct the repayment of the loan as well. Tax administrators would need information to ensure that either the proceeds of borrowing done abroad are included in the tax base or repayments of the foreign borrowing are not deducted.¹⁹

Some analysts have also stated that a wealth transfer tax would be needed for individuals who have accumulated assets in the United States but intend to emigrate.²⁰ Without such a tax, individuals could accumulate wealth tax-free in the United States and consume it tax-free abroad.

Unlike typical value-added taxes, a cash flow tax would not feature border tax adjustments. Sales of exports would be taxable like domestic sales, and business purchases of imports would be deductible. No border tax administration would be necessary.

¹⁸This discussion is based on James R. Hines, Jr., “Fundamental Tax Reform in an International Setting,” in Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (Washington, D.C.: The Brookings Institution, 1996), pp. 490-92.

¹⁹See Treasury, pp. 204-05.

²⁰See Treasury, p. 205; Aaron and Galper, p. 77; and Graetz, p. 253 for discussion of this tax need.

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