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BUSINESS TAX REFORM

Simplification and Increased Uniformity of Taxation Would Yield Benefits

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Comptroller General of the United States



Highlights of [GAO-06-1113T](#), a Testimony to the Committee on Finance, U.S. Senate

Why GAO Did This Study

Business income taxes, both corporate and noncorporate, are a significant portion of federal tax revenue. Businesses also play a crucial role in collecting taxes from individuals, through withholding and information reporting. However, the design of the current system of business taxation is widely seen as flawed. It distorts investment decisions, hurting the performance of the economy. Its complexity imposes planning and record keeping costs, facilitates tax shelters, and provides potential cover for those who want to cheat.

Not surprisingly, business tax reform is part of the debate about overall tax reform. The debate is occurring at a time when long-range projections show that, without a policy change, the gap between spending and revenues will widen.

This testimony reviews the nation's long term fiscal imbalance and what is wrong with the current system of business taxation and provides some principles that ought to guide the debate about business tax reform.

This statement is based on previously published GAO work and reviews of relevant literature.

www.gao.gov/cgi-bin/getrpt?GAO-06-1113T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

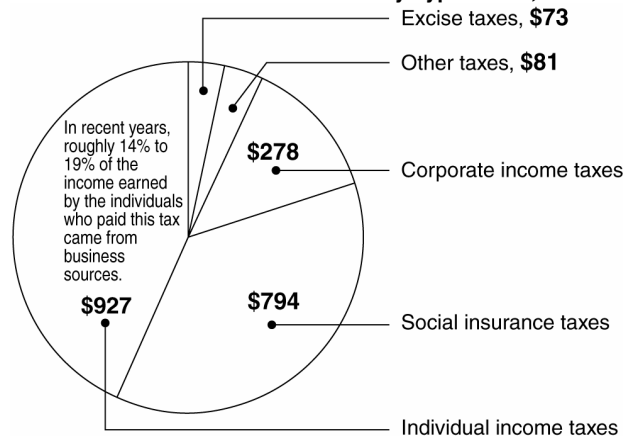
BUSINESS TAX REFORM

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What GAO Found

The size of business tax revenues makes them very relevant to any plan for addressing the nation's long-term fiscal imbalance. Reexamining both federal spending and revenues, including business tax policy and compliance must be part of a multipronged approach to address the imbalance.

Distribution of Federal Tax Revenue by Type of Tax, Fiscal Year 2005 (\$ billions)



Source: GAO analysis of data from the Office of Management and Budget and from Internal Revenue Service (IRS).

Some features of current business taxes channel investments into tax-favored activities and away from more productive activities and, thereby, reduce the economic well-being of all Americans. Complexity in business tax laws imposes costs of its own, facilitates tax shelters, and provides potential cover for those who want to cheat. IRS's latest estimates show a business tax gap of at least \$141 billion for 2001. This in turn undermines confidence in the fairness of our tax system—citizens' confidence that their friends, neighbors, and business competitors pay their fair share of taxes.

Principles that should guide the business tax reform debate include:

- The proposed system should raise sufficient revenue over time to fund our current and future expected expenditures.
- The tax base should be as broad as possible, which helps to minimize overall tax rates.
- The proposed system should improve compliance rates by reducing tax preferences and complexity and increasing transparency.
- To the extent other goals, such as equity and simplicity, allow, the tax system should aim for neutrality by not favoring some business activities over others. More neutral tax policy has the potential to enhance economic growth, increase productivity and improve the competitiveness of the U.S. economy in terms of standard of living.
- The consideration of transition rules must be an integral part of any reform proposal.

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to contribute to your consideration of business tax reform.

Businesses, both corporate and noncorporate, are a crucial pillar of our tax system. Corporate businesses paid \$278 billion in federal corporate income taxes in fiscal year 2005. In addition, between roughly 14 and 19 percent of the income of individuals who pay federal income tax comes from business sources.¹ Beyond paying income taxes, businesses are also responsible for remitting both the employer and employee shares of social insurance taxes, which amounted to \$794 billion in fiscal year 2005. Businesses are vital to our tax system in other ways too. They collect and remit a large fraction of individual income taxes through withholding. They report information about individuals' income and deductible expenses to the Internal Revenue Service (IRS). Such withholding and third-party information reporting greatly increases individual taxpayers' compliance while reducing the size and intrusiveness of IRS.

Taxes are necessary because they fund a broad array of essential services provided by the government. However, business taxes are part of our overall fiscal system that, as the committee is aware, is currently running large deficits and, as GAO's long-term budget simulations illustrate, is projected to run ever larger deficits in the future.

Beyond raising revenue, taxes affect business decision making, thereby affecting the performance of the economy. Taxes are only one factor affecting business decisions—others include input costs and market conditions—but they are a key factor controlled by policymakers. Making business decisions based on tax considerations, rather than on the underlying economic benefits results in the channeling of some investments into less productive activities. This, in turn, reduces the standard of living of all Americans.

Complexity in business tax laws imposes costs of its own, facilitates tax shelters, and provides cover for those who want to cheat. Although the precise amount of business tax avoidance is unknown, IRS's latest estimates show a business tax gap of at least \$141 billion for 2001. This in

¹See the explanation below for how these percentages were estimated and why we could not estimate them in terms of percent of taxed paid.

turn undermines confidence in the fairness of our tax system—citizens’ confidence that their friends, neighbors, and business competitors are paying their fair share of taxes.

Not surprisingly, there is a growing debate about reforming the tax system, including business taxes. The debate is partly about whether to reform the current income tax so that it has a broader base and lower rates or switch in whole or part to some form of a consumption tax. But it is also about other fundamental design issues such as whether to maintain different tax treatment for corporate and noncorporate business and the extent to which business’s foreign-source income should be taxed. The President’s Advisory Panel on Federal Tax Reform has taken a major step in beginning this debate. The panel suggested two alternative proposals for coordinated reform of the individual and corporate income taxes.

My statement reviews the nation’s long-term fiscal imbalance, describes what is wrong with our current system of business taxation, lists some of the major strategic choices we must make about how to tax businesses in the future, and then provides some principles that ought to guide the debate about business tax reform. These principles are based on three long-standing criteria typically used to evaluate tax policy—equity; economic efficiency; and a combination of simplicity, transparency, and administrability—which are discussed later.² The principles include the following:

- The proposed system should raise sufficient revenue over time to fund our current and future expected expenditures.
- The tax base should be as broad as possible, which generally helps to minimize tax rates, reduce complexity, lower compliance costs, lower economic efficiency costs per dollar of revenue raised, and which may improve equity.
- The proposed system should have attributes associated with high compliance rates—namely, taxable transactions that are transparent and few tax preferences or complex provisions.

²These criteria are also discussed at greater length in GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, [GAO-05-1009SP](#) (Washington, D.C.: September 2005).

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- To the extent that other objectives, such as equity and simplicity, allow, the tax system should aim for increased economic efficiency by remaining as neutral as possible in its other structural features; for example, avoiding differences in taxation based on legal form of organization, source of financing, or type of asset. More neutral tax policy has the potential to enhance economic growth, increase productivity and improve the competitiveness of the U.S. economy in terms of standard of living
 - Finally, the consideration of transition rules needs to be an integral part of the design of a new system.

My statement today is drawn from previous GAO reports and testimonies covering tax reform, alternative tax systems, and the costs of the current system, which were done in accordance with generally accepted government auditing standards, as well as reviews of relevant literature. The discussions in this statement that are not based on our own work reflect the consensus (and in some cases competing) views of economists as summarized in studies by the Joint Committee on Taxation, the Congressional Budget Office, the Congressional Research Service, the Department of Treasury, and the President's Advisory Panel on Federal Tax Reform. (See app. I for a list of relevant studies by GAO and these other sources.)

Background

Current Federal Taxation of Businesses

Most income derived from private sector business activity in the United States is subject to federal corporate income tax, the individual income tax, or both. The tax treatment that applies to a business depends on its legal form of organization. Firms that are organized under the tax code as "C" corporations (which include most large, publicly held corporations) have their profits taxed once at the entity level under the corporate income tax (on a form 1120) and then a second time under the individual income tax when profits are transferred to individual shareholders in the form of dividends or realized capital gains. Firms that are organized as "pass-through" entities, such as partnerships, limited liability companies, and "S" corporations are generally not taxed at the entity level; however, their net incomes are passed through each year and taxed in the hands of their partners or shareholders under the individual income tax (as part of

those taxpayers' form 1040 filing).³ Similarly, income from businesses that are owned by single individuals enters into the taxable incomes of those owners under the individual income tax and is not subject to a separate entity-level tax.

The base of the federal corporate income tax includes net income from business operations (receipts, minus the costs of purchased goods, labor, interest, and other expenses). It also includes net income that corporations earn in the form of interest, dividends, rent, royalties, and realized capital gains. The statutory rate of tax on net corporate income ranges from 15 to 35 percent, depending on the amount of income earned.⁴ The United States taxes the worldwide income of domestic corporations, regardless of where the income is earned, with a foreign tax credit for certain taxes paid to other countries. However, the timing of the tax liability depends on several factors, including whether the income is from a U.S. or foreign source and, if it is from a foreign source, whether it is earned through direct operations or through a subsidiary.

The base of the individual income tax covers business-source income paid to individuals, such as dividends, realized net capital gains on corporate equity, and income from self-employment. The statutory rates of tax on net taxable income range from 10 percent to 35 percent. Lower rates (generally 5 percent and 15 percent, depending on taxable income) apply to long-term capital gains and dividend income.⁵ Sole proprietors also pay both the employer and employee shares of social insurance taxes on their net business income. Generally, a U.S. citizen or resident pays tax on his or her worldwide income, including income derived from foreign-source

³Limited liability companies can elect to be taxed as C corporations, partnerships, or as "disregarded entities." Under the last option the company's income and expenses are simply attributed to its parent corporation.

⁴Also, marginal rates are higher over limited income ranges to recapture the benefits of the rates below 35 percent. In addition, present law imposes an alternative minimum tax (AMT) on corporations to the extent that their minimum tax liability exceeds their regular tax liability. In general, the AMT applies a lower tax rate to a broader tax base. Specifically, the regular tax base is increased for AMT purposes by adding back certain items treated as tax preferences and disallowing certain deductions and credits.

⁵Individuals may also pay tax under the alternative minimum tax (AMT). The base of this tax equals regular taxable income, plus the value of various tax items, including personal exemptions and certain itemized deductions that are added back into the base. This AMT income base is then reduced by a substantial exemption and then taxed at a rate of 26 percent or 28 percent, depending on the taxpayer's income level. Taxpayers compare their AMT tax liabilities to their regular tax liabilities and pay the greater of the two.

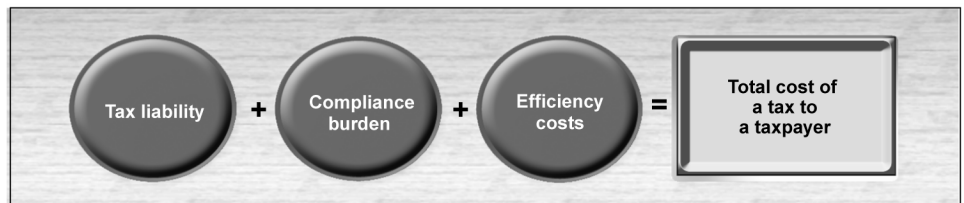
dividends and capital gains subject to a credit for foreign taxes paid on such income.

Criteria for Evaluating Business Tax Systems

Three long-standing criteria—economic efficiency, equity, and a combination of simplicity, transparency and administrability—are typically used to evaluate tax policy. These criteria are often in conflict with each other, and as a result, there are usually trade-offs to consider and people are likely to disagree about the relative importance of the criteria.

Specific aspects of business taxes can be evaluated in terms of how they support or detract from the efficiency, equity, simplicity, transparency, and administrability of the overall tax system. To the extent that a tax system is not simple and efficient, it imposes costs on taxpayers beyond the payments they make to the U.S. Treasury. As shown in figure 1, the total cost of any tax from a taxpayer's point of view is the sum of the tax liability, the cost of complying with the tax system, and the economic efficiency costs that the tax imposes. In deciding on the size of government, we balance the total cost of taxes with the benefits provided by government programs.

Figure 1: Components of the Total Cost of a Tax to Taxpayers



Source: GAO.

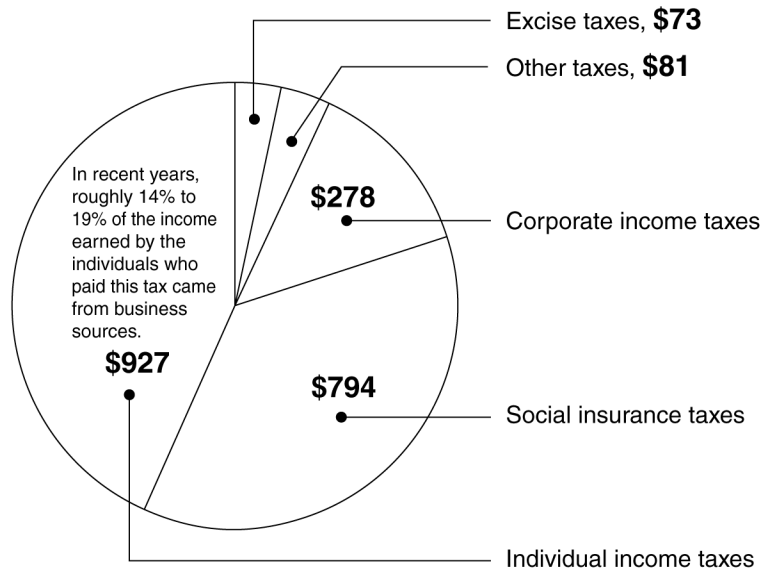
A complete evaluation of the tax treatment of businesses, which is a critical element of our overall federal tax system, cannot be made without considering how business taxation interacts with and complements the other elements of the overall system, such as the tax treatment of individuals and excise taxes on selected goods and services. This integrated approach is also appropriate for evaluating reform alternatives, regardless of whether those alternatives take the form of a simplified income tax system, a consumption tax system, or some combination of the two.

Taxes on Business Income Are a Significant Source of Federal Revenue and Must Be Part of the Overall Considerations for Fiscal Reform

Businesses contribute significant revenues to the federal government, both directly and indirectly. As figure 2 shows, corporate businesses paid \$278 billion in corporate income tax directly to the federal government in 2005. Individuals earn income from business investment in the form of dividends and realized capital gains from C corporations; income allocations from partnerships and S corporations; entrepreneurial income from their own sole proprietorships; and rents and royalties. In recent years this business-source income, which is all taxed under the individual income tax, has amounted to between roughly 14 percent and 19 percent of the income of individuals who have paid individual income tax.⁶ In addition to the taxes that are paid on business-source income, most of the remainder of federal taxes is collected and passed on to the government by businesses.

⁶Given the time frame available for preparing this statement we could not obtain the detailed data we would need to estimate the average rates of tax applied to business-source and non-business-source income. Consequently, we have not tried to estimate the percent of individual income tax attributable to business-source income.

**Figure 2: Distribution of Federal Tax Revenue by Type of Tax, 2005
(Billions of Dollars)**



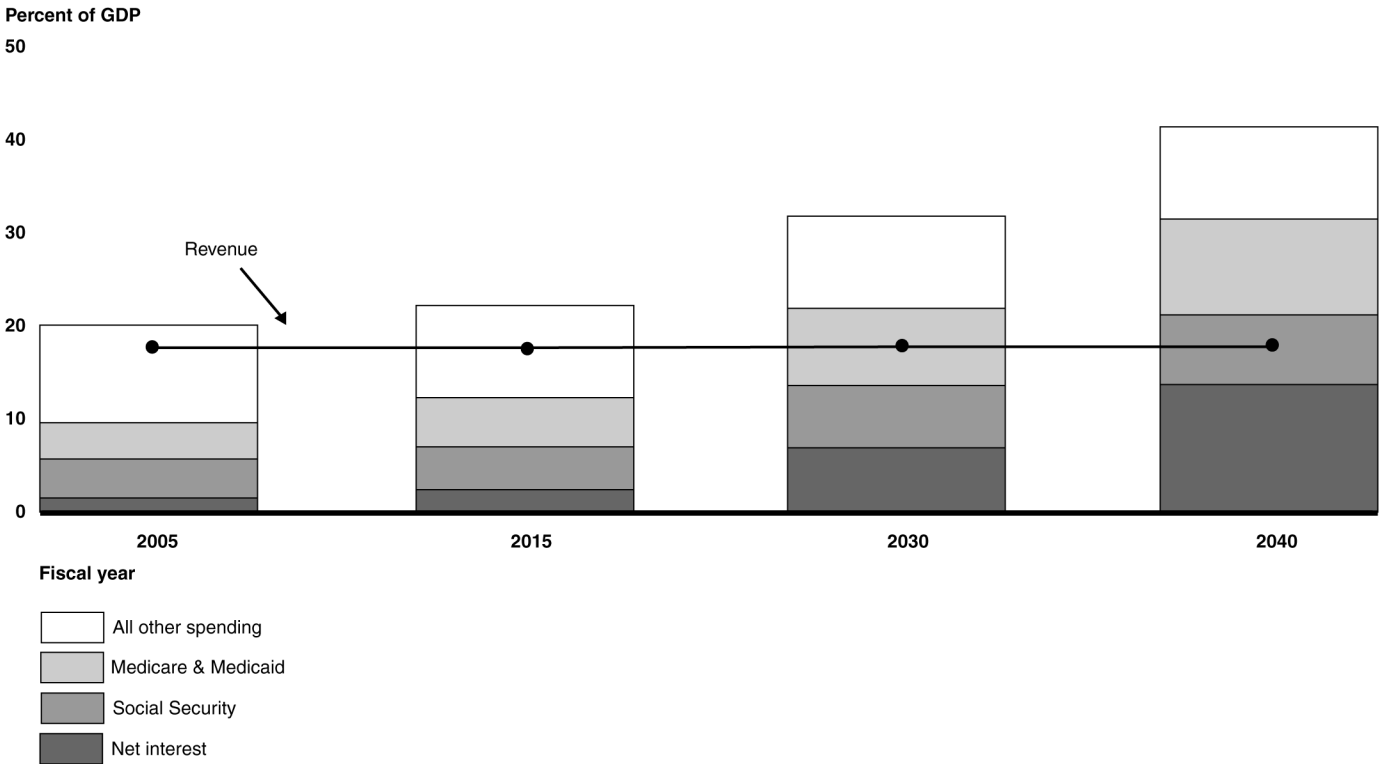
Source: GAO analysis of data from the Office of Management and Budget and from Internal Revenue Service (IRS).

Note: The business source income referred to in the figure includes the income of sole proprietors, income from partnerships and S corporations, dividends, capital gains, rents, and royalties. The percentage equals the ratio of (net business-source income minus losses) over adjusted gross income. When computing these percentages we did not include any income or losses of individuals who did not have a tax liability in a given year.

Business tax revenues of the magnitude discussed make them very relevant to considerations about how to address the nation's long-term fiscal imbalance. Over the long term, the United States faces a large and growing structural budget deficit primarily caused by demographic trends and rising health care costs as shown in figure 3, and exacerbated over time by growing interest on the ever-larger federal debt.⁷ Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security.

⁷Additional information about GAO's long-term fiscal simulations, assumptions, data, and charts can be found at <http://www.gao.gov/special.pubs/longterm/>.

Figure 3: Composition of Federal Spending as a Share of Gross Domestic Product (GDP), Assuming Discretionary Spending Grows with GDP after 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's August 2006 analysis.

Note: The revenue projection in this figure includes certain tax provisions that expired at the end of 2005.

We cannot grow our way out of this long-term fiscal challenge because the imbalance between spending and revenue is so large. We will need to make tough choices using a multipronged approach: (1) revise budget processes and financial reporting requirements; (2) restructure entitlement programs; (3) reexamine the base of discretionary spending and other spending; and (4) review and revise tax policy, including tax expenditures, and tax enforcement programs. Business tax policy, business tax expenditures, and business tax enforcement need to be part of the overall tax review because of the amount of revenue at stake.

Business tax expenditures reduce the revenue that would otherwise be raised from businesses. As already noted, to reduce their tax liabilities, businesses can take advantage of preferential provisions in the tax code, such as exclusions, exemptions, deductions, credits, preferential rates,

and deferral of tax liability. Tax preferences—which are legally known as tax expenditures—are often aimed at policy goals similar to those of federal spending programs. For example, there are different tax expenditures intended to encourage economic development in disadvantaged areas and stimulate research and development, while there are also federal spending programs that have similar purposes. Also, by narrowing the tax base, business tax expenditures have the effect of raising either business tax rates or the rates on other taxpayers in order to generate a given amount of revenue.

Efficiency, Complexity, Compliance, and Equity Concerns Contribute to Calls for Business Tax Reform

The design of the current system of business taxation causes economic inefficiency and is complex. The complexity provides fertile ground for noncompliance and raises equity concerns.

Varying Effective Rates of Taxation Across Different Types of Business Investments Reduce Economic Efficiency

Our current system for taxing business income causes economic inefficiency because it imposes significantly different effective rates of tax on different types of investments.⁸ Tax treatment that is not neutral across different types of capital investment causes significant economic inefficiency by guiding investments to lightly taxed activities rather than those with high pretax productivity.

However, the goal of tax policy is not to eliminate efficiency costs. The goal is to design a tax system that produces a desired amount of revenue and balances economic efficiency with other objectives, such as equity, simplicity, transparency, and administrability. Every practical tax system imposes efficiency costs.

There are some features of current business taxation that have attracted criticism by economists and other tax experts because of efficiency costs. My point in raising them here is not that these features need to be

⁸Statutory and effective tax rates are not necessarily the same. An effective tax rate, which is often lower—even substantially lower—than the statutory rate, measures the amount of tax that a corporation actually pays on a dollar of its economic income, when all aspects of the tax (deductions, credits, deferrals, etc.) are taken into account.

changed—that is a policy judgment for Congress to make as it balances various goals. Rather, my point is that these economic consequences of tax policy need to be considered as we think about reform. The following are among the most noted cases of nonneutral taxation in the federal business tax system:

- Income earned on equity-financed investments made by C corporations is taxed twice—under both the corporate and individual income taxes, whereas no other business income is taxed more than once. Moreover, even noncorporate business investment is taxed more heavily than owner-occupied housing—a form of capital investment that receives very preferential treatment. As a result, resources have been shifted away from higher-return business investment into owner-occupied housing, and, within the business sector, resources have been shifted from higher-return corporations to noncorporate businesses. Such shifting of investment makes workers less productive than they would be under a more neutral tax system. This results in employees receiving lower wages because increases in employee wages are generally tied to increases in productivity.⁹ As noted above, such efficiency costs may be worth paying in order to meet other policy goals. For example, many policymakers advocate increased homeownership as a social policy goal.
- Depreciation allowances under the tax code vary considerably in generosity across different assets causing effective tax rates to vary and, thereby, favoring investment in certain assets over others. For example, researchers have found that the returns on most types of investments in equipment are taxed more favorably than are most investments in nonresidential buildings.¹⁰ These biases shift resources away from some investments in buildings that would have been more productive than some of the equipment investments that are being made instead.

⁹Although it is difficult to estimate effective tax rates for broad categories of assets with precision, the estimates from one recent study showing the marginal effective tax rates on corporate investment, noncorporate investments, and owner-occupied housing to be 32 percent, 18 percent, and 2 percent, respectively, suggest the potential magnitude of the distortions. See Jane Gravelle, “The Corporate Tax: Where Has It Been and Where Is It Going?” *National Tax Journal*, vol. 57, no. 4 (2004): 903-23.

¹⁰See Jane G. Gravelle, *Capital Income Tax Revisions and Effective Tax Rates*, Congressional Research Service Report RL32099 (Washington, D.C.: Jan. 5, 2005); and U.S. Department of the Treasury, *Report to The Congress on Depreciation Recovery Periods and Methods* (Washington, D.C.: July 2000).

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- Tax rules for corporations favor the use of debt over shareholder equity as a source of finance for investment. The return on debt-financed investment consists of interest payments to the corporation's creditors, which are deductible by the corporations. Consequently, that return is taxed only once—in the hands of the creditors. In contrast, the return on equity-financed investment consists of dividends and capital gains, which are not deductible by the corporation. These forms of income that are taxed under the individual tax are paid out of income that has already been subject to the corporate income tax. The bias against equity finance induces corporations to have less of an “equity cushion” against business downturns.¹¹
 - Capital gains on corporate equity are taxed more favorably than dividends because that tax can be deferred until the gains are realized (typically when shareholders sell their stock). This bias against dividend payments likely means that more profits are retained within corporations than otherwise would be the case and, therefore, the flow of capital to its most productive uses is being constrained.¹²
 - The complex set of rules governing U.S. taxation of the worldwide income of domestic corporations (those incorporated in the United States) leads to wide variations in the effective rate of tax paid on that income, based on the nature and location of each corporation's foreign operations and the effort put into tax planning. In effect, the active foreign income of some U.S. corporations is taxed more heavily than if the United States followed the practice of many other countries and exempted such income from tax. However, other U.S. corporations are able to take advantage of flexibilities in the U.S. tax rules in order to achieve treatment that is equivalent to or, in some cases, more favorable than the so-called “territorial” tax systems that exempt foreign-source active business income. As a consequence, some U.S. corporations face a tax disadvantage, while others have an advantage, relative to foreign corporations when competing in foreign countries. Those U.S. corporations that have a disadvantage are likely to locate a

¹¹For a more detailed discussion of these issues see U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, D.C.: January 1992).

¹²Recent legislation has, at least temporarily, reduced and equalized the tax rates on dividends and realized capital gains. These changes have both reduced the extent of double taxation and the extent to which capital gains are favored over dividends. Capital gains still receive some preferred treatment because of the tax deferral.

smaller share of their investment overseas than would be the case in a tax-free world; the opposite is true for those U.S. corporations with the tax advantage. Moreover, the tax system encourages U.S. corporations to alter their cash-management and financing decisions (such as by delaying the repatriation of profits) in order to reduce their taxes.

The taxation of business income is part of the broader taxation of income from capital. The taxation of capital income in general (even when that taxation is uniformly applied) causes another form of inefficiency beyond the inefficiencies caused by the aforementioned cases of differential taxation across types of investments. This additional inefficiency occurs because taxes on capital reduce the after-tax return on savings and, thereby, distort the choice that individuals make between current consumption and saving for future consumption. However, although research shows that the demand for some types of savings, such as the demand for tax exempt bonds, is responsive to tax changes, there is greater uncertainty about the effects of tax changes on other choices, such as aggregate savings.

Sometimes the concerns about the negative effects of taxation on the U.S. economy are couched in terms of “competitiveness,” where the vaguely defined term competitiveness is often defined as the ability of U.S. businesses to export their products to foreign markets and to compete against foreign imports into the U.S. market. The goal of those who push for this type of competitiveness is to improve the U.S. balance of trade. However, economists generally agree that trying to increase the U.S. balance of trade through targeted tax breaks for exports does not work. Such a policy, aimed at lowering the prices of exports, would be offset by an increase in the value of the dollar which would make U.S. exports more expensive and imports into the United States less expensive, ultimately leaving both the balance of trade and the standard of living of Americans unchanged.¹³

¹³See relevant discussions in Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, JCX-22-06 (Washington, D.C.: June 21, 2006); CBO, *Effects of Adopting a Value-Added Tax*, (Washington, D.C.: February 1992); Brumbaugh, David L., *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, Congressional Research Service report RL33171 (Washington, D.C.: December 20, 2005); and Eric Toder, Assistant Deputy Secretary (Tax Analysis), U.S. Department of Treasury, Testimony before the Senate Budget Committee, February 22, 1995.

An alternative definition of competitiveness that is also sometimes used in tax policy debates refers to the ability of U.S.-owned firms operating abroad to compete in foreign markets. The current U.S. policy of taxing the worldwide income of U.S. businesses places some of their foreign operations at a disadvantage. The tradeoffs between a worldwide system and a territorial tax system are discussed below.

Businesses Bear Significant Compliance Burdens Arising Both from the Complexity of the Tax System and from Their Multiple Roles within the System

Tax compliance requirements for businesses are extensive and complex. Rules governing the computation of taxable income, expense deductions, and tax credits of U.S. corporations that do business in multiple foreign countries are particularly complex. But even small businesses face multiple levels of tax requirements of varying difficulty. In addition to computing and documenting their income, expenses, and qualifications for various tax credits, businesses with employees are responsible for collecting and remitting (at varying intervals) several federal taxes on the incomes of those employees. Moreover, if the businesses choose to offer their employees retirement plans and other fringe benefits, they can substantially increase the number of filings they must make. Businesses also have information-reporting responsibilities—employers send wage statements to their employees and to IRS; banks and other financial intermediaries send investment income statements to clients and to IRS.¹⁴ Finally, a relatively small percentage of all businesses (which nevertheless number in the hundreds of thousands) are required to participate in the collection of various federal excise taxes levied on fuels, heavy trucks and trailers, communications, guns, tobacco, and alcohol, among other products.

It is difficult for researchers to accurately estimate compliance costs for the tax system as a whole or for particular types of taxpayers because taxpayers generally do not keep records of the time and money spent complying with tax requirements. Studies we found that focus on the compliance costs of businesses estimate them to be between about \$40 billion and \$85 billion per year.¹⁵ None of these estimates include the costs

¹⁴Although this information reporting increases the compliance burden on businesses, it does enable IRS to enforce tax compliance by wage earners and investors at lower cost. This reduction in administrative costs, which are paid out of the federal budget, means that taxes are slightly lower than they otherwise would have to be.

¹⁵See GAO, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, [GAO-05-878](#) (Washington, D.C.: Aug. 26, 2005).

to businesses of collecting and remitting income and payroll taxes for their employees. The accuracy of these business compliance cost estimates is uncertain due to the low rates of response to their data-collection surveys. In addition, the range in estimates across the studies is due, among other things, to differences in monetary values used (ranging between \$25 per hour and \$37.26 per hour), differences in the business populations covered, and differences in the tax years covered.

Business Tax Complexity Also Makes IRS's Job of Enforcing Tax Rules Very Challenging and Can Reduce Public Confidence in the Fairness of the System

Although the precise amount of business tax avoidance is unknown, IRS's latest estimates of tax compliance show a tax gap of at least \$141 billion for tax year 2001 between the business taxes that individual and corporate taxpayers paid and what they should have paid under the law.¹⁶ Corporations contributed about \$32 billion to the tax gap by underreporting about \$30 billion in taxes on tax returns and failing to pay about \$2 billion in taxes that were reported on returns. Individual taxpayers that underreported their business income accounted for the remaining \$109 billion of the business income tax gap.¹⁷

A complex tax code, complicated business transactions, and often multinational corporate structures make determining business tax liabilities and the extent of corporate tax avoidance a challenge. Tax avoidance has become such a concern that some tax experts say corporate tax departments have become "profit centers" as corporations seek to take advantage of the tax laws in order to maximize shareholder value. Some corporate tax avoidance is clearly legal, some falls in gray areas of the tax code, and some is clearly noncompliance or illegal, as shown by IRS's tax gap estimate.

¹⁶Overall, IRS estimated a gross tax gap of \$345 billion for tax year 2001. It further estimated that eventually \$55 billion of the tax gap would be recovered through late payments and enforcement actions, resulting in a net tax gap of \$290 billion. The tax gap includes underreporting of taxes on tax returns, underpayment of taxes reported on returns, or nonfiling, which is when taxpayers fail to file returns on time or altogether.

¹⁷The amount of the business income tax gap attributed to individual taxpayers could be greater than \$109 billion. Although IRS estimated the tax gap for individual income tax underpayment and nonfiling (\$23 billion and \$25 billion, respectively, for tax year 2001), it did not estimate to what extent such noncompliance was attributed to business income, as opposed to nonbusiness income such as salaries and wages. Also, IRS estimated the tax gap that arises from individuals misreporting tax deductions and credits, but does not estimate what portion of the misreporting was from business-related deductions and credits.

Often business tax avoidance is legal. For example, multinational corporations can locate active trade or business operations in jurisdictions that have lower effective tax rates than does the United States and, unless and until they repatriate the income, defer taxation in the United States on that income, thus reducing their effective tax rate. In addition, investors can avoid paying the corporate income tax by putting their money into unincorporated businesses or into real estate.

Complicating corporate tax compliance is the fact that in many cases the law is unclear or subject to differing interpretations. In fact, some have postulated that major corporations' tax returns are actually just the opening bid in an extended negotiation with IRS to determine a corporation's tax liability. An illustration—once again from the complex area of international tax rules—is transfer pricing. Transfer pricing involves setting the appropriate price for such things as goods, services, or intangible property (such as patents, trademarks, copyrights, technology, or “know-how”) that is transferred between the U.S.-based operations of a multinational company and a foreign affiliate. If the price paid by the affiliate to the U.S. operation is understated, the profits of the U.S. operation are reduced and U.S. taxable income is inappropriately reduced or eliminated. The standard for judging the correct price is the price that would have been paid between independent enterprises acting at “arm's length.” However, it can be extremely difficult to establish what an arm's length price would be. Given the global economy and the number of multinational firms with some U.S.-based operations, opportunities for transfer pricing disputes are likely to grow.

Tax shelters are one example of how tax avoidance, including corporate tax avoidance, can shade into the illegal. Some tax shelters are legal though perhaps aggressive interpretations of the law, but others cross the line.¹⁸ Abusive shelters often are complex transactions that manipulate many parts of the tax code or regulations and are typically buried among legitimate transactions reported on tax returns. Because these transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter

¹⁸In a 2003 testimony, we reported that IRS had identified 27 kinds of abusive shelter transactions—called listed transactions—promoted to corporations and others. As of September 2006, IRS's Web site lists 31 such listed transactions. IRS also had a number of other transactions that had to be reported to IRS and may have had some characteristics of abusive shelters but were not, and possibly never would be, listed.

problem. Often lacking economic substance or a business purpose other than generating tax benefits, abusive shelters have been promoted by some tax professionals, often in confidence, for significant fees, sometimes with the participation of tax-indifferent parties, such as foreign or tax-exempt entities. These shelters may involve unnecessary steps and flow-through entities, such as partnerships, which make detection of these transactions more difficult.

Regarding compliance with our tax laws, the success of our tax system hinges greatly on individual and business taxpayers' perception of its fairness and understandability. Compliance is influenced not only by the effectiveness of IRS's enforcement efforts but also by Americans' attitudes about the tax system and their government. A recent survey indicated that about 10 percent of respondents say it is acceptable to cheat on their taxes. Furthermore, the complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce tax laws. The lack of transparency also fuels disrespect for the tax system and the government. Thus, a crucial challenge in evaluating our business tax system will be to determine how we can best strengthen enforcement of existing laws to give businesses owners confidence that their competitors are paying their fair share and to give wage earners confidence that businesses in general bear their share of taxes. One option that has been suggested as a means of improving public confidence in the tax system's fairness is to make the reconciliation between book and tax income that businesses present on schedule M-3 of their tax returns available for public review.

Business Tax Reform Entails Broad Design Choices about the Overall Tax System

Reform of our business tax system will necessarily mean making broad design choices about the overall tax system and how business taxes are coordinated with other taxes. The tax reform debate of the last several years has focused attention on several important choices, including the extent to which our system should be closer to the extreme of a pure income tax or the other extreme of a pure consumption tax, the extent to which sales by U.S. businesses outside of this country should be taxed, the extent to which taxes should be collected from businesses or individuals, and the extent to which taxpayers are compensated for losses or costs they incur during the transition to any new tax system. Generally there is no single "right" decision about these choices and the options are not limited to selecting a system that is at one extreme or the other along the continuum of potential systems. The choices will involve making tradeoffs between the various goals for our tax system.

Income vs. Consumption as the Tax Base

The fundamental difference between income and consumption taxes lies in their treatment of savings and investment. Income can be used for either consumption or saving and investment. The tax base of a pure income tax includes all income, regardless of what it is ultimately used for; in contrast, the tax base of a consumption tax excludes income devoted to saving and investment (until it is ultimately used for consumption). The current tax system is a hybrid between a pure income tax and a pure consumption tax because it effectively exempts some types of savings and investment but taxes other types.

As noted earlier, evidence is inconclusive regarding whether a shift closer to a consumption tax base would significantly affect the level of savings by U.S. taxpayers. There is, however, a consensus among economists that uneven tax treatment across different types of investment should be avoided unless the efficiency costs resulting from preferential tax treatment are outweighed by the social benefits generated by the tax preference. That objective could be achieved under either a consumption tax that exempts all new savings and investment from taxation (which means that all business profits are exempt) or a revised income tax that taxed all investments at the same effective rate. In comparison to the current system, a consumption tax's exemption of business-source income would likely encourage U.S. businesses to increase their investment in the United States relative to their foreign investment.

Both income and consumption taxes can be structured in a variety of ways, as discussed in the following subsections, and the choice of a specific design for either type of tax can have as significant implications for efficiency, administrability, and equity as the choice between a consumption or income base.¹⁹ The exemption of saving and investment can be accomplished in different ways, so consumption taxes can be structured differently and yet still have the same overall tax base.

¹⁹For additional information on how differences in the structures of both income and consumption taxes can affect tax administration and taxpayer compliance burdens, see *Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators*, GAO/GGD-98-37 (Washington, D.C.: Jan. 14, 1998).

Collecting the Tax at the Business or Individual Level

Both income and consumption taxes can be levied on individuals or businesses, or on a combination of the two. Whether collected from individuals or businesses, ultimately, individuals will bear the economic burden of any tax (as wage earners, shareholders, or consumers). 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 individuals at different rates. Individual-level taxes can allow for distinctions between different individuals; for example, standard deductions or graduated rates can be used to tax individuals with low income (or consumption) at a lower rate than individuals with greater income (or consumption). However, individual-level taxes require more tax returns, impose higher compliance costs, and would generally require a larger tax administration system.²⁰

A national retail sales tax, a consumption value-added tax, and an income value-added tax are examples of taxes that would be collected only at the business level. A personal consumption tax and an integrated individual income tax are examples of taxes that would be collected only at the individual level. The “flat tax” proposed by economists Robert Hall and Alvin Rabushka that has received attention in recent years is an example of a tax collected at both the business and individual level.²¹ Our current system for taxing corporate-source income involves taxation at both the corporate and individual level in a manner that results in the double taxation of the same income.

Territorial vs. Worldwide Taxation under an Income Tax

Under a pure worldwide tax system the United States would tax the income of U.S. corporations, as it is earned, regardless of where it is earned, and at the same time provide a foreign tax credit that ensures that the combined rate of tax that a corporation pays to all governments on each dollar of income is exactly equal to the U.S. corporate tax rate. Some basic differences between the current U.S. tax system and a pure worldwide system are that (1) in many cases the U.S. system permits corporations to defer U.S. tax on their foreign-source income until it is repatriated and (2) the U.S. foreign tax credit is limited to the amount of

²⁰For a further discussion of these issues, see [GAO/GGD-98-37](#).

²¹See app. II for brief descriptions of each of these types of taxes.

U.S. tax that would be due on a corporation's foreign-source income. In cases where the rate of foreign tax on a corporation's income exceeds the U.S. tax rate, the corporation is left paying the higher rate of tax.

Under a pure territorial tax system the United States would simply exempt all foreign-source income. (No major country has a pure territorial system; they all tax mobile forms of foreign-source income, such as royalties and income from securities.) The current U.S. tax system has some features that result in some cases in treatment similar to what would exist under a territorial system. First, corporations can defer U.S. tax indefinitely on certain foreign-source income, as long as they keep it reinvested abroad. Second, in certain cases U.S. corporations are able to use the excess credits that they earned for taxes they paid to high-tax countries to completely offset any U.S. tax that they would normally have to pay on income they earned in low-tax countries.²² As a result, that income from low-tax countries remains untaxed by the United States—just as it would be under a territorial system. In fact, there are some cases where U.S. corporations enjoy tax treatment that is more favorable than under a territorial system. This occurs when they pay no U.S. tax on foreign-source income yet are still able to deduct expenses allocable to that income. For example, a U.S. parent corporation can borrow money and invest it in a foreign subsidiary. The parent corporation generally can deduct its interest payments from its U.S. taxes even if it defers U.S. tax on the subsidiary's income by leaving it overseas.

Proponents of a worldwide tax system and proponents of a territorial system both argue that their preferred systems would provide important forms of tax neutrality. Under a pure worldwide system all of the income that a U.S. corporation earns abroad would be taxed at the same effective rate that a corporation earning the same amount of income domestically would pay. Such a tax system is neutral in the sense that it does not influence the decision of U.S. corporations to invest abroad or at home. If the U.S. had a pure territorial tax system all of the income that U.S. corporations earn in a particular country would be taxed at the same rate as corporations that are residents of that country. The pure territorial system is neutral in the specific sense that U.S. corporations investing in a

²²In cases where a U.S. corporation earns income in a country with a higher income tax than in the United States that corporation earns a larger tax credit than is needed to offset the U.S. tax owed on that foreign-source income. The difference between the foreign tax credit earned on a specific amount of foreign-source income and the amount of U.S. tax owed on that income is known as an excess foreign tax credit.

foreign country would not be at a disadvantage relative to corporations residing in that country or relative to other foreign corporations investing there.²³ In a world where each country sets its own tax rules it is impossible to achieve both types of neutrality at the same time, so tradeoffs are unavoidable.

A change from the current tax system to a pure territorial one is likely to have mixed effects on tax compliance and administration. On the one hand, a pure worldwide tax system, or even the current system, may preserve the U.S. tax base better than a territorial system would because U.S. taxpayers would have greater incentive under a territorial system to shift income and investment into low-tax jurisdictions via transfer pricing. On the other hand, a pure territorial system may be less complex for IRS to administer and for taxpayers to comply with than the current tax system because there would be no need for the antideferral rules or the foreign tax credit, which are among the most complex features of the current system.

Destination-Principle vs. Origin-Principle Consumption Tax

Broad-based consumption taxes can differ depending on whether they are imposed under a destination principle, which holds that goods and services should be taxed in the countries where they are consumed, or an origin principle, which holds that goods and services should be taxed in the countries where they are produced. In the long run, after markets have adjusted, neither type of tax would have a significant effect on the U.S. trade balance. This is true for a destination-based tax because products consumed in the United States would be taxed at the same rate, regardless of where they were produced. Therefore, such a tax would not influence a consumer's choice between buying a car produced in the United States or one imported from Japan. And at the same time, U.S. exports of cars would not be affected by the tax because they would be exempted. An origin-based consumption tax would not affect the trade balance because the tax effects that taxes have on prices would ultimately be countered by

²³The disadvantage that U.S. corporations have under the current system is one reason why some U.S. multinational businesses have undergone "corporate inversions," whereby their parent corporations have changed their place of incorporation from the United States to a foreign country.

the same price adjustment mechanism that we discussed earlier with respect to targeted tax subsidies for exports.²⁴

A national retail sales tax limited to final consumption goods would be a destination-principle tax; it would tax imports when sold at retail in this country and would not tax exports. Value-added taxes can be designed as either destination or origin-principle taxes.

A personal consumption tax, collected at the individual level, would apply to U.S. residents or citizens and could be formulated to tax their consumption regardless of whether it is done domestically or overseas. Under such a system, income earned abroad would be taxable but funds saved or invested abroad would be deductible. In that case, foreign-produced goods imported into the United States or consumed by U.S. citizens abroad would be taxed. U.S. exports would only be taxed to the extent that they are consumed by U.S. citizens abroad.

The Extent of Transition Provisions

A wide range of options exist for moving from the current business tax system to an alternative one, and the way that any transition is formulated could have significant effects for economic efficiency, equity, taxpayer compliance burden, and tax administration. For example, one transition issue involves whether tax credits and other tax benefits already earned under the current tax would be made available under a new system. Businesses that are deducting depreciation under the current system would not have the opportunity to continue depreciating their capital goods under a VAT unless special rules were included to permit it. Similar problems could arise with businesses' carrying forward net operating losses and recovering unclaimed tax credits. Depending on how these and other issues are addressed, taxpayer compliance burden and tax administration responsibilities could be greater during the transition period than they currently are or than they would be once the transition ends. Transition rules could also substantially reduce the new system's tax

²⁴This time the mechanism would operate in the reverse direction—the tax on U.S. exports would decrease the foreign demand for those products, leading to a drop in the value of the dollar. That decline in the dollar's value would reverse the tax-induced increase in the price of U.S. exports and would raise the price of imports into the United States, offsetting any price advantage they had gained from being exempt from the consumption tax.

base, thereby requiring higher tax rates during the transition if revenue neutrality were to be achieved.²⁵

Criteria for a Good Tax System Provide Principles to Guide Decisions and Issues for Consideration

Our publication, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*,²⁶ may be useful in guiding policymakers as they consider tax reform proposals. It was designed to aid policymakers in thinking about how to develop tax policy for the 21st century. The criteria for a good tax system, which our report discusses, provide the basis for a set of principles that should guide Congress as it considers the choices and tradeoffs involved in tax system reform. And, as I also noted earlier, proposals for reforming business taxation cannot be evaluated without considering how that business taxation will interact with and complement the other elements of our overall future tax system.

The proposed system should raise sufficient revenue over time to fund our expected expenditures. As I mentioned earlier, we will fall woefully short of achieving this end if current spending or revenue trends are not altered. Although we clearly must restructure major entitlement programs and the basis of other federal spending, it is unlikely that our long-term fiscal challenge will be resolved solely by cutting spending.

The proposal should look to future needs. Like many spending programs, the current tax system was developed in a profoundly different time. We live now in a much more global economy, with highly mobile capital, and with investment options available to ordinary citizens that were not even imagined decades ago. We have growing concentrations of income and wealth. More firms operate multinationally and willingly move operations and capital around the world as they see best for their firms.

As an adjunct to looking forward when making reforms, better information on existing commitments and promises must be coupled with estimates of the long-term discounted net present value costs from spending and tax commitments comprising longer-term exposures for the federal budget beyond the existing 10-year budget projection window.

The tax base should be as broad as possible. Broad-based tax systems with minimal exceptions have many advantages. Fewer exceptions generally

²⁵For further discussion of transition issues see [GAO-05-1009SP](#).

²⁶[GAO-05-1009SP](#).

means less complexity, less compliance cost, less economic efficiency loss, and by increasing transparency may improve equity or perceptions of equity. This suggests that eliminating or consolidating numerous tax expenditures must be considered. In many cases tax preferences are simply a form of “back-door spending.” We need to be sure that the benefits achieved from having these special provisions are worth the associated revenue losses just as we must ensure that outlay programs—which may be attempting to achieve the same purposes as tax expenditures—achieve outcomes commensurate with their costs. And it is important to supplement these cost-benefit evaluations with analyses of distributional effects—i.e., who bears the costs of the preferences and who receives the benefits. To the extent tax expenditures are retained, consideration should be given to whether they could be better targeted to meet an identified need.

If we must raise revenues, doing so from a broad base and a lower rate will help minimize economic efficiency costs. Broad-based tax systems can yield the same revenue as more narrowly based systems at lower tax rates. The combination of less direct intervention in the marketplace from special tax preferences, and the lower rates possible from broad-based systems, can have substantial benefits for economic efficiency. For instance, one commonly cited rule of thumb regarding economic efficiency costs of tax increases is that they rise proportionately faster than the tax rates. In other words, a 10 percent tax increase could raise the economic efficiency costs of a tax system by much more than 10 percent.

Aside from the base-broadening that minimizes targeted tax preferences favoring specific types of investment or other business behavior, it is also desirable on the grounds of economic efficiency to extend the principle of tax neutrality to the broader structural features of a business tax system. For example, improvements in economic efficiency can also be gained by avoiding differences in tax treatment, such as the differences in the current system based on legal form of organization, source of financing, and the nature and location of foreign operations. Removing such differences can shift resources to more productive uses, increasing economic performance and the standard of living of Americans. Shifting resources to more productive uses can result in a step up in the level of economic activity which would be measured as a one-time increase in the rate of growth. Tax changes that increase efficiency can also increase the long-term rate of economic growth if they increase the rate of

technological change; however, not all efficiency-increasing tax changes will do so.²⁷

Impact on the standard of living of Americans is also a useful criterion for evaluating policies to improve U.S. competitiveness. As was discussed earlier, narrower goals and policies, such as increasing the U.S. balance of trade through targeted tax breaks aimed at encouraging exports, are generally viewed as ineffective by economists. What determines the standard of living of Americans and how it compares to the standard of living in other countries is the productivity of American workers and capital. That productivity is determined by factors such as education, technological innovation, and the amount of investment in the U.S. economy. Tax policy can contribute to American productivity in several ways. One, discussed in this statement, is through neutral taxation of investment alternatives. Another, which I have discussed on many occasions, is through fiscal policy. Borrowing to finance persistent federal deficits absorbs savings from the private sector reducing funds available for investment. Higher saving and investment from a more balanced fiscal policy would contribute to increased productivity and a higher standard of living for Americans over the long term.

A reformed business tax system should have attributes associated with high compliance rates. Because any tax system can be subject to tax gaps, the administrability of reformed systems should be considered as part of the debate for change. In general, a reformed system is most likely to have a small tax gap if the system has few tax preferences or complex provisions and taxable transactions are transparent. Transparency in the context of tax administration is best achieved when third parties report information both to the taxpayer and the tax administrator.

Minimizing tax code complexity has the potential to reduce noncompliance for at least three broad reasons. First, it could help taxpayers to comply voluntarily with more certainty, reducing inadvertent errors by those who want to comply but are confused because of complexity. Second, it may limit opportunities for tax evasion, reducing intentional noncompliance by taxpayers who can misuse the complex code provisions to hide their noncompliance or to achieve ends through

²⁷See [GAO-05-1009SP](#) for further discussion on the relationship between efficiency and economic growth.

tax shelters. Third, reducing tax-code complexity could improve taxpayers' willingness to comply voluntarily.

Finally, the consideration of transition rules needs to be an integral part of the design of a new system. The effects of these rules can be too significant to leave them simply as an afterthought in the reform process.

Concluding Observations

The problems that I have reviewed today relating to the compliance costs, efficiency costs, equity, and tax gap associated with the current business tax system would seem to make a strong case for a comprehensive review and reform of our tax policy. Further, businesses operate in a world that is profoundly different—more competitive and more global—than when many of the existing provisions of the tax code were adopted. Despite numerous and repeated calls for reform, progress has been slow. I discussed reasons for the slow progress in a previous hearing on individual tax reform before this committee. One reason why reform is difficult to accomplish is that the provisions of the tax code that generate compliance costs, efficiency costs, the tax gap and inequities also benefit many taxpayers. Reform is also difficult because, even when there is agreement on the amount of revenue to raise, there are differing opinions on the appropriate balance among the often conflicting objectives of equity, efficiency, and administrability. This, in turn, leads to widely divergent views on even the basic direction of reform.

However, I have described some basic principles that ought to guide business tax reform. One of them is revenue sufficiency. Fiscal necessity, prompted by the nation's unsustainable fiscal path, will eventually force changes to our spending and tax policies. We must fundamentally rethink policies and everything must be on the table. Tough choices will have to be made about the appropriate degree of emphasis on cutting back federal programs versus increasing tax revenue.

Other principles, such as broadening the tax base and otherwise promoting tax neutrality, could help improve economic performance. While economic growth alone will not solve our long-term fiscal problems, an improvement in our overall economic performance makes dealing with those problems easier.

The recent report of the President's Advisory Panel on Federal Tax Reform recommended two different tax reform plans. Although each plan is intended to improve economic efficiency and simplify the tax system, neither of them addresses the growing imbalance between federal

spending and revenues that I have highlighted. One approach for getting the process of comprehensive fiscal reform started would be through the establishment of a credible, capable, and bipartisan commission, to examine options for a combination of selected entitlement and tax reform issues.

Mr. Chairman and Members of the Committee, this concludes my statement. I would be pleased to answer any questions you may have at this time.

Contact and Acknowledgments

For further information on this testimony, please contact James White on (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Individuals making key contributions to this testimony include Jim Wozny, Assistant Director; Donald Marples; Jeff Arkin; and Cheryl Peterson.

Appendix I: List of Studies Reviewed

Government Accountability Office

Individual Income Tax Policy: Streamlining, Simplification, and Additional Reforms Are Desirable. [GAO-06-1028T](#). Washington, D.C.: August 3, 2006.

Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches. [GAO-06-1000T](#). Washington, D.C.: July 26, 2006.

Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting. [GAO-06-851T](#). Washington, D.C.: June 13, 2006.

Understanding the Tax Reform Debate: Background, Criteria, & Questions. [GAO-05-1009SP](#). Washington, D.C.: September 2005.

Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined. [GAO-05-690](#). Washington, D.C.: Sept. 23, 2005.

Tax Policy: Summary of Estimates of the Costs of the Federal Tax System. [GAO-05-878](#). Washington, D.C.: August 26, 2005.

Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies. [GAO-05-527T](#). Washington, D.C.: April 14, 2005.

21st Century Challenges: Reexamining the Base of the Federal Government. [GAO-05-325SP](#). Washington, D.C.: February 1, 2005.

Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators. [GAO/GGD-98-37](#). Washington, D.C.: January 14, 1998.

Congressional Budget Office

Corporate Income Tax Rates: International Comparisons. Washington, D.C.: November 2005.

Taxing Capital Income: Effective Rates and Approaches to Reform. Washington, D.C.: October 2005.

Effects of Adopting a Value-Added Tax. Washington, D.C.: February 1992.

Congressional Research Service

Brumbaugh, David L. *Taxes and International Competitiveness*. RS22445. Washington, D.C.: May 19, 2006.

Brumbaugh, David L. *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*. RL33171. Washington, D.C.: December 20, 2005.

Gravelle, Jane G.. *Capital Income Tax Revisions and Effective Tax Rates*. RL32099. Washington, D.C.: January 5, 2005.

Joint Committee on Taxation

The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses. JCX-22-06. Washington, D.C.: June 21, 2006.

Options to Improve Tax Compliance and Reform Tax Expenditures. JCS-02-05. Washington, D.C.: January 27, 2005.

The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations. JCX-67-03. Washington, D.C.: July 3, 2003.

Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series. JCX-23-02. Washington, D.C.: April 4, 2002.

U.S. Department of the Treasury

Report to The Congress on Depreciation Recovery Periods and Methods. Washington, D.C.: July 2000.

Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once. Washington, D.C.: January 1992.

President's Advisory Panel on Federal Tax Reform

Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System. Washington, D.C.: November 2005.

Appendix II: Descriptions of Alternative Tax Systems

Over the past decade, 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. This appendix provides a brief description of several of these proposals.

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.

Consumption Value-Added Tax

A consumption 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.

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.

Flat Tax

The flat tax was developed in the early 1980s by economists Robert Hall and Alvin Rabushka.¹ 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 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

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

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.²

²To 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.

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