Top 10 Myths of a Consumption Tax System

By Stewart Karlinsky, Dale Pinto, and Jeff Pope

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Much of the recent tax policy literature and political rhetoric suggests that moving to a consumption tax (value added tax, goods and services tax, national sales tax, income minus investments) would be simpler, and less expensive to administer and comply with. Therefore, according to the rhetoric, the United States should drastically overhaul its tax system and repeal the income tax as we know it and substitute a consumption tax like a VAT or a GST that our trading partners are subject to. What those positions fail to mention is that our trading partners have a higher compliance and administrative cost than we do, and they have both an income tax (corporate and individual) and a VAT. Interestingly, Jeffrey Owens, OECD tax commissioner, who has the advantage of worldwide perspective on various tax systems, has observed that “there is no crisis (in the U.S. tax system), but lots of room for improvement.”

This article will discuss the top 10 myths regarding a consumption tax system to give readers, legislators, and tax policymakers an understanding of the issues that may arise if the United States moves to a substitute or complementary consumption tax system.

Myth #1: Consumption Tax Will Eliminate Gucci Gulch (K Street Lobbyists)

There is a perception among government policymakers that replacing the income tax with a consumption tax would eliminate the deadweight attributable to the lobbyists. We will now explore some reasons why the K Street gang members are not sweating their jobs.

Designating a product as eligible for zero rating in a consumption tax system would allow a refund of input credits previously paid on the items, while exemption status would not. Therefore, there would be significant lobbying opportunities to affect future consumption tax legislation to actualize refund opportunities. However, exemption status would be better than a taxable good, but not as good as zero rating.

Other opportunities for lobbyists include getting special rates for their clients’ goods and services, because very few countries have been able to have one tax rate for all goods and services. In some countries, food, housing, and medical care are exempt goods. Other exempt items include education or clothing. That ignores the typical hair-splitting issues that we see in the state sales tax arena, such as whether hot chicken is VAT taxable while cold chicken may be designated as food and therefore tax-exempt.

Another issue that will keep the K Street gang gainfully employed is the issue of vertical exemptions or what is called “exemption creep.” The issue involves the scenario in which a good is exempt from VAT but its inputs are not; if the inputs are treated as exempt (through legislative grace), a permanent savings would be received by the final producer of the exempt goods.

Another area ripe for lobbying efforts involves the financial services industry. Pure interest is generally not subject to VAT; but it is difficult to separate out fees from the time value of money payments. Therefore, many industrialized countries exempt financial services from VAT systems.

1Cited in Henry Aaron and Joel Slemrod, Crisis in Tax Administration, Brookings Institution, 2004.
2The name derives from a well-known book (Showdown at Gucci Gulch) about the passage of the Tax Reform Act of 1986, by Alan S. Murray and Jeffrey H. Birnbaum.

3Some consumption tax systems call it zero rated or GST-free.
4To give a sense of the magnitude of this refund issue, according to a paper prepared by staff of the International Monetary Fund, OECD, and World Bank for presentation at the International Tax Dialogue Conference on VAT held in Rome on March 15-16, 2005, entitled “The Value Added Tax: Experiences and Issues,” p. 27, countries such as United Kingdom, Netherlands, Russia, South Africa, and Canada have refund levels exceeding 40 percent of gross VAT collections.

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VAT. In a country like the United States where financial services are a major part of the business economy, the amount of financial service income that would not be subject to VAT would likely be very significant and would cause the base VAT rate to be higher.

Thresholds are another area that would produce a significant lobbying effort. Most VAT countries have a threshold at which the business does not have to register and is in effect exempt from compliance with VAT rules. Because it has been shown empirically that a relatively small proportion of firms typically accounts for a large proportion of the revenue collected, a threshold makes sense to reduce the compliance and administrative cost for small business and the government. For example, within the European Union, the threshold varies from zero to 100,000. Australia has an AUD 50,000 threshold, while Singapore has a SG$1 million dollar threshold. To make that area even more complex, some countries have different thresholds for different activities, sliding adjustments to help small businesses transition to no longer being exempt, and so forth. This is obviously an area ripe for both complexity and lobbying.

Anyone still believe that moving to a consumption tax would add lobbyists to the unemployment lines?

Myth #2: Consumption Tax Will Eliminate the Tax Lawyers and Accountants.

Five aspects that relate to most consumption tax systems dispel this myth: registration requirements, filing requirements, interpretation issues, exemptions, and tax planning. Each issue will be dealt with in turn, with relevant examples being drawn from the Australian GST system, which was introduced July 1, 2000.

Registration

Registration is fundamental to the operation of a consumption tax system and therefore compulsory for most businesses. Generally, only registered entities can charge consumption tax and get an input credit for consumption taxes paid. While most businesses would need to register for consumption tax purposes, there would be some for whom registration is optional. In those cases, professional advice would need to be sought as to the pros and cons of choosing to register. For example, unless an entity is registered, it could not normally claim input tax credits for the consumption tax it paid on its business inputs nor pass on entitlement to claim credits to its customers. However, apart from not having to charge consumption tax on its supplies, the main advantage of not registering would be that paperwork would be reduced — records need not be kept of consumption taxes paid or charged, the use of items need not be tracked, returns need not be lodged, and so on.

Most consumption tax systems have registration turnover thresholds beyond which registration is compulsory, and professional advice is often needed to determine if the relevant turnover threshold has been exceeded. That might seem like a simple finding but many consumption tax systems have complicated definitions of what turnover includes and excludes. Also, only entities that carry on an enterprise can register under consumption tax systems; again professional advice would be needed to determine whether a business meets the relevant definitions.

It is also important to register at the right time, because failure to register can result in penalties, especially since penalties can be retroactively applied, leaving the entity liable for the gross consumption tax that should have been charged.

Then there are the ubiquitous tax forms to be filled out. Typically an accountant would be needed to assist with the filing of the return on a timely basis. It is interesting to examine the dimension of the registration and filing opportunity by looking at the Australian experience. The previous wholesale sales tax (WST) had some 78,936 taxpayers in 1998-99. The new GST had some 2.2 million on June 30, 2003.6 As of July 2, 2004, the Australian Tax Office reported it had registered more than 4.5 million entities for a business number? Part of the reason for the quantum increase is the multistage nature of a consumption tax, with more taxpayers being involved than under a sales tax system, and the fact that many businesses register (whether they have to or not), as other businesses will not deal with them unless they are registered.

Filing Requirements

Businesses that are registered or required to be registered would need to periodically account for their consumption taxes in a return of some kind. In Australia, that is referred to as the business activity statement (BAS). The period may be as often as monthly and as rare as annually, depending on the annual turnover of the business concerned.

The BAS operates as a document of a business’s refund or consumption tax payable. The amount a business is liable for is the consumption tax it charges on supplies made less the input tax credits for that period. If the credits exceed the consumption tax charges, a refund is due.

If the BAS experience in Australia is anything to go by, businesses would need to seek the advice of their accountant or lawyer when completing those returns. Not only is there the normal compliance cost associated with the completion of those returns, but it is in many ways like completing an income tax return, with similar issues and problems.

Interpretation Issues

As with any form of tax legislation, consumption tax systems have many definitions and concepts that can cause interpretational difficulties. Concepts such as taxable supplies, GST-free supplies, input tax credits, carrying on an enterprise, the concept of an entity, and the grouping provisions, to name but a few, can all cause problems, uncertainties, and planning opportunities to arise regarding the consumption tax system. Again, it is not only desirable but often essential that advice be sought from an accountant or lawyer to determine the proper meaning of a concept within the legislation. That begins to sound no different than our current U.S. income
tax, just with new terminology and concepts. In effect, the GST is like any other tax — subject to challenge and differing interpretations, which further emphasizes the need for professional accounting and legal advice.

**Exemptions**

A consumption tax in its purest form is a broad-based tax that has few (or no) exemptions. In reality and for various political, social, and economic reasons, most countries that have introduced a consumption tax system have included exemptions. In Australia, the last-minute deal that was brokered by the government carved out an exemption for food, after much discussion occurred as to what constituted food — some of the arguments ranged from the ridiculous to the sublime — very similar to the issues we encounter at the state level relative to sales tax.

Exemptions inevitably introduce a degree of complexity to a consumption tax system, and businesses would need professional advice to avail themselves of an exemption or to ensure that they are not inappropriately claiming an exemption.

**Tax Planning**

As in Myth #1, there are ample opportunities for taxpayers and their advisers to plan and minimize the consumption taxes due. Examples include separating affiliated companies to take advantage of threshold levels, integrating activities to allow more businesses to be exempt, merging with companies that are exempt, fitting into the financial services category, and so forth.

In conclusion, it is submitted that far from eliminating the tax lawyers and accountants, a consumption tax will likely heighten the need for professional tax advisers.

**Myth #3: Consumption Tax Is Easy to Institute From Scratch.**

VAT is a relatively new tax phenomenon, with France being the first industrialized country to adopt it in 1948. Few other countries followed suit until the late 1960s and early 1970s. Therefore, we can examine the cost to institute a new tax system with relatively recent data. Australia is one of the most recent developed countries to adopt a consumption tax (2000), so again we will look at its experience as to how easy it is to institute a consumption tax system.

The planning for Australia's consumption tax system (a GST) reform took about two years and in hindsight that was too short a time. The government needs to introduce a VAT right the "first time" — otherwise there is added complexity, higher compliance costs, greater administrative and political difficulties, and a frustrated taxpayer population. Australia failed to get it right, as evidenced by legislative changes to small-business GST rules eight months after GST became effective.

VAT start-up costs are high, as are recurring compliance costs. Western Australia's experience in implementing the GST is a good model to look at as to compliance costs, because it includes many small businesses, tourism, farming, and mining industries as well as some manufacturing and financial services. It is similar to the mix you see in the United States.

GST small-business start-up compliance costs in Western Australia, on average, were $5,006 (excluding time). Also, the time required to comply averaged 131 hours per firm in seeking professional accounting and information technology advice to introduce new systems and procedures. Thus, time spent valued in dollars amounted to $2,620 (at an opportunity cost of $20 per hour), for a total estimated start-up cost of $7,626 per business. Extrapolating to American small businesses, the result is an astounding projected start-up cost of $125 billion.

**Myth #4: Once You Get the New System Going, It Is Easier to Enforce and Administer Than Income Tax.**

Not surprising, the experience of both developed and transition countries is that evading VAT is a common problem. The underground economy that has resulted in a large tax gap under our income tax system is also likely to be problematic under a consumption tax. Recent evidence points to the fact that developed countries have seen substantial abuses relative to their consumption tax systems. For example, the United Kingdom has seen an increase in the last decade from evasion estimated to be 8 percent of VAT revenue to a recent 15 percent of VAT revenue tax gap. That is to be compared to the U.S. tax system in which the $350 billion tax gap is 3.47 percent of gross domestic product and greater than 10 percent of tax revenue raised.

In a study by Bankman and Karlinsky it was found that one of the reasons for not reporting cash receipts for income tax purposes was to evade state sales taxes. If 5 percent to 9 percent state sales tax rates elicited that behavior from an important segment of the population, what behavior would a rate that is expected to be in the 20+ percent range evoke? That leads to nonregistration of businesses, underreporting of gross receipts, abuse of multiple rate structure, and nonremittance of taxes owed, as well as fake invoices and claiming of credits for noncreditable purchases.

Also, because exports are zero rated, it is not unheard of for taxpayers to manufacture bogus exports to get their input credits refunded and then sell the product for cash...
Table 1. GST Compliance Costs of Small Businesses in the United Kingdom, New Zealand, and Canada

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<th>Size of Business</th>
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<th>New Zealand</th>
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<td>100-200</td>
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<td>500-1,000</td>
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at a discount. Some policymakers argue that last-payer evasion is not as big a problem as in a sales tax system because each level of production has been assessed and paid some of the VAT. However, in some industries, there may be only one or two levels of business value added, and therefore, the last payer cheating would cost the government significant revenue. What are exempt financial institutions and what functions are exempt are also areas ripe for tax avoidance and potential abuse. If exemption or lower rates applied to food, housing, medical, clothing, and education, then extensive compliance costs, similar to what is encountered at the state level, would be needed at the federal level.

Everyone agrees that transfer pricing with an essentially territorial U.S. corporate income tax system is subject to much litigation, judgment, and complexity. Just look at the section 482 regulations, court cases, and rulings. Some people argue that transfer pricing issues will go away in a consumption tax world. However, industrialized nations still find that transfer pricing is a big issue. For example, what profit you earn is essentially what the VAT is imposed on. If you lower your profit in a 20 percent VAT country and transfer the profit to a 5 percent country or you are treated as VAT exempt in the foreign country, significant benefit will inure to the group.

Myth #5: Once You Get the New System Going, It Is Simpler and Easier to Comply With for Small Business and Individuals.

A recent European Commission working paper suggests that the cost for small and medium-size enterprises is 2.6 percent of sales and for large companies 0.02 percent of sales.15

Based on international research, recurrent VAT compliance costs are very regressive. The regressivity of small-business GST compliance costs has been clearly established by Cnossen (1994)16 in his comparative analysis of data from three countries — the United Kingdom, Canada, and New Zealand. (See Table 1.)

Together with administrative costs, compliance costs can be minimized by:

1. a wide tax base;
2. a high registration threshold; and
3. a single rate.

The major policy question is, what size of small business should be relieved of participating in the GST system, either partly (through simplified rules) or entirely (through optional registration)?

One argument that you hear from proponents of a consumption tax is that you eliminate the need for inventory and asset basis records. This issue was not found to be that complicated in the Ingraham/Karlinsky study.17 However, you do need to maintain records as to the input taxes paid so you can get a credit. Also, an important small-business issue, cash flow, is affected by paying taxes on inputs sooner than receiving the cash flow from outputs, which could cause hardship for small business. Another small-business compliance issue is the likely scenario that state and local sales tax and the new federal tax would have different filing dates, definitions, thresholds, and so forth.

Myth #6: Consumption Taxes Will Stop the Underground Economy18 and Cash Business Evasion.

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14Although theoretically the United States has a worldwide tax system imposed on its citizens, residents, and domestic corporations, the fact that foreign corporations are not subject to U.S. tax (sans CFC and passive foreign investment company regime) when earned essentially makes the United States a territorial system.


18Many other countries use the term “black economy” to describe this aspect of the business world.
Problems found in other countries with established VAT systems include nonregistration of businesses, underreporting of gross receipts, abuse of multiple rate structure, and nonremittance of taxes owed, as well as fake invoices and claiming credits for noncreditable purchases.\(^{19}\)

**Myth #7: Consumption Tax Can’t Be Progressive.**

One of the biggest arguments against consumption taxes is that they are regressive in nature. That is, someone making $500,000 per year consumes roughly the same as someone who earns $50,000 per year. Making a system more progressive introduces complexities into the system (zero lower rating or certain activity or thresholds). Another suggestion is that independent of the tax system, funds could be transferred to lower-income taxpayers rather than through the tax expenditure mechanism of the current income tax system. However, that creates its own bureaucracy.

**Myth #8: Consumption Taxes Work Well in an International Environment.**

One of the issues that the United States has faced vis-à-vis its trading partners is the ability to rebate VAT or GST on exports, making an exporting company’s goods more competitive. Because the United States does not have a consumption tax system, it has tried using domestic international sales corporation, foreign sales corporations, extraterritorial income (all of which have been declared illegal under the General Agreement on Tariffs and Trade by the World Trade Organization), and most recently the section 199 domestic production deduction to level the international playing field.

Normally, an important reason for advocating the introduction of a consumption tax is to make a country more internationally competitive.\(^{20}\) As Prof. Graeme Cooper and Richard Vann note, a consumption tax is intended to function as a tax on domestic consumption, and in international terms, that objective is achieved by subjecting imports to a consumption tax and freeing exports from consumption taxes already levied.\(^{21}\) However, as Cooper, Vann and others\(^{22}\) have said, “The argument that export competitiveness of goods is thereby increased overlooks adjustments to the exchange rate, though some transitional competitive advantage probably accrues, perhaps for as long as five years.”\(^{23}\)

On the Internet, the potential for revenue leakage becomes apparent. Currently, people shop on the Internet mainly to order tangible products, such as books or CDs. There is nothing very different about purchasing those products over the Internet compared to buying them in a shop, as the physical good is still delivered via the mail and hence the customs authorities can check it and collect any applicable duties or taxes.\(^{24}\) However, more products are becoming intangible — for example, the downloading of books, music, etc. to personal computers. Thus, there are few toll booths on the information superhighway, and consumption taxes become vulnerable to avoidance.

Another problem occurs when a consumption tax is viewed from an international perspective — the providing of services. Trade in services has grown much faster than trade in goods, both domestically and internationally.\(^{25}\) Two immediate problems occur with services relative to a consumption tax. First, there is a definitional problem of what is an import/export of a service as compared with goods. Second and perhaps more significantly, the international movement of services is not subject to any border control via customs authorities in the same way as goods are.

A related issue concerns the actual collection of consumption taxes on international transactions. Again, a distinction needs to be made between goods and services, with most of the problems occurring with internationally transacted services. For imported services, many countries have established a system known as the reverse charge, in which a buyer charges consumption tax on its acquisitions. That levy on the acquirer applies only when the importer is a registered person. It does not apply when the importer is an unregistered person (for example, a consumer downloading music). Therefore, imports of services by consumers may escape being taxed. While traditionally that has not been regarded as a major problem, the increasing ability of consumers to download products such as videos, CD's, and software, combined with being able to reprint books, will pose a serious threat to the ability of revenue authorities to detect any taxable transaction.

On the export side, similar problems arise, both with capturing all exported services and ensuring that services do not get the benefit of consumption tax-free treatment unintentionally.\(^{26}\)

Further, problems of double or nontaxation of internationally traded goods and services may occur, and it might be that existing (or new) double tax treaties may need to be considered to accommodate these concerns.

In short, far from consumption tax systems operating seamlessly and efficiently in an international environment, there are some real concerns and possible distortions that may occur with the application of a consumption-tax-based system with internationally traded goods and services.

\(^{19}\)See the discussion under Myth 4 supra.

\(^{20}\)For example, in the Australian context, the government advocated that the introduction of a GST would make Australia more internationally competitive. *Treasury, Tax Reform: Not a New Tax, a New Tax System*, August 1998 at 72.

\(^{21}\)Graeme Cooper and Richard Vann, “A Few Myths About the GST” 23 UNSWJ 252, 259 (2000). What follows on this point is adapted from that source, which is an excellent analysis of some of the myths applicable to the introduction of consumption tax systems.


\(^{23}\)Id. See also Cooper and Vann, supra note 21.

\(^{24}\)In other words, for the offline supply of goods and services via the Internet, no new problems are presented to VAT/GST authorities other than the significant increase in the number of transactions that can be expected. That in turn raises a question mark over the ability of customs’ authorities to be able to cope with the resulting demand.

\(^{25}\)Id.

\(^{26}\)Cooper and Vann, supra note 21, at 260.
Myth #9: A Consumption Tax Will Solve the Problem of Taxing E-Commerce and Intangibles.

As more goods and services become capable of being converted into electronic form, the application of consumption taxes—which many countries have adopted as a substitution for sales taxes—becomes more complicated, and the potential for revenue leakage increases considerably. Already, intangibles such as travel and ticketing services, software, entertainment (online gambling, games, and music), insurance and brokerage services, real estate services, banking, information services, legal services, and increasingly healthcare, education, and government services are appearing on the Internet. That trend will no doubt continue to increase, both in number and variety of services that become available.

It is beyond the scope of this article to examine in detail the many challenges to consumption taxes. However, by way of summary, there are two critical points worth mentioning in relation to the application of a consumption tax in an electronic commerce world that militate against the assertion that a consumption tax will solve the problem of taxing e-commerce and intangibles:

i) Tax administrators will experience three main problems in relation to the application of consumption tax rules, particularly as they may apply to international services, namely:
   - ascertaining when a transaction occurs;
   - determining where the place of supply is; and
   - attaching a value to the transaction: that is, what would be the consideration applicable to the transaction.

ii) For most businesses, a consumption tax is not a real cost but normally flows through to the final customer who ultimately bears the economic burden of it. However, for businesses that are exempt from consumption taxes, they can be a real cost, as the businesses may not be able to claim a credit for consumption taxes charged on their business inputs. A good example of this is a business that operates in the financial sector, such as a bank. Because banks cannot recover fully the consumption taxes which are normally charged on their business expenditures, they may look to the Internet to try to achieve real cost savings. Banks may try to avoid their consumption tax liabilities by seeking out nonresident suppliers that have no business or other fixed establishment within the domestic jurisdiction. Those businesses could then establish by contractual arrangements an artificial source of supply outside the domestic jurisdiction, thereby avoiding the application of a consumption tax. That type of arrangement would undermine the place-of-supply rules that are a central feature of traditional consumption tax systems.

Hence, the advent of electronic commerce not only has implications for countries that operate under sales tax systems but will have implications for consumption taxes. And contrary to the view that a consumption tax may solve many of the tax challenges presented by e-commerce, it may in fact exacerbate some of them.

Myth #10: It Is Hard to Increase Rates in a Consumption Tax World.

Some conservative economists (particularly Milton Friedman) are bemoaning the withholding-at-source concept because it fools the public as to what they owe the government. That is true with a consumption tax because it is hidden in every good and service provided. This makes it easier for politicians to raise taxes by a percentage point or two and raise significant funds for pet projects. Ease of raising VAT rates is one of several weaknesses of those taxes. Another indirect way to change the tax level is to increase or decrease the exemptions and thresholds. For example, the Philippines is currently raising its VAT rate from 10 percent to 12 percent (a 20 percent increase) and eliminating exemptions on power generation and airline fares. Just like we have seen huge increases on our airline tickets, so may the government easily raise rates without people realizing it. One international Big 4 tax accountant criticized the potential for a VAT to be a money machine in the hands of an undisciplined government.

In conclusion, moving to a consumption tax is expensive (one estimate is $125 billion). It won’t allow society to kill all the tax lawyers, accountants, and lobbyists; it won’t solve the underground economy; it would be expensive to comply with especially for small businesses, and if the United States does not eliminate the state sales tax it may very well be inflationary. Fixing the current income tax system is doable with less transition costs. The issue of tax complexity and simplification is not a new phenomenon. In England, trusts were used as early as the 13th century to avoid primogeniture and the

Addendum: Simplification in a Complex World

by Stewart Karlinksy

The issue of tax complexity and simplification is not new. In England, trusts were used as early as the 13th century to avoid primogeniture and the
As former IRS Commissioner Fred Goldberg has stated, "Tax simplification is everyone’s favorite orphan. All of us involved in the tax system — Congress, the executive branch, practitioners and taxpayers — proclaim our afflication for this chink of our dreams, but few are willing to adopt her as our own.” Other comments argue that tax simplification has no constituency to lobby for it. Nonetheless, the National Taxpayer Advocate Nina Olson in her 2005 annual report to Congress, identified tax law complexity as the greatest single problem facing taxpayers and tax administrators.

All of us who deal with the income tax law will readily agree that it is complex. The relevant question is whether it requires a huge overhaul or would an alignment and a tune-up fix the system. To put all this rhetoric in perspective, OECD Tax Commissioner Jeffrey Owens, who has the advantage of an international perspective, pointed out that “there is no crisis (in the U.S. tax system), but lots of room for improvement.” The ways of improving the system will be the focus of this addendum.

Unfortunately, from the complexity perspective, the tax system is being used for a variety of political, social, and economic purposes, rather than just to raise revenue so that the government may function. Those nonrevenue uses of the tax system are a major contributor to the tax law’s complexity, and the rate of distinctions and complexity has been growing at an exponential rate. Many argue that the tax system has to be complicated to reflect the complexity of business transactions and growing globalization, as well as new techniques created every day for good business reasons such as hedging, derivatives, doing business across borders, and the like. Nonetheless, there are things we can do to the current tax system to make it less complicated. Let’s look at some areas that could be simplified without pulling out the tax code by its roots.

In my professional and academic experience, any time you differentiate the essentially same item into different tax treatments, you get a more complicated system and create opportunities for tax planning and tax abuses. One commentator has pointed out that there are nine different provisions dealing with education incentives. Making the definitions and terms uniform among these provisions and consolidating the rules would help reduce the complexity of that area that affects many middle-income taxpayers. Similarly, there are 12 different tax-advantaged retirement planning vehicles available to the workforce and their employers. Simplifying and consolidating those provisions would make the law easier to apply and enforce for the vast majority of businesses, particularly smaller ones. Both of those items involve an above-the-line deduction, so even if a taxpayer doesn’t itemize, those rules complicate and confound the life of businesses and individuals.

Another area that is made complex by distinguishing similar items’ tax treatment is interest expense, especially given money’s fungibility. For individuals, the U.S. tax law has seven different treatments — business, investment, home mortgage, passive, personal, tax-exempt and capitalized. Each of those has different rules attached to it, and if it is deductible, is done so on different parts of the tax return.

Constructive ownership is another area begging for simplification. There are at least four major code provisions and many modifications and exceptions to those rules in dealing with who is deemed to own an entity. For example, section 318 covers parents, grandparents, children, and grandchildren, while sections 267 and 544 adds brothers and sisters, as well as all ancestors and lineal descendants. In some cases section 1563 does not attribute a husband’s stock to a wife or a father’s stock to a son or daughter. A corporation’s ownership of an entity will be deemed owned proportionately for purposes of sections 267 and 544, but ignored unless it has a threshold more than 50 percent for purposes of section 318, and 5 percent for purposes of section 1563. I could go on with these hair-splitting differences, but hopefully those examples will give the reader an understanding of why our tax law is perceived to be complicated. Why not have one central definition of constructive ownership?

In one of the ironies of tax life, it is well-documented that the tax and regulatory compliance cost for small business on a revenue or employee basis is significantly higher than for midsize and large companies. The same is true for other costs, such as healthcare, shipping, and manufacturing. Therefore, the tax law has traditionally provided provisions that favor small business. Yet there

32Henry Aaron and Joel Slemrod, Crisis in Tax Administration, Brookings Institution 2004, p. 348.
34I t would be an interesting experiment to see if people would pay slightly more in taxes in return for serious simplification of the tax system. I would venture a guess that taxpayers want their cake and to eat it too — no increased taxes and a simpler system.
37Major constructive ownership provisions include sections 267, 318, 544, and 1563; variations on a theme include sections 304, 382, 958, and 1239.
are more than 40 different ways that the tax law has defined a small business, and taking advantage of those myriad provisions involves compliance costs that is the raison d'être of the provision in the first place. Clearly, two, or three, or, ideally, one provision could be used to define small business for all tax purposes.

Capital gains and dividends are favorably treated under the U.S. tax system over interest income, rent or royalty income, and other investment returns. However, the tax benefit of capital losses is limited for individuals to capital gains plus $3,000 ordinary income. The amount of complexity attributed to the special capital gain provisions alone has been estimated to complicate the tax law by 15 percent. It also affected 383 different code provisions out of 584 in existence at the time. To make matters worse, it is not a particularly efficient mechanism in that its tax expenditure complexity (TEC) model efficiency rating was 78, while tax-exempt interest had an efficiency rating of 258.

Probably one of the more ironic complexity issues deals with the alternative minimum tax because it affects individuals and corporations. Although the minimum tax concept has gone through several iterations since its implementation in 1969, its basic concept is to prevent perceived abuses of the tax system by high-income individuals who were paying no federal income taxes. Ironically, under the current system, wealthy people can and are still avoiding paying any taxes by investing in tax-exempt bonds. Nonetheless, the lack of inflation adjustment of the statutory exemption, the phaseout of the exemption at relatively low levels of alternative minimum taxable income ($150,000) and the high rate of tax (26 percent and 28 percent) relative to the regular tax rates (33 percent and 35 percent) make the AMT a political time bomb that could be diffused by raising the level of phaseout or reducing the rates. The complex part of AMT is really the minimum tax credit mechanism in which a permanent and temporary difference computation must be made. Ironically, it is not a complexity issue for corporations, only individuals.

On the corporate AMT side, differentiating AMT adjustments from the adjusted current earnings calculation is clearly something that could be eliminated and would reduce complexity. There is no particular policy reason why some preferences are 75 percent bad and others are 100 percent bad. Make all these adjustments and preferences either 100 percent or 75 percent, but don’t add significant complexity to the system by differentiating various treatments and requiring different bases calculations, different gain or loss computations and different tax rules.

Kudos to Congress in one respect relative to corporate AMT. In 1998 the legislature passed a simplifying provision (section 55(e)) relative to AMT and small businesses. It was done with forethought and intelligently, such that few issues have arisen relative to it and it really does simplify the corporate life for hundreds of thousands of small businesses. That just shows that simplifying the tax law is possible.

There are many other things that we can do to simplify the income tax system without ripping it out by its roots. For example, we could raise the standard deduction and eliminate the need for the itemized deduction for a large portion of the population. Taking this one step further, we might adapt Stanford Law School Prof. Joseph Bankman’s ReadyReturn concept, which would take the burden off the lower- and middle-income taxpayer by sending them a prepared return reflecting their salary, wages, interest and dividends, and the tax thereon. If they were satisfied with the computation and inclusions, they would simply sign and mail back the return. If the analysis was not correct, they could file their own return. That is something that 36 countries are currently doing. Prefiling has been found to be popular with many taxpayers, even though paying taxes will never be.

Another complicating feature of the congressionally passed tax code is that we have phaseouts embedded in the code for much longer than a one- or two-year transition period. Those mathematical calculations for normal everyday tax features will probably phase (pun intended) the middle-income and upper-middle-income taxpayer more than most (for example, the phaseout of the itemized deductions, personal and dependency exemptions, AMT exemptions, and active real estate loss provisions, etc.). To make that computation more complicated, there are nine different definitions of income above which the phaseout kicks in. For example, the AMT exemption is phased out at $150,000 AMTI while section 469(i) begins to be phased out at $100,000 of modified adjusted gross income, which is computed before IRA deductions, section 199 deductions, and qualified real estate losses. Ridiculous!

Sometimes Congress is so intent on making the revenue estimates, avoiding perceived abuses, or reaching a political compromise, that they use an elephant gun on a flea or try customizing a tax system for each individual’s unique situation. Congress might think about the 80/20 rule; that is, getting the tax situation right for 80 percent of the population with 20 percent of the complexity. Going after the other 20 percent of the population is where 80 percent of the complexity comes from. I would argue that the latter 20/80 is what the AMT was intended

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40 Id. at 78. TEC measures the tax expenditures efficiency by comparing the dollar amount of the preference divided by the complexity factor. Another way to look at efficiency is that less than 10 percent of individual tax returns filed reflected capital gains and losses, yet it complicated the tax code by 15 percent (p. 52).

41 Currently, almost two-thirds of the individuals filing returns do not itemize their deductions.

42 Heidi Glenn, “Complexity Concerns Dominate Tax Return Due Date Rhetoric,” Tax Notes, Apr. 18, 2005, p. 275, points out that there are 14 different phaseouts just within benefits to families.
for, and should be reestablished with that in mind. Make
the AMT exemption high enough that you eliminate 80
percent of the population and use it to have the 20
percent group be treated in accordance with the public
policy that Congress thinks is appropriate.

An important multijurisdictional issue that has not
gotten wide press coverage is the potential effect on state
income tax compliance costs of the United States moving
to a consumption tax system. Currently, many states
receive the bulk of their revenue from sales tax, property
taxes, excise taxes, and corporate and individual income
taxes. Individuals almost universally use as their starting
point federal taxable income, and then make additions
and subtractions from that base. If there was no federal
taxable income, the state income tax compliance function
would become infinitely more complex. According to R.
Bruce Johnson,43 chair of Multistate Tax Commission’s
Executive Committee, 37 states impose a broad-based
personal income tax, three states compute their tax as a
percentage of federal tax liability, and many states im-
pose a corporate income or franchise tax. What perceived
simplicity may be gained at the federal level will likely be
swamped out by state tax compliance impact.

In conclusion, yes, our income tax system needs
several improvements, but better the devil we know than
the one we don’t know. We should start by having
Congress stop blaming the tax system they created and
have them look at the ideas presented in this paper and
by many other tax policymakers for ways to apply the
80/20 rule discussed above. Make the individual tax
system 20 percent complex to reach 80 percent of the
population and the rest of the complexity will arise
through a narrowly focused AMT system. Stop trying to
close every loophole or tailor a tax system for every
group of taxpayers. Make one phaseout rule; make one
income level to phase out at; make one constructive
ownership rule; make one control rule; make one or two
sets of retirement rules; make the AMT and ACE systems
one; make one educational incentive regime; make one or
two uniform small-business definitions; increase the
standard deduction to simplify life for most taxpayers;
increase the AMT statutory exemption or reduce the tax
rate to avoid the middle-income taxpayers unintention-
ally being affected by it; conform the AMT and ACE
adjustment treatment; and pilot a federal prefiling system
similar to Bankman’s California’s ReadyReturn to get the
government out of the hair of the average taxpayer.

43Heidi Glenn, “Tax Reform Witnesses Criticize Deprecia-
tion, Research Credit,” Tax Notes, Apr. 25, 2005, p. 419.