Tax Policy Conference
Reinvigorated Tax Reform Arrives for 2015 - What It Means for You and Your Company
Friday, May 15, 2015
8:00 am – 3:00 pm
SJSU Lucas Business Complex, 2933 Bunker Hill Lane, Santa Clara

Topics and Presenters

8:00 - Registration + light breakfast

8:20 - Welcome

8:30 - Political and Budgetary Challenges of Federal Tax Reform
- Caroline Bruckner, Kogod Tax Center at American University, Washington, DC; Former Counsel to Senate Committees on Energy and Small Business, Washington, DC
- Rohit Kumar, PwC National Tax Office, Washington, DC; Former Domestic Policy Director and Deputy Chief of Staff for Senate Republican Leader Mitch McConnell

10:00 – Break

10:15 - 2015 Federal Tax Reform Proposals
Moderator: Annette Nellen, San José State University
Speakers:
- Roger Royse, Royse Law Firm, Palo Alto
- Eric Ryan, DLA Piper, Palo Alto

10:55 - What about State Tax Reform?
The 50th Anniversary of the Willis Commission Report – Relevance for Today
- Professor Annette Nellen, San José State University
What the Feds Can Learn from State Cross-Border/Jurisdictional Concerns
- Greg Turner, Sheppard Mullin Richter & Hampton LLP
- John Paek, Baker & McKenzie LLP

12:05 - Lunch

12:45 - Inequality and Income Segregation through the U.S. Tax System
- Professor Kirk J. Stark, UCLA School of Law

1:45 – Break

2:00 - Takeaways for Businesses
Moderator: Peter Waterstreet, Director – International Tax, Synopsys
Speakers: Presenters from earlier panels.

3:00 - End

Thank you for attending!
Political and Budgetary Challenges of Tax Reform

Caroline Bruckner
Managing Director, American University Kogod School of Business Tax Policy Center

Rohit Kumar
Principal, PwC
Co-Leader Tax Policy Services

TEI-SJSU Tax Policy Conference
May 15, 2015

Agenda

Federal budget 101
Politics of tax reform
Tax reform: Accounting basics
Significant activities to date
Other relevant topics
# Federal budget 101

## Key facts on debt and deficit

### National debt
- Money the federal government borrowed and hasn’t paid back
- FEDERAL DEBT = debt held by the public + intragovernmental debt
- **Current status:** $18 trillion
- **Debt to GDP ratio:** 74.2%

### Annual deficit
- The annual change in national debt
- DEFICIT = outlays – receipts
- **Current status:** $486 billion
- **Deficit to GDP ratio:** 2.7%
  -- In 2009 deficit peaked at 9.8% of GDP
# Quick debt stats

**Total national debt = $18.437 trillion**
- Public debt = $13.36 trillion
- Intragovernmental debt = $5.077 trillion

**GDP = $18.016 trillion**

**Debt to GDP ratio = 74.2%**
- Note that Debt to GDP usually counts only debt held by the public
- The ratio of all federal debt is 100%
- By 2025, CBO projects the debt will rise to 77% of GDP; this has serious negative consequences, particularly when interest rates return to more typical levels (i.e., federal spending on interest payments increases substantially)

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**The Eurozone**

In order to join the Eurozone, member states must keep budget deficits at no more than 3% of GDP and maintain a debt to GDP ratio of less than 60%

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**Federal budget outlook, FY 2015-2025**

Source: Congressional Budget Office, *Updated Budget Projections: 2015 to 2025* (March 2015); PwC calculations.
### Revenues and spending as a percent of GDP, 2015-2025

![Bar chart depicting revenues and spending as a percent of GDP from 2015 to 2025.](chart)

Source: Congressional Budget Office, Updated Budget Projections: 2015 to 2025 (March 2015).

### Distribution of spending, FY 2014

**Major entitlements accounted for 47% of outlays**

![Pie chart showing distribution of spending in FY 2014.](chart)

**FY 2014 outlays (in billions)**

<table>
<thead>
<tr>
<th>Category</th>
<th>Outlays (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$3,504</td>
</tr>
<tr>
<td>Discretionary</td>
<td>1,179</td>
</tr>
<tr>
<td>Social Security</td>
<td>845</td>
</tr>
<tr>
<td>Medicare</td>
<td>505</td>
</tr>
<tr>
<td>Medicaid</td>
<td>301</td>
</tr>
<tr>
<td>Other Mandatory</td>
<td>445</td>
</tr>
<tr>
<td>Net Interest</td>
<td>229</td>
</tr>
</tbody>
</table>

Source: Congressional Budget Office, Budget and Economic Outlook: 2015 to 2025 (March 2015); PwC calculations
**Politics of tax reform**
Key tax policymakers in the 114th Congress

Administration

US House of Representatives

US Senate

President Obama

Speaker Boehner

Minority Leader Pelosi

Majority Leader McConnell

Minority Leader Reid

Treasury Secretary Lew

Chairman Ryan

Ranking Member Levin

Chairman Hatch

Ranking Member Wyden

Key tax reform drivers

– Leadership from the White House and Treasury Department

– Bipartisan Congressional support

– Need for U.S. international business competitiveness

– Current tax laws viewed as complicated and unfair
Bipartisan cooperation or continued gridlock?

<table>
<thead>
<tr>
<th></th>
<th>Senate</th>
<th>House</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republicans</td>
<td>54</td>
<td>246**</td>
</tr>
<tr>
<td>Democrats</td>
<td>46*</td>
<td>188</td>
</tr>
<tr>
<td>Net Change from 113th Congress</td>
<td>+9 Republicans</td>
<td>+13 Republicans</td>
</tr>
</tbody>
</table>

* Includes two Independents: Senators Bernie Sanders (I-VT) and Senator Angus King (I-ME) who caucus with Democrats


Senate Control Could Change Over the Next Two Election Cycles

In 2016, Democrats will be defending 10 seats — all in states won twice by President Obama. Republicans will be defending in 7 states (FL, IL, IA, NH, OH, PA, WI) won twice by President Obama and in 2 states (IN, NC) won by President Obama in 2008.

In 2018, Republicans will defending 8 seats — all in states won by Mitt Romney in 2012. Democrats will be defending 5 seats in states (WV, MO, SD, MT, IN) Mitt Romney won by 9 percentage points or more.

2016 Senate election outlook

Source: University of Virginia Center for Politics, updated April 17, 2015
### Fiscal deadlines, other dates affecting tax policy

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2014</td>
<td>Business and individual tax provisions expired</td>
</tr>
<tr>
<td>February 2, 2015</td>
<td>President’s FY 2016 budget submitted to Congress</td>
</tr>
<tr>
<td>February 27, 2015</td>
<td>Department of Homeland Security funding expired</td>
</tr>
<tr>
<td>March 15, 2015</td>
<td>Federal statutory debt limit suspension period expired</td>
</tr>
<tr>
<td>March 31, 2015</td>
<td>Medicare “doc fix” expires; physician payments reduced 21%</td>
</tr>
<tr>
<td>April 15, 2015</td>
<td>House &amp; Senate budget resolution target date</td>
</tr>
<tr>
<td>May 31, 2015</td>
<td>Highway funding expires</td>
</tr>
<tr>
<td>June 1, 2015</td>
<td>FISA &amp; PATRIOT Act national security provisions expire</td>
</tr>
<tr>
<td>June/July 2015</td>
<td>US Supreme Court decision expected in <em>King v. Burwell</em> case</td>
</tr>
<tr>
<td>June 30, 2015</td>
<td>Export-Import Bank authorization expires</td>
</tr>
<tr>
<td>August 2015</td>
<td>GOP presidential primary debates begin; Iowa straw poll held</td>
</tr>
<tr>
<td>October 1, 2015</td>
<td>FY 2016 begins; budget “sequestration” reinstated, Internet tax moratorium expires</td>
</tr>
<tr>
<td>October /November 2015</td>
<td>Treasury debt limit “extraordinary measures” expire</td>
</tr>
</tbody>
</table>

### Tax reform: Accounting basics
What is the definition of revenue-neutral?

| Revenue Baseline | **Current-law baseline** assumes expiration of temporary business and individual tax provisions (“tax extenders”) and resulting increase in revenue | **Current-policy baseline** assumes renewal of tax extenders without offsets and therefore no revenue from expiration and no cost for extension. |
| Estimation Period | Congress uses **10-year budget window** to measure revenue effects of tax legislation. | The Obama Administration wants **long-run sustainability**, meaning revenue neutrality beyond the 10-year budget window, and opposes using one-time revenue (e.g., mandatory repatriation) and timing differences (e.g., realization of LIFO reserves) to pay for permanent rate reductions. |
| Scoring Methodology | **Conventional revenue estimation**, by the staff of the Joint Committee on Taxation includes behavioral responses. | The House has adopted **dynamic scoring**, which includes the macroeconomic growth (and revenue) effects of tax reform. |

Dynamic scoring – new House rule

**Macroeconomic dynamic scoring**

- Conventional revenue estimates include behavioral responses to legislation but hold the overall size of the economy fixed
- Former House Rule XIII required an advisory macroeconomic impact analysis (or statement of why one was not calculable)
- New 2015 House Rule calls for JCT staff to incorporate macroeconomic analysis into revenue estimates for ‘major legislation’ ‘to the extent practicable’
  - Major legislation defined as:
    - Gross budgetary effect (before incorporating macroeconomic effects) in any fiscal year equal to or greater than 0.25 percent of gross domestic product (approx. $45 billion in 2015), or
    - Designated by the Chairman of the Ways and Means Committee
- In the 113th Congress, only 3 bills considered by the House met this dollar threshold (two bills making bonus depreciation permanent and the 1-year extenders bill that was enacted)
What does comprehensive tax reform cost?

**Individual rate reduction**
- 10% and 25% tax rates with AMT repeal reduces revenues by $3.8 trillion over 10 years

**Corporate rate reduction**
- 25% top rate with AMT repeal reduces revenue by $1.3 trillion over 10 years

**International reform**
- Territorial system without expense allocation reduces revenues by $130 billion over 10 years
- Territorial system with full expense allocation raises $76.2 billion over 10 years


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Estimates for repealing selected tax expenditures ($ Billions, 2012 – 2021)

Source: Joint Committee on Taxation letter to Rep. Levin (October 27, 2011)

<table>
<thead>
<tr>
<th>Provision</th>
<th>5-year amount ($ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferral of active income of controlled foreign corporations</td>
<td>$418.0</td>
</tr>
<tr>
<td>Deferral of gain on like-kind exchanges</td>
<td>$68.0</td>
</tr>
<tr>
<td>Deduction for income attributable to domestic production activities</td>
<td>$65.1</td>
</tr>
<tr>
<td>Exclusion of interest on public purpose tax-exempt bonds</td>
<td>$49.2</td>
</tr>
<tr>
<td>Tax credit for low-income housing</td>
<td>$38.8</td>
</tr>
<tr>
<td>Deferral of gain on non-dealer installment sales</td>
<td>$34.0</td>
</tr>
<tr>
<td>Expensing of research and experimental expenditures</td>
<td>$28.4</td>
</tr>
<tr>
<td>Reduced rates for first $10 million of corporate taxable income</td>
<td>$20.4</td>
</tr>
<tr>
<td>Inventory property sales source rule exception</td>
<td>$15.3</td>
</tr>
<tr>
<td>Last-in, first-out inventory method (&quot;LIFO&quot;)</td>
<td>$7.8</td>
</tr>
</tbody>
</table>

* Excludes non-corporate business tax expenditures.

Source: Joint Committee on Taxation, JCX-97-14 (2014)

Significant activities to date
Recent tax reform developments

W&M Chairman Rangel tax reform bill (HR 3970)

Senator Wyden tax reform bills (S 3018; S 727)

President Obama ‘framework for business tax reform’

SFC Chairman Baucus international; cost recovery; administration; energy tax reform drafts

Obama Admin. FY 2016 budget proposes minimum tax on foreign earnings of US-based company CFCs

Former House Ways and Means Chairman Dave Camp Tax Reform Act of 2014

Key provisions

- Intended to be revenue neutral during the 10-year window
- Shift from a worldwide to a territorial-based system
- Reduce the top corporate tax rate to 25% over a 5-year period
- Eliminate the majority of corporate and individual tax credits
- Repeal the corporate and individual AMT
President Obama

Framework for business tax reform

- Reduce corporate rate from 35% to 28%
- Provide 25% rate for certain domestic manufacturing income
- Minimum tax on foreign earnings of US-based company CFCs
- Has proposed using $150 billion in ‘one-time’ tax reform revenue to fund infrastructure spending
- Budget also included a “financial crisis responsibility fee”

Congressional taxwriting committee leaders

House Ways & Means Chairman Paul Ryan (R-WI)

- Supports top rate of 25% for individuals and corporations
- Open to a ‘phase 1’ approach focusing on business tax reform
- Ways and Means will pursue an ‘aggressive’ timeline for reform

Senate Finance Chairman Orrin Hatch (R-UT)

- Finance Republican staff paper: ‘Comprehensive Tax Reform for 2015 and Beyond’
- Tax reform principles: economic growth, fairness, simplicity, permanence, competitiveness, promotion of savings and investment, and revenue neutrality
- Bipartisan tax reform working groups: individual income tax, business income tax, savings & investment, international tax, community development & infrastructure
Senate Finance Committee tax reform working groups

Bipartisan working group co-chairs:

Individual Income Tax:  
Senator Chuck Grassley (R-IA) & Senator Mike Enzi (R-WY), Senator Debbie Stabenow (D-MI)

Business Income Tax:  
Senator John Thune (R-SD) & Senator Ben Cardin (D-MD)

Savings & Investment:  
Senator Mike Crapo (R-ID) & Senator Sherrod Brown (D-OH)

International Tax:  
Senator Rob Portman (R-OH) & Senator Chuck Schumer (D-NY)

Community Development & Infrastructure:  
Senator Dean Heller (R-NV) & Senator Michael Bennet (D-CO)

Working groups timeline

• February / early April: Education sessions
• April / May: Roundtable presentations
• May 25: Report to Chairman Hatch & Ranking Member Wyden

Senators Marco Rubio (R-FL) & Mike Lee (R-WY)

Economic Growth and Family Fairness Tax Reform Plan

• Lowers rate on corporate and pass-through business income to 25%
• Allows full expensing of capital purchases
• Eliminates interest deductions for new debt
• Eliminates ‘tax extenders’ that expired at the end of 2014
• Replaces the existing international tax system with a territorial regime
  – transitions to a territorial regime with a 6% tax on deemed repatriation of existing foreign earnings, tax to be paid over 10 years
  – will include measures to reduce base erosion and profit shifting
• No tax on capital gains or dividends
Rep. Devin Nunes (R-CA)

American Business Competitiveness Act of 2015
discussion draft

• Lowers tax rates on business income (corporate and non-corporate) to 25% over 10 years
• Replaces most credits and deductions by moving to full expensing of business costs and cash method of accounting
• Establishes a territorial international tax system
  -- 5% transition tax on undistributed foreign earnings
  -- repeals most subpart F provisions

OECD base erosion and profit shifting (BEPS)
project and European Commission State Aid
investigations

• Uncertainty
• Administrative burden
• Complexity
• Controversy
• Misalignment between tax and economics
• Double taxation
• Taxation
**Other relevant topics**

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**Comparison of foreign earnings repatriation proposals**

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<tbody>
<tr>
<td>Tax rate on historic earnings</td>
<td>Mandatory bifurcation - E&amp;P retained as cash and cash equivalents is taxed at 8.75% with all other E&amp;P taxed at 3.5%</td>
<td>Mandatory 14% tax on previously untaxed foreign earnings with credit for foreign taxes paid</td>
<td>Voluntary 6.5% tax on previously untaxed foreign earnings</td>
</tr>
<tr>
<td>JCT revenue estimate</td>
<td>$170.4 billion over 10 years</td>
<td>Raises $217.2 billion over 10 years</td>
<td>Costs $118 billion over 10 years</td>
</tr>
</tbody>
</table>
Piecemeal tax legislation

Tax ‘extender’ provisions

- More than 50 provisions expired December 31, 2014
- Include research credit, Subpart F exception for active financing income, look-through treatment for CFCs, bonus depreciation; Section 179 enhanced expensing limits
- Short-term extensions often retroactive (e.g., every extension of the research credit since 1993 has been retroactive)

Expired business & individual tax provisions

<table>
<thead>
<tr>
<th></th>
<th>Senate Finance Committee • 2-years (2014 / 2015)</th>
<th>House Ways and Means Committee • Permanent</th>
<th>H.R. 5771, Tax Increase Prevention Act • 1-year (2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research credit</td>
<td>-$16.0 billion</td>
<td>-$155.5 billion*</td>
<td>-$7.6 billion</td>
</tr>
<tr>
<td>CFC look-through</td>
<td>-$2.5 billion</td>
<td>-$20.3 billion</td>
<td>-$1.2 billion</td>
</tr>
<tr>
<td>Active financing</td>
<td>-$10.4 billion</td>
<td>-$58.8 billion</td>
<td>-$5.1 billion</td>
</tr>
<tr>
<td>Bonus depreciation</td>
<td>-$3.5 billion</td>
<td>-$287.4 billion*</td>
<td>-$1.5 billion</td>
</tr>
<tr>
<td>All other business and individual provisions</td>
<td>-$51.6 billion (50 other provisions)</td>
<td>-$302.9 billion (six other bills)</td>
<td>-$26.2 billion (49 other provisions including technical corrections)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>-$84 billion</strong></td>
<td><strong>-$824.9 billion</strong></td>
<td><strong>-$41.6 billion</strong></td>
</tr>
</tbody>
</table>

* Denotes bill passed House of Representatives
Research credits & patent box regimes

Countries with solid bars have patent box regimes (Ireland's Knowledge Development Box is under development). R&D tax subsidy rate does not reflect patent box. US rate is a weighted average of alternative simplified and regular research tax credits.

Treaty overview

The Senate Foreign Relations Committee has reported out favorably the following treaties and protocols but the prospects for Senate ratification remain unclear due to procedural objections by Senator Rand Paul (R-KY)

- Hungary
- Luxembourg
- Switzerland
- Chile
- Spain
- Poland

Treaties submitted to Senate
- Japan

Treaties initialed and awaiting signature
- Norway

Treaties in negotiation
- United Kingdom
- Vietnam

Note: A protocol to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters was also considered and reported out favorably on April 1, 2014.
2015 Federal Tax Reform Proposals

Roger Royse, Royse Law Firm
Eric Ryan, DLA Piper
Annette Nellen, SJSU (moderator)

Agenda

• Introductions
• Overview of Tax Reform
• Summary of Selected Proposals
• International Tax Aspects of Tax Reform
• Conclusion
2015 Tax Reform Proposals

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Twitter @rroyse00

Overview

• Last comprehensive tax reform was in 1986
• Tax reform is now seen as essential and the current tax system is described by many as not being fit for purpose
• Common themes among legislative proposals announced to-date include:
  – Broadening the tax base
  – Reducing the headline rates of tax
  – Simplification
• Overview:
  – Chairman Camp’s 2014 discussion draft
  – Senator Hatch’s report on tax reform
  – Congressman Nunes’ proposal for a flat tax
  – Other proposals
  – White House Budget 2016
  – Tax credit proposals
Chairman Camp’s Reform Proposal

• Most comprehensive attempt at tax reform to date
  – Discussion draft released in February 2014
  – Almost 1,000 pages long (not including analysis from the Joint Committee of Taxation)
  – Proposed a complete overhaul of the US tax system
• Business tax rate brought down to 25% but individual tax rate only lowered to 35%
• Draft was revenue neutral however it shifted $580 billion of the tax burden from individuals to businesses
• Chairman Camp’s proposal expired with the 113th Congress however, given its scope and relatively bipartisan nature, the proposal is likely to influence future attempts at tax reform

Individual Taxation

• Three rates of tax for individuals:
  – 10% tax on income up to $36,900 ($73,800 for married couples filing jointly)
  – 25% tax on income between $36,901 ($73,801) and $400,000 ($450,000)
  – 35% tax on income in excess of $400,000 ($450,000)
• Eliminates the personal exemption but increases the standard deduction to $11,000 ($22,000)
• Eliminate deductions such as state and local taxes, real estate taxes, medical expenses, and tax preparation fees
**Chairman Camp’s Reform Proposal**

**Business Taxation**
- Headline rate of tax decreased to 25% but there is an overall increase to the tax burden for businesses of $580 billion
- Depreciation and amortization periods extended
- Industry specific deductions such as the Section 199 manufacturing deduction would be eliminated, however the R&D tax credit would be made permanent
- Repeal of favorable treatment for small business stock under Sections 1045 and 1202
- Quarterly excise tax on banks of 0.035% of assets in excess of $500 billion
- S Corporation income would be taxable as self-employment income
- Most carried interest would be taxable as ordinary income

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**Senator Hatch’s Report on Tax Reform**

- In late 2014, the Senate Finance Committee Republican Staff (headed by Senator Hatch) released a 300 page report titled “Comprehensive Tax Reform for 2015 and Beyond”
- The report does not put forward specific proposals but rather seeks to highlight the issues policymakers will need to confront in order to reform the tax code
- Senator Hatch states that tax reform should abide by seven key principles:
  1. Economic growth
  2. Fairness
  3. Simplicity
  4. Permanence
  5. Competitiveness
  6. Promoting savings and investment
  7. Revenue neutrality
Senator Hatch’s Report on Tax Reform

• In January 2015, Senator Hatch and Senator Wyden announced the launch of five bipartisan Finance Committee Working Groups aimed at spurring reform in the following areas:
  – Individual income tax
  – Business income tax
  – Savings and investment
  – International tax
  – Community development and infrastructure
• Analysis should be completed by the end of May
• Ideas are being solicited from the general public

Congressman Nunes’ Proposal

• House Ways and Means Committee Member Nunes drafted the American Business Competitiveness Act (still in discussion draft form)
• Only reforms business income tax
• Tax rate would be reduced to 25% over ten years
• Full and immediate deduction for all expenditure including capital assets such as real property
• Eliminates the deduction for interest expense
Other Proposals

• Economic Growth and Family Fairness Tax Reform Plan
  – Proposal put forward by Senators Rubio and Lee
  – Lowers individual tax rates to 15% for the first $75,000 ($150,000 married) and 35% above that
  – Reduces elements of double taxation by eliminating taxation of dividends, capital gains on sale of stock, and estate taxes
  – Reduces business income tax to 25%
  – Allows immediate expensing of investments

• Progressive Consumption Tax Act introduced by Senator Cardin
  – Proposes a broad consumption tax of 10%
  – Income tax exemptions increased to $50,000 ($100,000 married) to maintain progressivity
  – Top marginal tax rate would be 28%
  – Retains deductions for charitable contributions, state and local taxes, and mortgage interest

White House Budget 2016

• The budget proposal for the 2016 fiscal year contains a mixture of old and new proposals

• Business taxation
  – Previous proposal to reduce business tax rate to 28% has been eliminated
  – Imposes a bank tax of 0.07% of liabilities for banks with assets of over $50 billion
  – S Corporation income would be taxable as self-employment income
  – Eliminates oil, gas, and coal provisions
  – Repeals LIFO
  – Expands Section 179 to allow expensing of up to $1 million
  – Makes the R&D tax credit permanent
  – Retains incentives for renewable energy
  – Taxes carried interest as ordinary income
• **Individual taxation**
  – Increases capital gains tax to 28% and eliminates step up in basis on death
  – Introduces a “Fair Share Tax” (a.k.a. Buffet Rule) to ensure a 30% minimum tax on high earners
  – Increases estate tax rate to 45% and reduces the exemption to $3.5 million
  – Increases and expands Child Tax Credit (CTC) and American Opportunity Tax Credit
  – Expands Earned Income Tax Credit (EITC)

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**Tax Credit Proposals**

• **Working Families Tax Relief Act**
  – Would make the EITC and CTC permanent, expand EITC for workers without children, and index CTC to inflation

• **Early Refund Tax Credit**
  – Proposal to make up to $500 of the EITC payable in advance of tax return filing
  – Workers would enroll through their employer half-way through the year to request early payment

• **American Opportunity Tax Credit**
  – Proposal to make the AOTC permanent and expand the maximum credit to $3,000 up from $2,500
US International Tax System

• Since Japan lowered its rate in 2011, the US now has highest statutory corporate tax rate among all OECD members
  – Most OECD members have gradually reduced rates, year after year
• US is also one of the few remaining OECD members with a worldwide (“WW”) tax system (but has a Foreign Tax Credit mechanism)
  – Others include Chile, Ireland, Israel, Korea, and Mexico
  – Most OECD members now use a territorial system (generally not taxing foreign profits)
• Highest corporate tax rate + WW tax system = US may also have the highest average effective tax rate (“ETR”) of any OECD member
• Notwithstanding, US companies (Apple, Google, Amazon, Starbucks, Caterpillar) are at the forefront of criticism for inappropriate use of low tax / no tax countries and structures
• Offshore earnings are effectively “locked out” of the US

US Tax System v. OECD Members

Top 10 and bottom 10 combined corporate tax rates OECD countries, 2014

Source: OECD Tax Database and PwC Worldwide Tax Summaries
OECD Members w/ Territorial Systems

All G-7 countries except the United States follow territorial tax systems

U.S. MNEs - Offshore Earnings

Exhibit 1: Earnings Continue to Pile Up Overseas, 2001-2013, S&P 500

Note: Analysis excludes REITs and companies domiciled outside U.S.
Source: Company filings, Calcbench and ISI Group estimates
OECD BEPS TIMELINE

June 2012: G20 asks OECD at leaders’ meeting to report on “the need to prevent base erosion and profit shifting”


September 6, 2013: OECD publishes discussion draft on Intangibles (Action 8)

October 22, 2013: OECD releases public comments on Intangibles (Action 8)

January 30, 2014: OECD presents discussion draft on CbC Reporting (Action 13)

February 23, 2014: OECD releases public comments on CbC Reporting (Action 13)

March 13, 2014: OECD publishes discussion draft on Treaty Abuse (Action 6)

March 19, 2014: OECD releases public comments on Treaty Abuse (Action 6)

April 11, 2014: OECD releases public comments on Treaty Abuse (Action 6)

May 7, 2014: OECD releases public comments on Hybrids (Action 2)

July 30, 2013: OECD published revised discussion draft on Intangibles (Action 8)

September 6, 2013: G20 leaders endorse OECD’s work on BEPS at Russian summit

February 12, 2013: OECD publishes first report “Addressing Base Erosion and Profit Shifting,” listing 6 key pressure areas

January 30, 2014: OECD publishes discussion draft on CbC Reporting (Action 13)

September 16, 2014: OECD releases 7 progress and final reports (Actions 1, 2, 5, 6, 8, 13, 15)

February 14, 2014: OECD presents webcast on 2014 deliverables

September 6, 2013: G20 asks OECD at leaders’ meeting to report on “the need to prevent base erosion and profit shifting”

March 24, 2014: OECD publishes discussion draft on the Digital Economy (Action 1)

April 11, 2014: OECD publishes discussion drafts on Hybrids (Action 2)

May 26, 2014: OECD presents webcast on BEPS project update

December 2014 to-date: OECD releases 9 drafts/guidance (Actions 1, 4, 6, 7, 8-10, 13, 14)

OECD BEPS

<table>
<thead>
<tr>
<th>Action</th>
<th>Report Title</th>
<th>Draft Issued</th>
<th>Request for Input</th>
<th>Public Consultation</th>
<th>Deliverable Release</th>
</tr>
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<tbody>
<tr>
<td>1. Digital Economy</td>
<td>Digital Economy</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
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<td></td>
<td>VAT/GST B2C Guidelines</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>2. Hybrid Mismatch Arrangements</td>
<td>Hybrid Mismatch Arrangements</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
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<td>3. CFC Rules</td>
<td>CFC Rules</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>4. Interest</td>
<td>Interest Deductions</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Sept./Dec. 2015</td>
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<tr>
<td>6. Treaty Abuse</td>
<td>Treaty Abuse</td>
<td>✓</td>
<td>✓</td>
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<td></td>
<td>Follow-Up Work</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
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<td>7. PE Status</td>
<td>PE Status</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Sept. 2015</td>
</tr>
<tr>
<td>8. TP for Intangibles</td>
<td>TP Aspects of IP</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td></td>
<td>Low Value-Adding Services</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Sept. 2015</td>
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<tr>
<td></td>
<td>Commodity Transactions</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Sept. 2015</td>
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### OECD BEPS cont’d

<table>
<thead>
<tr>
<th>Action</th>
<th>Report Title</th>
<th>Draft Issued</th>
<th>Request for Input</th>
<th>Public Consultation</th>
<th>Deliverable Release</th>
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<tbody>
<tr>
<td>9. TP for Risks and Capital</td>
<td>Profit Splits</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Sept. 2015</td>
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<tr>
<td></td>
<td>Risk, Recharacterization &amp; Special Measures</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>Sept. 2015</td>
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<tr>
<td>10. TP for High-Risk transactions</td>
<td>Cost Contribution Arrangements</td>
<td>✓</td>
<td></td>
<td>5/29/15</td>
<td>7/6/15</td>
</tr>
<tr>
<td>11. Data on BEPS</td>
<td>Analysis of BEPS</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td>5/18/15</td>
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<tr>
<td>13. TP Documentation</td>
<td>Guidance on CbC Reporting</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td></td>
<td>Implementation of CbC Reporting</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>Feb. 2015</td>
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<tr>
<td>15. Multilateral instrument</td>
<td>Multilateral Instrument</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

### International Tax Features - Proposals

<table>
<thead>
<tr>
<th>Date</th>
<th>Baucus Draft</th>
<th>Camp Tax Reform Act</th>
<th>Nunes Act</th>
<th>Obama 2016 Budget</th>
<th>Rubio Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>November 2013</td>
<td>February 2014</td>
<td>January 2015</td>
<td>February 2015</td>
<td>March 2015</td>
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</table>

<table>
<thead>
<tr>
<th>System of taxation</th>
<th>Y: Worldwide Z: Territorial</th>
<th>Territorial</th>
<th>Territorial</th>
<th>Territorial</th>
<th>Territorial</th>
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</thead>
</table>

<table>
<thead>
<tr>
<th>Corporate tax rate</th>
<th>[+30%]</th>
<th>25%</th>
<th>25%</th>
<th>28%</th>
<th>25%</th>
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</thead>
</table>

<table>
<thead>
<tr>
<th>Excess returns tax</th>
<th>No</th>
<th>Option A</th>
<th>No</th>
<th>No</th>
<th>Maybe</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Minimum tax on FSI</th>
<th>Option Y</th>
<th>Option B</th>
<th>No</th>
<th>Yes (19% rate)</th>
<th>Maybe</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Repatriation holiday</th>
<th>Yes (20% rate)</th>
<th>Mandatory (85% deduction)</th>
<th>Yes (5% rate)</th>
<th>Mandatory (14% rate)</th>
<th>Mandatory (6% rate)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Limit interest deductions</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>No</th>
<th>Maybe</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Foreign branches treated as CFCs</th>
<th>Eliminates CTB regime for entities with ≥1 owner</th>
<th>Yes</th>
<th>n/a</th>
<th>No</th>
<th>Uncertain</th>
</tr>
</thead>
</table>
## BEPS v. US Int’l Proposals

<table>
<thead>
<tr>
<th>BEPS Action / Deliverable</th>
<th>Int’l Proposal</th>
<th>US Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Neutralize the Effects of Hybrid Mismatch Arrangements</td>
<td>Restrict the use of hybrid arrangements that create stateless income</td>
<td>Obama 2016 Budget</td>
</tr>
<tr>
<td>4. Interest Deductions and Other Financial Payments</td>
<td>Restrict deductions for excessive of members of financial reporting groups</td>
<td>Obama 2016 Budget</td>
</tr>
<tr>
<td>8. Guidance on Transfer Pricing Aspects of Intangibles</td>
<td>Expand definition of “Intangible”</td>
<td>Baucus Discussion Draft; Obama 2016 Budget</td>
</tr>
</tbody>
</table>

## Selected European IP / Patent Box Regimes

<table>
<thead>
<tr>
<th>Country</th>
<th>Effective tax rate</th>
<th>Qualifying IP</th>
<th>Qualifying Income</th>
<th>Capital gains</th>
<th>IP self-developed or acquired</th>
<th>Comparison to Ireland: points to note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>2.5% - 12.5%</td>
<td>Patents, brands, trademarks, copyrights, secret processes, commercial experience and related goodwill</td>
<td>All income from the sale of goods &amp; services that derive greater part of their value from IP or managing, developing, exploiting IP</td>
<td>No – but alternative exit strategies available</td>
<td>Either self-developed IP or acquired IP</td>
<td>n/a</td>
</tr>
<tr>
<td>Belgium</td>
<td>0% - 6.8%</td>
<td>Patents or extended patent certificates</td>
<td>Patent income and compensation for patent embedding in sale price of patented product</td>
<td>No</td>
<td>Self-developed IP or acquired IP only to the extent required further developed</td>
<td>- Narrow definition of qualifying IP - Non-application to capital gains - Limitations where IP acquired</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5%</td>
<td>Patents and IP for which an R&amp;D declaration is obtained</td>
<td>Income related to the IP, including sales/service income related to the IP</td>
<td>Yes</td>
<td>Self-developed IP or acquired IP only to the extent required further developed</td>
<td>- Narrow definition of qualifying IP - Limitations where IP acquired</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>0% - 5.76%</td>
<td>Patents, trademarks, copyrights, domain names, designs</td>
<td>Income and capital gains derived from use or license to use IP</td>
<td>Yes</td>
<td>Either self-developed IP or acquired IP - except where acquired from an associated company (name only) defined</td>
<td>- Narrow definition of qualifying IP, though broader than BelNL which may cast doubt on compatibility with EU law</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>10%</td>
<td>Patents granted by UK, EU, EEA patent offices</td>
<td>Income derived from qualifying patents</td>
<td>Yes</td>
<td>Self-developed IP or acquired IP - only to the extent required further developed and manages</td>
<td>- Narrow definition of qualifying IP - Limitations where IP acquired</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0% - 10%</td>
<td>Good application</td>
<td>Broad application</td>
<td>Yes</td>
<td>Either self-developed IP or acquired IP</td>
<td>- Not specific patent box regime - rating required - Under pressure from EU</td>
</tr>
</tbody>
</table>
International Tax - What High Tech Businesses Want
Silicon Valley Tax Directors Group

• International tax reform in 2015
• 4 components:
  1) 95% DRD system (post-enactment earnings)
     • 5% × 35% CIT rate = 1.75% ETR
  2) 85% DRD system (pre-enactment earnings)
     • Mandatory transition tax, payable over 8 years
     • 15% × 35% CIT rate = 5.25% ETR
  3) Minimum tax relating to foreign profits; or
     • 10-15% minimum tax applied to foreign sub earnings
  4) US innovation box (preferred)
     • 10-15% rate on all IP profits of US group from foreign customers; or
     • 10-15% rate on innovation (non-marketing) profits of US group from WW customers
     • Tax-free domestication of foreign IP

Source: 2015 SVTDG Washington, DC Trip Materials

International Tax - What Manufacturing Businesses Want
National Association of Manufacturers

• Near term priority, not far off goal
• Corporate tax rate to 25% or less
• Territorial system, not worldwide system
  – Supports a 95% DRD system (post-enactment)
  – Opposes deemed repatriation system
  – Prefers repatriation of pre-enactment earnings tax free
    • If not tax free, then at least allow CFC profits and losses to be offset
• Retain certain taxpayer favorable features
  – CFC look-through rules
  – Active financing exception to Subpart F
  – Opposes US minimum tax on foreign earnings
• US innovation box - open to the concept
• Permanent R&E incentive
• Strong capital cost-recovery system

* Source: NAM Comments to Senate Finance Committee, 4/15/2015
If No Comprehensive Business Tax Reform, How About Another Separate Repatriation Holiday?

• In 2004, Congress enacted Section 965, granting “one-time” repatriation holiday at low 5.25% rate
  – The provision increased income taxes paid
  – But subsequently criticized that substantially went to dividends, executives
• Highway Trust Fund (“Fund”) will go bankrupt. Thus, some (bipartisan) legislators wish to enact second one-time repatriation holiday
• Boxer (D-CA) / Paul (R-KY) (1/29/15) – 6.5% rate; voluntary
  – Repatriated cash could only be used for R&D, public-private partnerships and acquisitions
  – 5 years to complete transfer
• McCain (R-AZ) / Franks (R-AZ) (2/17/15) – 8.75% rate; voluntary
  – If expand payroll by 10% through job creation or higher payroll, 5.25% rate
  – $75k penalty added to gross income per each FT position eliminated
  – Similar proposal introduced in 2011
• By contrast, Chairman Ryan working on a short-term measure to raise $10B to support Fund through end of 2015

Conclusion

• Tax reform is a hot-topic item for 2015
  – International only?
  – Corporate only?
• Most of the focus is on lowering headline rates and broadening the base
• “Comprehensive tax reform” - simplify tax system and eliminate many existing deductions/credits (base broadening)
• Some key deductions look set to remain under all proposals e.g. mortgage interest deduction
• Reform proposals to-date are revenue neutral
  – Dynamic versus static scoring will be an issue to address.
The 50th Anniversary of the Willis Commission Report – Relevance for Today

Professor Annette Nellen
Graduate Tax Program
San Jose State University
http://www.cob.sjsu.edu/nellen_a
http://www.21stcenturytaxation.com

USSC cases that led to PL 86-272


Court: “From the quagmire there emerge, however, some firm peaks of decision which remain unquestioned.”

◦ Congress has exclusive power to regulate interstate commerce
◦ State can’t impose a tax ...  
  ◦ On privilege of engaging in interstate commerce
  ◦ That provides a direct advantage to local businesses
◦ Ok to impose net income tax on revenues derived from interstate commerce if fairly apportioned
  ◦ “founders did not intend to immunize [interstate] commerce from carrying its fair share of the costs of the state gov’t in return for the benefits it derives from within the State.”
Dissent in *Northwestern Cement Co. v. Minn.*

Justice Frankfurter –

- “today's decision will stimulate, if indeed it does not compel, every State of the Union, which has not already done so, to devise a formula of apportionment to tax the income of enterprises carrying on exclusively interstate commerce. As a result, interstate commerce will be burdened not hypothetically but practically, and we have been admonished again and again that taxation is a practical matter.”
- 2 key problems:
  1. Burden on small interstate businesses of dealing with tax rules in 49 states (before Hawaii was a state!)
  2. Continued litigation of appropriate apportionment approaches

Congress responded

Concern that states would become more aggressive in taxing multistate income including for past years.

PL 86-272 enacted 9/14/59

- Just 7 months after Court's decision
  - Query: What if Quill had lost in 1992? Would we have a sales tax version of PL 86-272?
  - Purpose - a more certain rule for when a multistate business is subject to income tax in any particular state.
More on background to PL 86-272

Senate Rpt. No. 658 (8/11/59) –

- “Your committee believes that as a result of the broad scope of the language of the S Ct ... and the apprehension that it has generated in the business community over the minimum amount of local activity within a State that would constitute a sufficient “nexus” to subject a business to tax on income derived from interstate commerce and “property apportioned” to the State, business, particularly small- and medium-sized businesses, may be hesitant to develop new markets in some State by extending their solicitation activities to such States, or may cause the withdrawal of such activities from some existing markets in other States, should mere solicitation of orders be regarded as a local activity forming a sufficient “nexus” with the State, where the burdens of compliance with the taxing requirements of the State make such a course of action advantageous. This may tend to leave the markets to larger businesses who activities are already widespread and which can better absorb the overhead [compliance].

- Believed certainty was needed to prevent damage to the economy.

- The legislation "is not a permanent solution to the problem." Instead it was intended to "serve as an effective stopgap or temporary solution while further studies are made of the problem."

PL 86-272

Prohibits a state from imposing a net income tax if a company’s only state activities are solicitation of orders for sales of tangible personal property which are sent outside the state for approval or rejection and are filled by shipment or delivery from a point outside of the state.

Sales by independent contractors:

- Person not considered engaged in business activities in a state merely due to sales in the state or solicitation of orders for sales in the state, of TPP, on behalf of the person by one or more ICs or due to maintaining an office in the state by one or more ICs whose activities on behalf of the person consist solely of making sales or soliciting orders for sales of TPP

Ok to impose net income tax wrt (1) any corporation incorporated in the state or (2) any individual domiciled in or a resident of the state.

[15 USC 381]
PL 86-272 also ...

Called for a study and report on state taxation by a congressional subcommittee

- “Willis” Commission – issued report in 4 volumes over 1964-1965
  - 1,200+ pages
  - Extensive analysis of operation and issues of all types of state taxes
  - Recommendations made, but not acted upon

PL 86-272 remains in its 1959 language

http://www.cob.sjsu.edu/nellen_a/TaxReform/PL86-272-50thAnniversary.htm

Congressman Edwin Willis

D-Louisiana
b. 1904  d. 1972
Attorney
Owner and operator of a plantation
Served in Congress from 1949 to 1969; lost election in 1968

P.L. 86-272 – called for report on ...

To fully address "all matters pertaining to the taxation by the States of income derived within the State from the conduct of business activities which are exclusively in furtherance of interstate commerce or which are part of interstate commerce."

Purpose - allow for recommendations to provide uniform standards for imposition of income taxes by the states.

Due by July 1, 1962.

P.L. 87-17, 75 Stat. 41 (1961) – scope broadened to include sales tax

Became a 3-year project.

Commission approach

- State taxation literature review
- Public hearings with over 100 witnesses; specific questions posed by Commission.
- Staff summarized laws of each state
- Studies laws on nexus, apportionment, definition of taxable income, sales/use tax, capital stock taxes.
- Questionnaires sent to over 30K companies
- Staff studies compliance costs for 100 retail and manufacturing multistate businesses
- Studied state revenue data from Census and state questionnaire
1982 GAO report on multistate tax issues

Main reason nothing was enacted after Willis Commission report was state opposition.

States believed that state-level actions on uniformity and other income tax matters would be a better approach than federal legislation.


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A few tidbits from the Willis Comm’n report

DOESN’T SOME OF IT SOUND LIKE IT WAS WRITTEN TODAY?
Letter of transmittal

“This study represents a landmark in our constitutional history. For 175 years, the courts have had to shoulder the entire responsibility for balancing the conflicts between the tax policies of the States and the national policy of assuring the free flow of commerce. This is the first time that the Congress has undertaken a general review of the impact of State taxation on interstate commerce. That this is long overdue is beyond dispute.” 6/15/64

G. Major Defects Pervading the System

It has been found that the present system of State taxation as it affects interstate commerce works badly for both business and the States. It has also been found that the major problems encountered are not those of any one of the taxes studied but rather are common to all of them. This is not surprising in that all of these problems reflect the pervasive conflict between the approach to the taxation of interstate companies as it appears in State and local law, and the practical difficulties of realistic compliance expectations and effective enforcement. Increasingly the States, reinforced by judicial sanction, have broadened the spread of tax obligations of multistate sellers. As the principle of taxation by the State of the market has been accepted, the law has prescribed substantially nationwide responsibility for more and more companies. The expanding spread of tax obligations has not, however, been accompanied by the development of an approach by the States which would allow these companies to take a national view of their tax obligations. The result is a pattern of State and local taxation which cannot be made to operate efficiently and equitably when applied to those companies whose activities bring them into contact with many States.
Income tax

1920s – states moved from separate accounting to apportionment as multistate business activity grew. [130]

Nexus/jurisdiction to tax – state laws, PL 86-272 and Federal Constitution “falls short of providing clear guidelines to liability.” [147]

PL 86-272 – as stopgap legislation, met its purpose. Helps small businesses, but perhaps results in unintended benefits for large businesses (such as those with large shipments to states where they have no tax obligations). [439]

Nexus and apportionment rules should be mostly consistent / complementary. [489]
  ◦ Thus, did not like the permanent establishment rules used for int’l tax.

Recommended 2-factor apportionment – payroll and property (easier to use than sales + tied to gov’t benefits).

Multistate disputes to be resolved by Treasury and US Tax Court.

C. Qualitative Jurisdictional Rules, p 489...

4. Summary

Whether a qualitative rule can provide acceptable jurisdictional lines depends primarily on the division-of-income rules which it must complement.

If the position is taken that the division-of-income rules should have either no sales factor or one without a destination orientation, the use of a qualitative jurisdictional rule merits serious consideration. Such a rule, using the permanent-establishment concept as its core but perhaps including items such as inventories in public warehouses, would probably be capable of adequate enforcement, would be generally consistent with the compliance-burden criterion, and would be reasonably consistent with the division-of-income rules.

If, on the other hand, division-of-income rules with destination-oriented sales factors are considered acceptable, no qualitative rule appears to come reasonably close to satisfying all the considerations involved. The evidence clearly suggests that no qualitative rule can be found which would result in liability in cases in which liability is appropriate and also result in exemption in cases in which exemption is appropriate. Moreover, there is very substantial reason to believe that a qualitative rule which goes far beyond the permanent-establishment concept is not capable of being systematically enforced on an equitable basis.
Sales tax – 1965 or today?

the United States. From the point of view of raising revenue, the sales tax has been an outstanding success, providing a substantial portion of total tax revenue wherever it is employed. In terms of collection and administration, the tax has also been generally successful, especially with respect to over-the-counter sales for consumption by individuals. However, significant problems have been encountered in the application of the tax to interstate transactions.

Viewed broadly, these problems appear to stem from a tax system which tends to divide a national market into insulated blocks of consumers, with each sales tax State erecting its own scheme for taxing consumption within its borders. Could the tax be collected from each individual and business as goods were consumed by them, differences in schemes from State to State would be of little consequence. However, the usual method of imposition everywhere is collection of the tax by the seller at the time of sale. As a result, a firm selling in a number of States is required to meet the peculiarities of the law in each State. If the seller is beyond the jurisdiction of the State or otherwise does not collect the tax, the sale is likely to end up tax free. For local businessmen, this raises the specter of competitive disadvantage: for the States it means a loss of revenue.

---

Food and drugs are perhaps the only major areas of consumption as to which the States differ. Beyond this, the exemptions offered are characterized more by their number and variety than by the number of States which provide for any one of them. In short, although differences in taxability among the States may result from a number of considerations, fundamental and widely held policy is generally not involved. Nor do considerations of policy demand the diversities and complexities which are encountered in the administration of the tax. In this area, especially, differences among the States are largely the result of different men deciding at different times on how to deal with similar problems. All things considered, the situation appears one in which it would appear entirely possible to fashion practical solutions to practical problems.

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REPORT OF SPECIAL SUBCOMMITTEE ON STATE TAXATION 895

The Subcommittee’s study of sales taxation shows that the present system is exceedingly troublesome to business and falls short of accomplishing the purposes for which it was adopted. As a national problem, the task of making the sales tax effective and workable for interstate sales inevitably falls upon the Congress.
Next steps

Still on congressional agenda:
- Update PL 86-272
  - Example - Business Activity Tax Simplification (HR 2992, 113th Cong) + earlier Congresses
- Address sales tax nexus in response to 1992 Quill decision
  - Examples - variations of Marketplace Fairness
- Address mobile workforce income and withholding tax rules

Still on state agendas
- Should UDITPA be updated and address nexus?
- Streamlined Sales and Use Tax
- State challenge to possible today

And ...

State experience with nexus, measurement and apportionment of multijurisdictional income, sourcing, and measure of taxable income ...

...are similar to issues relevant for federal tax reform, particularly regarding taxation of international income.
LETTER OF TRANSMITTAL

COMMITTEE ON THE JUDICIARY,
HOUSE OF REPRESENTATIVES,

HON. JOHN W. MCCORMACK,
Speaker of the House of Representatives,
Washington, D.C.

DEAR MR. SPEAKER: I am pleased to transmit to you the recommendations of the Committee on the Judiciary with respect to State taxation of interstate commerce. These recommendations are the result of the broad study provided for in Public Law 86-272. The study itself was contained in three volumes which have already been filed with the House. These are House Report 1480, 88th Congress, 2d Sess., and House Report 565, 89th Congress, 1st Sess. The first of these concerns income taxes and the second sales and use, capital stock, and gross receipts taxes.

The Committee on the Judiciary has considered the proposals presented by the Special Subcommittee and has unanimously approved them. It seems to us that in an area in which acceptable solutions are elusive, the Subcommittee has succeeded in fashioning a program which represents a resolution of competing interests within the best traditions of our structure of government. For the States, matters of local policy remain matters for local determination. For interstate commerce, national rules are provided where national rules are required. It is the view of the Committee that the enactment of legislation based on these recommendations will make a substantial contribution to the vitality of our Federal system and to the well-being of our common market.

Respectfully submitted,

EMANUEL CELLER,
Chairman.
LETTER OF TRANSMITTAL

Committee on the Judiciary,
House of Representatives,

Hon. Emanuel Celler,
Chairman, Committee on the Judiciary,
Washington, D.C.

My Dear Mr. Chairman: In the previous volumes of this report, we have described the system of State and local taxes as it affects interstate commerce. Based on a nationwide survey of the system, both as it is prescribed by law and as it operates in practice, it was concluded that the situation demands action by the Congress. Accordingly, we have formulated a program of recommendations for legislation designed to deal with the problems revealed in our study. The Subcommittee has unanimously endorsed this program and has ordered it reported to the full Committee with a recommendation that it be favorably reported to the House.

In drawing up these proposals we have been mindful not only of the very important responsibility of the Congress under the commerce clause of the United States Constitution but also of the delicate nature of Federal-State relations involved. The program we have formulated, therefore, is one which goes only so far as is absolutely necessary to assure a fair and reasonable system for taxing interstate businesses. And while a more efficient system could undoubtedly be achieved by legislating a greater degree of uniformity and by providing for a comprehensive system of Federal administration, we advise the more moderate course.

Volume 4 of the report, which I am transmitting herewith, contains a detailed description of each of our recommendations as well as a discussion of their implications for both business and the States. Since Federal legislation is contemplated, a bill embodying these proposals is being drafted and will be introduced as soon as it is completed. It is expected that public hearings on that bill will be held early in the second session of the 89th Congress.

In proposing this program, the Subcommittee has made every effort to achieve the best possible solution to the very difficult problems confronting it. The study upon which these recommendations are based was long and thorough; the staff which conducted it was as able, creative, and dedicated a group of professionals as one could possibly hope to bring together; the Members of the Subcommittee who were responsible for the study have, each and every one, been impressed by the importance of the work and have taken a most statesmanlike approach to it. Nevertheless, given the scope and complexity of the problems involved, it would be folly to hold out these recommendations as the embodiment of perfection. To the extent that they can be improved, we stand prepared to do so. We believe, however, that in its essentials this program represents a balanced and equitable set of rules for regulating the taxation of interstate commerce.

Respectfully submitted,

Edwin E. Willis,
Chairman, Special Subcommittee on
State Taxation of Interstate Commerce.
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Chapter 37

THE PRESENT SYSTEM—ITS CUMULATIVE IMPACT

A. Introduction

As of the end of 1964, there were in effect at the State level 38 sets of corporate income tax laws, 38 sales and use tax laws, 37 capital stock tax laws, and 8 gross receipts tax laws of general applicability. In addition, corporate income taxes were being imposed by over 100 local governments, sales taxes by over 2,300 localities, and gross receipts taxes by over 1,000 localities. Each of these types of taxes—on both the State and local levels—were considered separately in the previous volumes of this report. However, it is important to keep in mind that a company selling goods across State lines is usually subjected not to one or the other of these taxes, but rather must cope simultaneously with several of them, as well as with a variety of other taxes such as property taxes, gasoline taxes, and various special excises. As troublesome as all of these taxes are when viewed separately, the difficulties which they present appear compounded when they are considered in terms of their cumulative effect.

This chapter serves a twofold purpose. In bringing together the four taxes studied, it reviews in very general terms some of the principal findings set forth in detail in the first three volumes of this report. In addition, it serves as a brief description of the total system to which the Committee's program of legislative recommendations is directed. The recommendations themselves are presented in subsequent chapters of this volume.

B. Circumstances in Which a Business Is Taxable

With respect to all of the taxes considered in this report, the threshold question facing the interstate company is whether or not its activities within a State are sufficient to make it taxable by that State. For each kind of tax, there is a broad range of activities for which liability is asserted by some States and not by others. In many cases, the determination of whether or not liability exists is difficult, if not impossible. The following conclusion reached in the report with respect to corporate income taxes is equally applicable to the other studied taxes:

While few activities are so slight as to escape the attention of all States, the diversity of treatment is sufficient to require an examination of potential liabilities in each State in which the company is in some way present. This examination, however, is as likely as not to produce uncertain conclusions.¹

When the problem of determining whether there is liability is reviewed in terms of the cumulative effect of all four types of taxes,

the variety and complexity is greatly increased. Not only do jurisdictional standards differ among the States, but they are also nonuniform for different taxes within a single State. For example, a comparison of the jurisdictional assertions for income taxation and use tax collection in the 26 States imposing both taxes yields some interesting illustrations of what the interstate company must contend with in determining its liabilities. Table 37-1 considers seven different types of possible activities within a State, showing the number of States which, on the basis of the described contact, (a) impose the use tax but not the income tax and (b) impose the income tax but not the use tax. It is evident from the table that a company having any one of these activities in a number of States will be required to consider its situation in respect to each tax separately in each State.

<table>
<thead>
<tr>
<th>Contact in taxing State</th>
<th>Number of States requiring—</th>
<th>Income tax but no use tax collection</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Use tax collection but no income tax</td>
<td></td>
</tr>
<tr>
<td>Orders received by mail or telephone at place of business outside State, goods regularly shipped into State by mail or common carrier and—</td>
<td></td>
<td></td>
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<tr>
<td>(1) sales catalogs mailed to prospective customers in the State</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>(2) corporation has an administrative office in the State</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>(3) corporation has a research facility in the State</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>(4) corporation has a stock of raw materials in the State</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>(5) corporation has realty in the State held for investment</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Salesmen soliciting orders in the State, subject to out-State acceptance; goods are shipped from a place of business outside the State by mail or common carrier, and—</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) corporation displays goods in space leased for short term</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>(2) corporation operates a sales office in the State</td>
<td>2</td>
<td>1</td>
</tr>
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Sources: (1) State Income Tax Nexus Questionnaire; (2) State Use Tax Nexus Questionnaire.

These comparisons between the circumstances in which income tax liability is asserted and the circumstances in which use tax collection liability is asserted are merely one instance of the lack of uniformity that exists among different types of taxes within a State. A similar lack of uniformity appears when the jurisdictional assertions for income taxation and capital stock taxation are compared, or when comparisons are made between gross receipts taxes and use taxes.

C. Tax Accounting for Sales

There is little evidence of serious effort on the part of the States to attempt to minimize compliance problems by providing any carryover of required data from one tax to another, even where this could readily be done. This is most clearly seen in the case of States which provide methods of apportioning both income and capital stock by formula. Of twenty such States, only six use the same formula for both taxes. Thus, an individual tax-by-tax approach which fails to consider each tax as part of a total system results in the computation of different apportionment percentages using different formulas for the same company in a single State. It is not surprising that, in a system in which possibilities for uniformity within States have been disregarded, uniformity among States has not yet been achieved.

This nontransferability of data from one tax to another is encountered most sharply with respect to the treatment of sales. Under the present system sales data must be compiled for the sales factors of income tax and capital stock tax apportionment formulas as well as for sales tax bases and gross receipts tax bases. One would assume, in the absence of detailed knowledge to the contrary, that within the same State there would be a substantial carryover from one tax to another in such data. However, this appears to be generally not the case. There are two primary areas of difference in the sales data which may be required. First, there are differences in the attribution rules by which sales are assigned to a particular State or locality for tax purposes. Second, there are differences in the particular sales to be included in the measure of the tax.

In determining which sales are to be attributed to a State for purposes of income tax apportionment, any one or a combination of standards may be applied. As was noted in the discussion of the sales factor which appeared earlier in this report:

Sales are assigned to States by six general standards. These standards are used either singly or in combination. The most prevalent standard is destination, followed by sales office, origin, sales activity, place of acceptance, and intrastate shipments. Within these general standards, there is further diversity. For example, there are about a half-dozen variations among those States which adhere to a destination standard. There are also three major variations in the concept of origin.

The extent to which the attribution of sales in accordance with the standard used for income tax purposes may also be used to meet the sales-reporting requirements of other forms of taxes varies from State to State and from tax to tax. In the apportionment of capital stock, sales are often attributed in the same way as for the apportionment of income, but this is not always the case. In four States having sales factors in the formulas for both taxes, there are simply no rules for attributing sales for capital stock purposes. In the remaining twelve States applying sales factors for both taxes, eight use the same standard, while four do not.

On the other hand, the attribution rules used for income tax purposes frequently have no applicability for sales taxes or gross receipts taxes. If any standard other than destination is applied for income tax purposes, it will not be applicable for a sales tax, which is always destination oriented. Nor will it entirely satisfy the accounting
In the previous volumes of this report, an analysis of the spread of tax payments revealed that for each of the taxes studied companies tend to file returns only in States in which they have business locations, regardless of the jurisdictional assertions made. While the jurisdictional limits of none of these taxes have yet extended to the mere making of sales into a State, they do reach well beyond the mere presence of a business location. Nevertheless, more than three-fifths of the studied companies which filed returns in more than one State did not file a return for any of the four types of State or local taxes studied except where they had a business location. No more than 1 in 10 filed returns in more than three States in the absence of a business location, and only about 1 out of 100 filed in more than fifteen States where no business location was maintained.

The fact that compliance with any of the taxes studied is poor in the absence of a place of business suggests that it is neither a single type of tax nor even the aggregate of tax laws to which the typical interstate company is responding. Instead, what is suggested is that it is only when businessmen maintain premises in a State for the conduct of business that they tend to regard themselves as responsible for State taxes.

**E. Taxpayer Reporting Practices**

Not only is the complexity of the legal system facing the interstate company reduced by failure to file all returns which may be required, but further simplification results from actual reporting practices. Faced with diversity in State laws, taxpayers often impose their own brand of uniformity. While this ameliorates the impact on the part of the diversity in the system, it creates further inequity between those who comply accurately and those who do not.

It was found that sales factors reported for the apportionment of income and capital stock are often computed inaccurately. Reliance is placed on sales records maintained for other purposes which may or may not yield the State-prescribed total. Further, variations among States in sales-factor standards are often ignored. Sales are attributed to every State by a single method, sometimes because the taxpayer is unaware that differences exist. In some cases, the disparity between law and practice is both recognized and accepted by tax authorities.

Similar, although less extreme inaccuracy prevails in the operation of other apportionment factors. The greater degree of uniformity in State rules for property and payroll attribution, and their greater correspondence with generally available company information reduces the pressures which generate inaccuracy in these areas. Even then, however, variations in details from State to State are often ignored.

Inaccuracy in the determination of State taxable income appears to be frequent whenever prescribed departures from the Federal base are complex. Variations in such matters as depreciation or the accounting for installment sales are often accepted by enforcement officials, but not always.

In the operation of sales taxes, a variety of inaccuracies have been observed. Companies engaged in sales tax collection may ignore variations in the tax base from State to State. Sales records of some companies are not maintained in sufficient detail to report the information called for on the State’s tax return. Business purchasers
widely disregard their obligation for use tax payment on goods for which collection was not made by the seller.

The frequent disregard by both taxpayers and tax collectors of detailed variations among States in their application of the same tax raises serious problems of equity among taxpayers. In addition, it suggests that some differences which are presumed to reflect particular State tax policies may, in fact, have no operating significance.

F. Cost of Compliance

In the earlier volumes of this report, detailed analyses were made of the tax compliance costs incurred by the 100 companies participating in the Cost Study conducted by the Special Subcommittee. Estimates were made of two categories of costs. One category included those compliance costs that were incurred in connection with State and local income taxes and capital stock taxes, but primarily attributable to income taxes. The other category included those incurred in connection with State and local sales and gross receipts taxes, but primarily attributable to State sales taxes.

With respect to costs attributable to income and capital stock taxes the following conclusion was reached:

Although it cannot be said that interstate business is today incurring burdensome compliance costs, the reasons for the absence of these costs require serious issues in themselves. What has happened is that the complexity of the multistate tax system, instead of producing large amounts of compliance cost, has resulted in noncompliance and in the inequities which come with a tax system in which formal requirements have been abandoned. Present costs are high enough, however, to warn against an effort to meet problems of unfairness through vigorous enforcement of those requirements of the law which are presently disregarded. Instead, it would seem that simplification in the multistate tax system through a reduction of its multiplicity, variety and mutability, is a necessary preliminary to achieving a reasonable level of compliance within tolerable cost levels.3

With respect to costs attributable to sales and gross receipts taxes, the following conclusion was reached:

[For the company selling goods into other States, the prevailing system for collecting sales taxes would not appear to be costly. Indeed, the Cost Study revealed no cost barrier to the extension of sales tax registration to most companies wherever they sell goods. This is not to say that such a step would be desirable under existing circumstances, for the Cost Study also revealed that the prevailing system is characterized by numerous demands upon the businessman which would not seem to be justified by the needs of the States. This is especially true for industrial retailers—a class of sales tax registrants for whom the existing system does not seem to be designed.4]

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3 Taking both categories of costs together, it cannot be said that at present levels of compliance they constitute a serious burden on interstate commerce. However, it must be borne in mind that these costs reflect a system that is operating unsatisfactorily when evaluated by such important criteria as equity among taxpayers, certainty of liability, and full collection of revenue. In addition, there is ample reason to suspect that many companies—especially smaller companies—would incur very burdensome compliance costs were they to attempt to adhere to the complex and unwieldy requirements that are prescribed.

G. Major Defects Pervading the System

It has been found that the present system of State taxation as it affects interstate commerce works badly for both business and the States. It has also been found that the major problems encountered are not those of any one of the taxes studied but rather are common to all of them. This is not surprising in that all of these problems reflect the pervasive conflict between the approach to the taxation of interstate companies as it appears in State and local law, and the practical difficulties of realistic compliance expectations and effective enforcement. Increasingly the States, reinforced by judicial sanction, have broadened the spread of tax obligations of multistate sellers. As the principle of taxation by the State of the market has been accepted, the law has prescribed substantially nationwide responsibility for more and more companies. The expanding spread of tax obligations has not, however, been accompanied by the development of an approach by the States which would allow these companies to take a national view of their tax obligations. The result is a pattern of State and local taxation which cannot be made to operate efficiently and equitably when applied to those companies whose activities bring them into contact with many States.

First, it was found that the system is characterized by widespread noncompliance. This includes both a failure to file returns, especially where jurisdiction is asserted on the basis of something less than a place of business in the State, and a failure among companies which do file to comply accurately with the requirements of the prescribed system. For the States, the gap between what is prescribed and what is practiced means a loss of revenue. For business, the result is inequity among similarly situated taxpayers, some of whom comply and most of whom do not. However, noncompliance is to be replaced by full compliance with all of the requirements of the prescribed system, it is likely that the inequities of hardship taxation would be transformed into the burden of excessive compliance costs.

A second defect of the current system is its tendency to give rise to overtaxation and undertaxation. Over taxation is implicit in inconsistencies in the rules prescribed by the various States. These inconsistencies also give rise to undertaxation, which is augmented by noncompliance. The Subcommittee's studies confirm the fact that both of these departures from a coherent system do in fact occur.

A third defect of the present system is the existence of provisions which are advantageous to locally based companies relative to competitors based elsewhere. While litigation might ultimately invalidate some of these provisions, the generally low level of State tax rates
and the expense and uncertainty of the litigation process discourages taxpayers from seeking relief by that means.

A fourth defect of the present system is the attitude which it has generated among taxpayers, especially small and moderate-sized companies. The diversities and complexities in legal rules, the prevalence of returns in which the cost of compliance exceeds the tax, the demand that a distant seller account for a local buyer's tax under circumstances in which taxability depends on what the buyer is to do with the goods—these and other aspects of the present system have produced widespread resistance to the assumption of taxpayer responsibility.

The problems found in this system as it operates today are sufficiently troublesome to require that something must be done. Even more disquieting, however, are the prospects for the future. There is every reason to believe that, without congressional action, the worst features of the present system will continue to multiply. For the company selling in interstate commerce, the likelihood that it will be caught up in the troubles of the system becomes greater with increased exposure through the passage of time and the widening of its spread of activities.

In addition, increases in the number of jurisdictions imposing each kind of tax and the expanding emphasis on taxation by the State of the market will inevitably magnify the difficulties which inhere in the system. Only through the creation of a more orderly scheme can the multiplication and aggravation of these problems be forestalled.

A prescribed system as widely disregarded as the present one cannot be said to be one which the interests of the States demand be preserved intact at all costs. At the same time the interests of the nation in a free flow of commerce, unhampered by needless interference, clearly call for a change. The recommendations which follow present a program designed to establish a system that will work better for both business and the States.
Chapter 38

SUMMARY OF RECOMMENDATIONS

A. Introduction

The preceding chapter summarized the impact upon the interstate company of the prevailing system of State and local taxation. It was seen that regardless of the particular form of tax considered, the system operated in much the same way. It was also seen that the present situation is characterized by a conflict between the diversity and multiplicity prescribed by the various State laws and the limited extent to which such a system can realistically be complied with or enforced. In dealing with the problems which result, two approaches are possible. Under one approach, jurisdiction to tax the interstate company would be extended to all States into which it sells. The resulting broad spread of tax obligations would be made compatible with a reasonable level of compliance by the formulation of uniform provisions on such matters as measurement of the tax base, exemptions, attribution rules, and reporting methods. Furthermore, to achieve an effective level of enforcement, a broad assumption of administrative and collection responsibilities by the Federal Government would be required.

The alternative is to restrict the spread of jurisdiction to tax to a degree which is consistent with both operational practicability and a continuation of diversity in important areas of State tax law. This approach has been accepted as the basic framework for the Committee's recommendations. It is the approach which is most consistent with the preservation of maximum freedom in State and local tax policy, produces the least departure from existing practices, and is an effective means of resolving the serious problems which now exist. In the area of sales taxation, however, the logic of the tax has suggested the desirability of making available to the States the option of participation in a program of cooperative administration. Thus procedures for Federal assistance in the enforcement of seller-collection requirements on a nationwide basis are proposed for those States which may choose to take advantage of such a system.

In formulating its recommendations, the Committee has followed a number of principles with respect to all of the taxes involved:

First, while ease of compliance has not been the only consideration in formulating these recommendations, it has been an important factor. It is felt that the reduction of compliance burdens will result in ameliorating the inequities in the operation of the present system and consequently in a more cooperative attitude by taxpayers toward their responsibilities.

Second, just as ease of compliance has been an important but not sole consideration in formulating these proposals, so too has the effect of the proposals on State revenues been given substantial weight.
Based on the application to published industrial data of revenue estimating techniques, the soundness of which has now been substantiated empirically by computations made by a number of States from their own income tax returns, estimates were made of the revenue impact of the proposals with respect to income, capital stock, and gross receipts taxes. These estimates indicate that under the recommended program no State stands to gain or lose a significant percentage of its tax revenue. Furthermore, by broadening jurisdiction to collect sales taxes and strengthening enforcement against out-of-State sellers, the recommendations would tend to increase sales tax collections, particularly in destination-oriented States. It is in these States that a small decrease in potential revenue is likely to result from placing on an origin basis the low-rate taxes on income, capital stock, and gross receipts.

Third, a single standard is prescribed for determining the circumstances in which the property is required to file returns and pay tax to a State. The test selected makes liability depend on owning or leasing realty in the State or having an employee whose services are performed entirely in the State—basically a business-location standard. This test conforms closely to the general practice, in which businesses tend to disregard the differences in jurisdictional standards from one kind of tax to another and to limit all of their tax responsibilities to States in which they have places of business. The test is also one which is readily understandable and may be easily applied in the great majority of cases.

There is some deviation from this single jurisdictional rule under the sales tax with respect to those States which choose to participate in the cooperatively administered program. Although in those States businesses would have tax obligations only to the States that have not have business locations, this would occur only within a context of uniform provisions, unified administration, and unified audits.

The recommended program provides the interstate company with a body of uniform rules for attributing tax bases to the States. The income tax and capital stock tax areas of this uniformity are achieved through the use of a two-factor property-payroll apportionment formula in the gross receipts tax area it is achieved by a uniform rule that attributes gross receipts from the sale of goods to the State of origin. Sales taxes, on the other hand, are to be collected for the State where the buyer is located.

These proposals are designed to achieve congruence between jurisdiction and the attribution of tax bases. In short, whenever income, capital stock, sales, or gross receipts are attributed to a particular State by the uniform attribution rules that State has jurisdiction to impose a tax. Thus, if income is attributed to a State which imposes an income tax, that State may tax it. However, if income is attributed to a State which does not impose an income tax that income cannot be taxed by any other State.

In summary, the program which is recommended is a moderate one, avoiding on the one hand the extreme of a general program of Federal administration and collection, and on the other hand the suggestion that all that need be done is to extend Public Law 86-272 to other types of taxes. Measures are recommended which are broad enough to meet the problems found but which avoid unnecessary changes in present practices.

The material which follows briefly states the major features of the recommendations with respect to each form of tax. Subsequent chapters then describe more fully each of the recommendations and its effects.

B. The Recommendations

1. Income Taxes

Division of income.—All income is apportioned by a two-factor formula based on property and payroll.

The property factor includes all tangible property except: (1) inventory; (2) personality leased out for more than 1 year; and (3) property outside the United States. Property is valued at its original cost. For purposes of the property factor numerator, moving property is attributed to a State if: (1) it is operated entirely within that State or (2) if it is operated partly within the State and its base of operations is in the State. Moving property is eliminated from both the numerator and denominator if its operation is not entirely within a State and it has no base of operations in any State.

The payroll factor includes wages paid to employees except retirement pay and the amount of wages in excess of $40,000 per annum paid to any one employee. For purposes of the payroll factor numerator, the two primary tests used by all the States for unemployment compensation are adopted. Wages are attributed to a State if: (1) the employee's service is entirely within the State or (2) the employee's service is partly within the State and his base of operations is in the State. Wages are eliminated from both the numerator and denominator if the service is not entirely within one State and the employee has no base of operations in any State.

Jurisdiction.—Jurisdiction is congruent with the apportionment of income. A corporation is taxable if it: (1) owns or leases realty in the State or (2) has an employee whose services are performed entirely in the State. If a corporation has personality in a State but has neither realty nor an employee in that State, the personality is eliminated from the denominator of the property factor for all States. Any State may tax the income attributed to it by the uniform formula regardless of whether the State tax is imposed in the form of a franchise tax or a direct tax. Liability is barred for unassessed taxes from prior years in which the corporation had neither realty nor an employee in the State.

Tax base.—Federal taxable income must be used as the starting point for the computation of State tax bases. Each State may require its own adjustments to Federal taxable income except that no adjustments are permitted which favor local taxpayers or which involve depreciation, amortization, or the time for reporting items of income or expense.

Consolidation of returns.—Consolidation can be required by a State, and must be permitted, in any case of affiliation by common ties of more than 50 percent ownership. Consolidation is prohibited with respect to any income which is exempt from Federal taxation because considered to be derived from sources outside the United States.

Uniform regulations and forms.—The Treasury Department is to issue rules and regulations for the operation of the uniform apportionment.
ment formula and to devise a uniform return form for the filing of apportionment data. Periodic conferences are to be held with State administrators and procedures are provided whereby State administrators can contribute their knowledge and experience to the operation and development of the uniform apportionment program.

Modification.—The Secretary of the Treasury or his delegate is authorized to prescribe a modified apportionment formula or separate accounting for particular taxpayers. This power is to be sparingly exercised, only as necessary to effectuate the policies of the recommendations, and upon notice to the taxpayer and all affected States. Any modification made and the supporting findings shall be published.

Resolution of multistate conflicts.—Procedures are established for the resolution of multistate tax disputes by the Treasury Department whenever the interested States do not agree to be bound by the findings of a single State. The determinations by Treasury are subject to review by the Tax Court.

Local income taxes.—Subdivisions of States are subject to the same rules that apply to States.

2. Capital Stock Taxes

The apportionment formula and jurisdictional rules that apply to corporate income taxes are also made applicable to capital stock taxes, except that no restrictions are imposed on the States with respect to taxes measured by the capital account (i.e., par value or number of shares) of domestic corporations. It is not recommended that Congress prescribe a uniform capital stock tax base. Liability is barred for unassessed taxes from prior years in which the corporation had neither realty nor an employee in the State.

3. Sales and Use Taxes

Locating sales.—Under uniform rules applicable to all States, sales are taxable by the State in which the buyer first receives physical delivery of the goods. The State of consumption or use may also impose a tax, but must give a credit for prior taxes paid to other States, or a refund to the extent of taxes subsequently paid to the State of delivery. However, persons who establish a new residence in any State may not be taxed by that State on previously acquired personal effects, household goods, or automobiles.

Jurisdiction.—A State may not require a seller to collect a sales or use tax unless the seller: (1) owns or leases realty in the State, or has his own vehicles or a private parcel service to make deliveries to private residences in the State.

However, in States which participate in a system of cooperative administration by adopting a model sales tax law to be prescribed by Congress, any seller making sales into the State will be required to collect taxes in accordance with the uniform rules provided. Each State will set its own rate and will administer the model law with respect to predominantly intrastate sales. Under the model law, no collection is required if the seller: (1) does not offer to make sales other than by prepaid mail order, and (2) has no contacts with the State other than the dissemination of advertising.

Tax base.—The model law will apply only to the sale or lease of tangible personalty. It will provide for a broad base. Each State will be free to tax or exempt food and prescription drugs; otherwise no goods will be exempt, although each State will be free to grant refunds to purchasers. It will also provide for uniform rules determining the appropriate point in the chain of distribution at which the tax is to be imposed. Services unconnected with interstate sales are not affected.

Tax accounting.—The model law will provide for uniform rules as to when the tax becomes due on a transaction and for such other sales tax accounting problems as arise in connection with bad debts, discounts, repossessions, trade-ins, and returned goods.

Administration under the cooperative system.—Administration of the model law is to be shared by the Treasury Department and State administrators. State administrators have general responsibility for auditing intrastate sales. Treasury has general responsibility for auditing interstate sales. Procedures are established for cooperative audits and such audits are to be encouraged. The Treasury Department is given responsibility for issuing uniform regulations, making rulings, and devising uniform tax return forms. Periodic conferences are to be held with State administrators and procedures are provided whereby State administrators can contribute to the operation and development of the program.

All taxes on interstate transactions imposed under the model law are to be remitted directly to the States by the sellers. As with similar programs involving State administration of local sales taxes, Federal administrative costs are to be met by State contributions based on a percentage of the taxes received by the States from interstate sales.

Direct payment programs.—The model law authorizes the Secretary of the Treasury or his delegate to relieve sellers to business buyers of collection liabilities in the maximum extent consistent with effective enforcement of the tax. Whenever practicable, business buyers are to be placed on a direct-payment basis. Farmers are not to be included in direct-payment programs but are to be registered as purchasers for resale of feed, seed, and fertilizer.

Immunity and registration numbers.—Each State may grant a purchaser total immunity from tax by providing that purchaser with an immunity number. Under the model law, retailers receive registration numbers which may be accepted by sellers as conclusive proof that their purchases are for resale; direct payment numbers are conclusive proof that no tax is collectible on any purchase; farmers’ registration numbers are conclusive proof that their purchases of seed, fertilizer, and retail food are for resale; immunity numbers are conclusive proof that all purchases are immune.

Local sales taxes.—In either a participating or nonparticipating State, a local tax is not required to collect a local tax unless the seller: (1) owns or leases realty in the locality, or (2) has an employee whose services are performed entirely in the locality, or (3) regularly uses his own vehicles or a private parcel service to make deliveries to private residences in the locality.

Miscellaneous provisions.—A number of rules are recommended which would apply both to States which participate in the cooperatively administered system and those which do not. In both cases, sellers are relieved of collection liabilities on the first $100 of interstate
sales per reporting period in each State. Provisions favoring local transactions or locally established persons are prohibited and the liability resulting from an interstate transaction may be computed in the same manner as if the transaction were wholly local. In the participating States freight charges are not included in the measure of the tax, if separately stated. The same rule applies as to interstate sales in the nonparticipating States. Charges for out-of-State audits are prohibited. Finally, liability is barred for unassessed taxes for prior years in which the company had neither realty nor an employee in the State, nor made deliveries to private residences in the State.

4. Gross Receipts Taxes

Gross receipts from the sale of tangible personality may be taxed only by the State of origin. The jurisdictional rule for corporate income taxes also applies to determine the circumstances in which a person is liable for a gross receipts tax. Liability is barred for unassessed taxes from prior years in which the company had neither realty nor an employee in the State. Subdivisions of States are subject to the same rules that apply to States.

5. Interstate Tax Conference

An Interstate Tax Conference is established, to be composed of the tax administrators of each of the States. The Conference is to serve in an advisory capacity to the Secretary of the Treasury on interstate tax matters. The Secretary is to consult with the Conference periodically concerning the operation and development of the uniform apportionment and interstate sales tax programs.

6. Additional Studies

The Secretary of the Treasury shall determine if there is a need for legislation with respect to the interstate tax problems of: Transportation companies, utilities, insurance companies, financial institutions, investment companies, and holding companies. On finding that a need exists, the Secretary shall recommend appropriate legislation to the Congress. The Secretary shall report his findings and recommendations to the Congress within 2 years from the enactment of the proposed program.

If uniformity is required in the division of income, the Secretary may recommend the adoption of the general apportionment formula or special rules. Insofar as it may be appropriate, special rules shall reflect the policy manifested by the general formula.

The Secretary shall also, within 2 years of enactment of the proposed program, determine if there is a need for legislation relating to the interstate aspects of income taxes imposed on individuals and unincorporated businesses and, if he finds that such a need exists, shall recommend appropriate legislation to the Congress.
What the Feds Can Learn from State Cross-Border/Jurisdictional Concerns

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Agenda

‒ OECD BEPS Project Overview
‒ Jurisdiction to Tax
‒ Tax Base
‒ Apportionment
‒ Combined Reporting
‒ Intergovernmental Cooperation and Information Sharing
OECD BEPS Project Overview

1) Address tax challenges of the digital economy
2) Neutralize the effects of hybrid mismatch arrangements
3) Strengthen CFC rules
4) Limit base erosion via interest deductions and other financial payments
5) Counter harmful tax practices more effectively, taking into account transparency and substance
6) Prevent treaty abuse
7) Prevent the artificial avoidance of PE status
8) Transfer pricing for intangibles
9) Transfer pricing for risks and capital
10) Transfer pricing for other high-risk transactions
11) Establish methodologies to collect and analyze data on BEPS and the actions to address it
12) Require taxpayers to disclose their aggressive tax planning arrangements
13) Re-examine transfer pricing documentation
14) Make dispute resolution mechanisms more effective
15) Develop a multilateral instrument designed to provide an innovative approach to international tax matters

Jurisdiction to Tax

– The OECD’s recommendations would redefine and expand a country’s ability to impose tax on multinational businesses.
– BEPS Action #1, while specifically addressing the tax challenges of the digital economy, recommends modifying the definition of PE to impose a tax on multinational enterprises that do not have a fixed place of business.
– BEPS Action #7 seeks to prevent the artificial avoidance of PE.
– States have similarly adopted expansive nexus policies to increase the number of companies subject to their tax jurisdiction.
Nexus vs. Permanent Establishment

- **Nexus:** A state is not permitted to tax an entity, including a foreign corporation, unless such entity has a substantial nexus with the taxing state.
  > Due Process Clause
  > Commerce Clause
  - The nexus standard is generally lower than the standard for a permanent establishment.

- **Permanent Establishment ("PE"):** Defined in the U.S. Model Income Tax Convention as “a fixed place of business through which the business of an enterprise is wholly or partly carried on.”
  - States are not generally bound by federal tax treaties, so a foreign corporation can be subject to state taxes without having a PE in the United States.

Nexus

- **Sales Tax Nexus**
  - Requires an in-state physical presence
    - Agency or Affiliate Nexus
    - “Click-Through” Nexus

- **State Income Tax Nexus**
  - Does not necessarily require a physical presence
    - Economic Nexus
    - Factor Presence Nexus
    - Nexus through Economic Substance Challenges
Sales Tax Nexus – Affiliate Nexus

- The in-state activities of an entity can create nexus for an otherwise out-of-state affiliate.
  - “An out-of-state vendor has substantial nexus with this State for the collection of both state and local use tax if:
    - The out-of-state vendor and an in-state business maintaining one or more locations within this State are related parties; and
    - The out-of-state vendor and the in-state business use an identical or substantially similar name, tradename, trademark, or goodwill, to develop, promote, or maintain sales . . . .” Ala. Code § 40-23-190(a).

Sales Tax Nexus – Agency Nexus

- Nexus may be created through the in-state activities of unrelated parties acting on behalf of the otherwise out-of-state company.
  - “[T]he crucial factor for governing nexus is whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in [the] state.” *Tyler Pipe Industries, Inc. v. Department of Revenue*, 483 U.S. 232 (1987) (quoting 715 P.2d 123 (Wash. 1986)).
  - Several states have enacted statutes permitting Departments of Revenue to categorize in-state salespeople as agents and to hold such agents jointly liable with the out-of-state company for sales tax. See, e.g., N.J. Rev. Stat. § 54:32B-2(i)(2).
Sales Tax Nexus – “Click-Through” Nexus

- States have successfully asserted sales tax nexus on remote vendors who execute agreements with in-state affiliates under which the affiliates, for a commission or other consideration, refer potential customers to the remote vendor.
- The New York Court of Appeals in Amazon.com v. NYS Dep’t of Tax & Fin., 987 N.E.2d 621 (N.Y. 2013), held that New York’s affiliate nexus provision, which created a rebuttable presumption of nexus, was facially constitutional.
  - Amazon.com offered an “Associates Program” through which third parties (“Associates”) agreed to place links on their website that, when clicked, would direct users to Amazon.com’s site.
  - The Associates were compensated on a commission basis.

Income Tax Nexus – Economic Nexus

- States are increasingly asserting that the size of a foreign taxpayer’s economic footprint is enough to establish nexus irrespective of the taxpayer’s physical presence in the state.
  - “It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus.” Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993).
  - “Rather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes.” See also Commissioner v. MBNA America Bank, 640 S.E.2d 226 (W. Va. 2006).
- States have taken the position that royalty income derived from intangible property, such as trademarks, located in the state is sufficient to establish nexus between the state and the foreign owner of the intellectual property.
Income Tax Nexus – Factor Presence

- Many states have recently adopted factor presence or “bright line” nexus statutes, which base nexus determinations exclusively on a set of quantitative criteria.

- In California, a taxpayer is considered doing business in the state if:
  - Its California sales exceed the lesser of $500,000* or 25% of its total sales;
  - Its California real and tangible personal property exceed the lesser of $50,000* or 25% of its total real and tangible personal property; or
  - It California payroll exceeds the lesser of $50,000* or 25% of its total payroll. Cal. Rev. & Tax. Cd. § 23101(b)(2)–(4).

- New York enacted an economic nexus statute which provides that a corporation is “doing business” in New York if it derives $1 million or more in New York receipts in a given year. N.Y. Tax Law § 209(1)(b) (Effective for years beginning on or after 1/1/2015).

Nexus via Economic Substance Challenges

- States have successfully asserted that a corporate parent’s in-state activity confers nexus on its out-of-state subsidiary, typically an intangible holding company, on the basis that the out-of-state subsidiary lacks economic substance as a separate business entity.
  - See, e.g., Syms Corp. v. Commissioner, 765 N.E.2d 758 (Mass. 2002);
  - Comptroller of the Treasury v. SYL, Inc. 825 A.2d 399 (Md. 2003)
  - Presumes that the parent’s in-state business produces the subsidiary’s apportioned income.

- Transactions are examined to determine whether they have:
  - Valid, Non-Tax Business Purpose
  - Economic Substance

- Similarly, the OECD, in its discussion draft to BEPS Actions 8, 9 and 10, has proposed to re-characterize related party transactions if they lack the “fundamental economic attributes of arrangements between unrelated parties.”
State Income Tax Uniformity – Entity Classification and Starting Point

- **Entity Classification**: States generally conform to the federal entity classification rules.
  - Conformity implemented to simplify tax administration, resulting in reduced state income tax planning opportunities.
  - Some relatively minor disparities still exist, but not nearly as significant as those that existed 10-15 years ago.

- **Computational Starting Point**: Most states use federal adjusted gross income (AGI) as the starting point in calculating the income tax base.
  - Federal AGI is then modified by state-specific adjustments to arrive at the taxable base.

Related Party Addbacks

- To combat related party intellectual property tax planning and benefits derived from intercompany loans, many states implemented statutes disallowing the deduction of intangible expenses paid to a related party (“Addback Rules”).
  - Addback statutes are often defined very broadly and generally encompass:
    - Certain expenses, losses and costs related to the acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property.
    - Interest expenses
    - Losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions.
    - Royalty, patent, technical, and copyright fees.
    - Licensing fees
Related Party Addback – Exceptions

Some of the common addback exceptions are:

- The related member is subject to tax in another jurisdiction.
- The related member acts as a conduit in paying interest or intangible expense to an unrelated third party.
- The related member transaction has a valid, non-tax business purpose.
- The related member transaction is made at arm’s length.
- The taxpayer enters into a written agreement with the taxing authority.

OECD Proposal – Non-recognition of Intercompany Transactions

The OECD released a public discussion draft on December 19, 2014 related to BEPS Actions 8, 9 & 10 which addresses revisions to Chapter I of the Transfer Pricing Guidelines.

- Contains a proposal to ignore certain transactions between members of a controlled group (“Non-recognition”).
- Non-recognition is necessary when controlled groups have the ability to structure transactions that lack arm’s-length characteristics and cannot be priced under an arms-length standard.
  - “The key question is whether the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties...”

- Related party addback statutes are substantially similar to the OECD’s proposal, as they both operate to effectively disregard transactions between related parties.
Apportionment

- The OECD has acknowledged the possibility of adopting some form of formulary apportionment to geographically distribute the income earned by a multinational taxpayer to the various jurisdictions in which the taxpayer does business.
- States generally use formulary apportionment methods.
  - An apportionment formula is considered fair if it is both internally and externally consistent. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).
    - Internal Consistency: “[T]he formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business’ income being taxed.”
    - External Consistency: “The factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.”
  - Discretionary alternative apportionment

- Limitations on Apportionment: The Unitary Business Principle
  - To be apportionable, there must be a unitary relationship between the gain recognized and the taxpayer’s business.
    - A unitary business is evidenced by functional integration, centralization of management, and economies of scale.
  - A taxpayer’s business income is apportioned to the various states with which it has nexus, while a taxpayer’s nonbusiness income is allocated to a specific state based on its source.
    - Allocation: An item of income is attributed to a particular jurisdiction in its entirety
    - Apportionment: An item of income is divided among several jurisdictions.
Apportionment

- A state may only constitutionally tax that portion of a corporation’s net income that is reasonably attributable to the corporation’s activities in the taxing state.

- Historically, the evenly-weighted, three factor apportionment formula has been universally accepted as a reasonable method to apportion a multistate taxpayer’s income to the states with which it has nexus.
  - The formula apportions income to a particular state based on the proportion of sales, property, and payroll a taxpayer employs in that state.
  - Receipts from sales other than sales of tangible personal were typically sourced to the location of the income producing activity, based on costs of performance.

\[
\text{Business Income} \times \left( \frac{\text{State A sales}}{\text{All sales}} \right) + \left( \frac{\text{State A property}}{\text{All property}} \right) + \left( \frac{\text{State A payroll}}{\text{All payroll}} \right)
\]

Apportionment

- The recent trend among states has been to depart from the three-factor formula in favor of a single sales factor formula with market-based sourcing.
  - Reflection of a digital / service economy

- The Multistate Tax Commission ("MTC") has recently recommended that member states adopt a three-factor, double-weighted sales factor apportionment formula with market-based sourcing.
Apportionment

- Income may be taxed at significantly more or less than 100% if states take differing positions with respect to the business/nonbusiness treatment, or sourcing, of a particular item of income.

  - Taxpayer sold a tract of land located in Delaware used to grow timberland.
  - The gain was characterized as nonbusiness income under Delaware law and was 100% allocated to Delaware.
  - Under Pennsylvania law, the gain was characterized as business income and 43% of the gain was apportioned to Pennsylvania.

Apportionment

- Throwback Rule
  - Designed to prevent “no-where income,” the throwback rule modifies a taxpayer’s receipts factor by reassigning receipts to the state from which goods are shipped if the taxpayer is not taxable in the destination state. This modification increases the sales factor numerator of the origin state.
  - Uniform Division of Income for Tax Purposes Act (UDITPA) § 16(b)
    - Receipts from the sale of tangible personal property are sourced to a state if “the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.”
    - A majority of the states have enacted some form of throwback provision.
Apportionment

– Throw-out Rule
  - Removes receipts from the denominator of the sales factor if such receipts are not taxable in the destination state,
    - Increases the share of income taxable by the state from which the goods are shipped.
  - Effectively converts the sales factor from “in-state receipts over receipts everywhere” to “in-state receipts over taxed receipts everywhere”.
  - The New Jersey Supreme Court held that New Jersey’s throw-out rule was facially constitutional in certain circumstances. Whirlpool Properties, Inc. v. Division of Taxation, 26 A3d 446 (N.J. 2011).
  - New Jersey has since repealed its throw-out rule.

Combined vs. Separate Reporting

– Separate reporting states:
  - Separate reporting states require each entity to file its own return, regardless of common ownership.
  - Intercompany transactions are generally respected if I.R.C. § 482 principles are observed.
– Combined reporting – on a Unitary group basis.
  - States which utilize a combined reporting approach require separate entity taxpayers engaged in a unitary business to file a combined report.
  - All intercompany transactions between the entities in a combined report are ignored for state income tax purposes.
Background: Worldwide Combined Reports

- In the 1970s, the California Franchise Tax Board (“FTB”) began to require foreign affiliates to be included as part of the combined group, which became known as the worldwide combined report.
- The worldwide combined report was met with significant resistance from foreign trading partners.
- The constitutionality of worldwide combined reporting was sustained in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).
  - Many states enacted worldwide combined reporting statutes shortly after the *Container Corp.* decision.

Worldwide Combined Reports

- Responding to pressure from multinational enterprises and foreign governments in the aftermath of the *Container* case, President Reagan convened a Worldwide Unitary Taxation Working Group.
  - The Worldwide Unitary Taxation Working Group's recommendations ultimately led to proposed federal legislation limiting combined apportionment to a U.S. water’s edge combined group.
- Responding to the pressure from proposed federal legislation, states repealed their mandatory worldwide combined reporting statutes and enacted legislation to either limit combined reporting to water’s edge income or provide taxpayers with an option to make a water’s edge election.
- A water’s edge election generally limits the entities in the combined report to U.S. corporations, with certain exceptions.
“Tax Haven” Statutes – Beyond the Water’s Edge

- To combat perceived abusive structures, some states appear to be moving back towards a worldwide combined reporting approach with the enactment of “tax haven” statutes.
  - Intended to prevent multistate and multinational taxpayers from shifting income to low or no tax jurisdictions.
  - Tax haven statutes include in the combined group income from affiliates incorporated in or doing business in “tax haven” jurisdictions.
  - States have generally taken two different approaches to drafting their tax haven legislation:
    1. Define “tax haven” as a jurisdiction possessing certain attributes or factors.
       - *E.g.*, A jurisdiction that imposes a low or no rate of tax on corporate income, lacks legislative transparency, etc.
    2. Expressly provide a list of tax haven countries in the statute.

- States that have enacted tax haven legislation:
  - Alaska, D.C., Montana, Oregon, Rhode Island, West Virginia.
  - Oregon proposed legislation (H.B. 2099) would include the Netherlands and Hong Kong as tax havens.
  - Montana proposed legislation (S.B. 167) would add Switzerland, Ireland, the Netherlands, and Hong Kong as tax havens.
  - Montana S.B. 166 proposes to make Montana a worldwide combined state by eliminating Montana’s water’s edge election.
“Tax Haven” Statutes – Beyond the Water’s Edge

– In 2015, the legislatures in Massachusetts, Kentucky, Maine, and New Hampshire also introduced tax haven bills.
  ▪ Massachusetts HB 2477 includes Switzerland as a tax haven.
  ▪ Maine (L.D. 341) includes Ireland as a tax haven.
– The recent proliferation of tax haven statutes may be the beginning of the end for water’s edge combined reporting.

Intergovernmental Cooperation and Information Sharing

MTC: Joint Audit Program

– The Multistate Tax Commission ("MTC") is an intergovernmental state tax agency created by the Multistate Tax Compact to promote uniformity and facilitate the administration of tax laws in the United States.
– The MTC operates a joint audit program pursuant to which member states pool their resources to select candidates for corporate income/franchise, sales and use, and gross receipts tax audits
  ▪ Assists states in identifying any inconsistent reporting to different states by multistate taxpayers
  ▪ Over the last 5 years the MTC Audit program completed the equivalent of 1,647 state income and sales tax audits.
– Taxpayer information is shared with various member states during the course of an MTC audit.
Inequality, Income Segregation, and the Rise of the Super ZIPS

- Yes income inequality, but also *income segregation*.

- Income segregation entails *fiscal segregation*.

- Why care about fiscal segregation?
  - Economic effects: impact of federal tax law may vary by geography
  - Political effects: differential impact across states, congressional districts
  - Isolation and attitude formation; social cohesion

- This project: one dimension of the tax law’s disparate geographical impact—i.e., the operation of the federal income tax in the nation’s wealthiest communities, or “Super ZIPS.”
Overview of IRS ZIP Code Data

- Published by IRS Statistics of Income
- Categorized by ZIP Code appearing on return
- 2012 data include individual income tax returns (1040, etc.) filed and processed between January 1, 2013 and December 31, 2013.
- Address shown on the tax return may differ from taxpayer’s residence.
- Excluded returns: filed from foreign addresses and U.S. territories, very small ZIPs (< 100 returns).
Tax Return Items Included in Data

- 76 variables from Forms 1040, 1040A, 1040EZ
- **Taxpayer:** # of returns, filing status (single, joint, HOH), # of exemptions, # of dependents
- **Income:** AGI, Composition of AGI, Taxable Inc.
- **Deductions:** itemize v. standard, Sch. A deductions (e.g., MID, SALT, CC)
- **Credits:** Child Tax Credit, Dep Care Tax Credit, EITC
- **Tax Owed:** AMT, Income Tax Amount, Refunds

Specification of “Tax Super ZIPS”

- Murray used Census income and education data to identify what he called Super ZIPS, 882 ZIP codes (population > 500 adults aged 25 or older) representing the highest earning, most highly educated subset of the U.S. population.
- “Tax Super ZIPS” are defined here as those ZIP codes:
  - (1) from which at least 1,000 returns were filed, and
  - (2) had a per return AGI of at least $200,000.
- These limitations leave a total of 322 “Tax Super ZIPS”
A Sampling of the Golden State’s Golden ZIPS
(aka, the usual suspects...)

- **94027 (Atherton)**
  - AGI per return: $1,464,534
  - 44.4% of returns with AGI > $200k

- **94301 (Palo Alto)**
  - AGI per return: $961,332
  - 32.2% of returns with AGI > $200k

- **94028 (Portola Valley)**
  - AGI per return: $709,600
  - 40.0% of returns with AGI > $200k

- **90210 (Beverly Hills)**
  - AGI per return: $590,681
  - 33.2% of returns with AGI > $200k

- **90077 (Bel-Air)**
  - AGI per return: $497,480
  - 34.5% of returns with AGI > $200k

---

Table 2: Distribution of Tax Super ZIPS across the States, 2012

<table>
<thead>
<tr>
<th>State</th>
<th>Number of Tax Super ZIPS</th>
<th>Number of ReturnsFiled</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Total</td>
<td>322</td>
<td>2,681,450</td>
</tr>
<tr>
<td>California</td>
<td>60</td>
<td>541,360</td>
</tr>
<tr>
<td>New York</td>
<td>58</td>
<td>612,140</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>31</td>
<td>172,150</td>
</tr>
<tr>
<td>Florida</td>
<td>26</td>
<td>201,160</td>
</tr>
<tr>
<td>New Jersey</td>
<td>25</td>
<td>153,350</td>
</tr>
<tr>
<td>Texas</td>
<td>22</td>
<td>240,790</td>
</tr>
<tr>
<td>Illinois</td>
<td>16</td>
<td>129,870</td>
</tr>
<tr>
<td>Connecticut</td>
<td>15</td>
<td>100,090</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>8</td>
<td>33,050</td>
</tr>
<tr>
<td>Virginia</td>
<td>8</td>
<td>73,160</td>
</tr>
<tr>
<td>Michigan</td>
<td>5</td>
<td>43,030</td>
</tr>
<tr>
<td>Minnesota</td>
<td>5</td>
<td>26,160</td>
</tr>
<tr>
<td>Maryland</td>
<td>4</td>
<td>60,990</td>
</tr>
<tr>
<td>Missouri</td>
<td>4</td>
<td>29,760</td>
</tr>
<tr>
<td>Ohio</td>
<td>4</td>
<td>29,000</td>
</tr>
<tr>
<td>Washington</td>
<td>4</td>
<td>42,050</td>
</tr>
<tr>
<td>Arizona</td>
<td>3</td>
<td>30,710</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>3</td>
<td>34,780</td>
</tr>
<tr>
<td>Tennessee</td>
<td>3</td>
<td>32,000</td>
</tr>
<tr>
<td>Colorado</td>
<td>2</td>
<td>14,050</td>
</tr>
<tr>
<td>Georgia</td>
<td>2</td>
<td>23,600</td>
</tr>
<tr>
<td>Kansas</td>
<td>2</td>
<td>7,880</td>
</tr>
<tr>
<td>Nevada</td>
<td>2</td>
<td>6,100</td>
</tr>
<tr>
<td>Wyoming</td>
<td>2</td>
<td>8,030</td>
</tr>
<tr>
<td>Alabama</td>
<td>1</td>
<td>5,250</td>
</tr>
<tr>
<td>Arkansas</td>
<td>1</td>
<td>20,630</td>
</tr>
<tr>
<td>Delaware</td>
<td>1</td>
<td>4,140</td>
</tr>
<tr>
<td>North Carolina</td>
<td>1</td>
<td>4,310</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>1</td>
<td>1,860</td>
</tr>
</tbody>
</table>
Nationwide Tax Return Data versus “Tax Super ZIPs”

<table>
<thead>
<tr>
<th></th>
<th>Nationwide</th>
<th>Tax Super ZIPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total returns filed</td>
<td>144,928,472</td>
<td>2,681,450</td>
</tr>
<tr>
<td>Personal exemptions</td>
<td>287,733,123</td>
<td>5,019,750</td>
</tr>
<tr>
<td>Income Reported and Tax Paid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AGI per return</td>
<td>$62,791</td>
<td>$330,251</td>
</tr>
<tr>
<td>% returns w/ AGI over $200,000</td>
<td>3.6%</td>
<td>26.1%</td>
</tr>
<tr>
<td>Income tax per return</td>
<td>$8,157</td>
<td>$63,130</td>
</tr>
<tr>
<td>Composition of Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and Wages</td>
<td>69.2%</td>
<td>44.3%</td>
</tr>
<tr>
<td>Interest/Dividends</td>
<td>4.1%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Business Income</td>
<td>3.9%</td>
<td>21.3%</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>7.1%</td>
<td></td>
</tr>
<tr>
<td>Retirement Income</td>
<td>11.7%</td>
<td></td>
</tr>
<tr>
<td>Other (e.g., Sch. E)</td>
<td>4.0%</td>
<td></td>
</tr>
<tr>
<td>Itemize v. Standard Deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage Itemizing</td>
<td>31.5%</td>
<td>59.0%</td>
</tr>
<tr>
<td>Standard Deduction</td>
<td>68.5%</td>
<td>41.0%</td>
</tr>
<tr>
<td>Major Personal Deductions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MID per itemizing return</td>
<td>$9,547</td>
<td>$10,711</td>
</tr>
<tr>
<td>Charitable Contributions per itemizing return</td>
<td>$5,334</td>
<td>$16,386</td>
</tr>
<tr>
<td>SALT per itemizing return</td>
<td>$6,821</td>
<td>$42,981</td>
</tr>
<tr>
<td>Effective tax rates (before EITC)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income tax as % of AGI</td>
<td>13.1%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Income tax as % of TI</td>
<td>18.6%</td>
<td>25.0%</td>
</tr>
</tbody>
</table>

AGI per Tax Return

Top 10 Tax Super ZIPs by AGI per Tax Return Filed

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>AGI per return (# returns; # exemptions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>94027</td>
<td>Atherton, CA</td>
<td>$1,465,000 (3,220; 6,320)</td>
</tr>
<tr>
<td>19035</td>
<td>Gladwyne, PA</td>
<td>$1,052,000 (2,040; 3,920)</td>
</tr>
<tr>
<td>10005</td>
<td>NY, NY (Wall Street)</td>
<td>$984,000 (5,580; 7,850)</td>
</tr>
<tr>
<td>33480</td>
<td>Palm Beach, FL</td>
<td>$967,000 (5,580; 8,360)</td>
</tr>
<tr>
<td>94301</td>
<td>Palo Alto, CA</td>
<td>$961,000 (8,490; 15,570)</td>
</tr>
<tr>
<td>10577</td>
<td>Purchase, NY</td>
<td>$897,000 (1,520; 2,920)</td>
</tr>
<tr>
<td>89451</td>
<td>Incline Village, NV</td>
<td>$886,000 (2,280; 4,210)</td>
</tr>
<tr>
<td>90067</td>
<td>LA, CA (Century City)</td>
<td>$857,000 (3,250; 5,360)</td>
</tr>
<tr>
<td>02493</td>
<td>Weston, MA</td>
<td>$727,000 (5,010; 10,840)</td>
</tr>
<tr>
<td>60043</td>
<td>Kenilworth, IL</td>
<td>$716,000 (1,210; 2,650)</td>
</tr>
</tbody>
</table>
### % of Returns with AGI over $200k

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>% returns with AGI over $200k</th>
</tr>
</thead>
<tbody>
<tr>
<td>10282</td>
<td>NY, NY (TriBeCa)</td>
<td>47.7%</td>
</tr>
<tr>
<td>07075</td>
<td>Wood Ridge, NJ</td>
<td>46.2%</td>
</tr>
<tr>
<td>10504</td>
<td>Armonk, NY</td>
<td>45.0%</td>
</tr>
<tr>
<td>94027</td>
<td>Atherton, CA</td>
<td>44.4%</td>
</tr>
<tr>
<td>10007</td>
<td>NY, NY (TriBeCa)</td>
<td>43.0%</td>
</tr>
<tr>
<td>60043</td>
<td>Kenilworth, IL</td>
<td>42.1%</td>
</tr>
<tr>
<td>10069</td>
<td>NY, NY (Upper West Side)</td>
<td>41.4%</td>
</tr>
<tr>
<td>10514</td>
<td>Chappaqua, NY</td>
<td>41.1%</td>
</tr>
<tr>
<td>60022</td>
<td>Glencoe, IL</td>
<td>40.5%</td>
</tr>
<tr>
<td>19085</td>
<td>Villanova, PA</td>
<td>40.4%</td>
</tr>
</tbody>
</table>

### AGI Composition: Capital Gains

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>AGI as a Percentage of AGI</th>
<th>(# returns; # exemptions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>23219</td>
<td>Richmond, VA</td>
<td>81.8%</td>
<td>(1,660; 2,080)</td>
</tr>
<tr>
<td>76102</td>
<td>Fort Worth, TX</td>
<td>64.0%</td>
<td>(3,850; 6,160)</td>
</tr>
<tr>
<td>94111</td>
<td>San Francisco, CA</td>
<td>51.3%</td>
<td>(2,670; 4,020)</td>
</tr>
<tr>
<td>19035</td>
<td>Gladwyne, PA</td>
<td>49.1%</td>
<td>(2,040; 3,920)</td>
</tr>
<tr>
<td>94027</td>
<td>Atherton, CA</td>
<td>48.9%</td>
<td>(3,220; 6,320)</td>
</tr>
<tr>
<td>81611</td>
<td>Aspen, CO</td>
<td>47.9%</td>
<td>(3,700; 5,850)</td>
</tr>
<tr>
<td>33480</td>
<td>Palm Beach, FL</td>
<td>47.9%</td>
<td>(5,580; 8,360)</td>
</tr>
<tr>
<td>10005</td>
<td>NY, NY (Wall Street)</td>
<td>45.1%</td>
<td>(5,580; 7,850)</td>
</tr>
<tr>
<td>83014</td>
<td>Wilson, WY</td>
<td>44.5%</td>
<td>(1,640; 2,670)</td>
</tr>
<tr>
<td>94028</td>
<td>Portola Valley, CA</td>
<td>43.2%</td>
<td>(3,450; 6,770)</td>
</tr>
</tbody>
</table>
# Home Mortgage Interest Deduction

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>MID Amount per Itemizing Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>92657</td>
<td>Newport Coast, CA</td>
<td>$19,090</td>
</tr>
<tr>
<td>94507</td>
<td>Alamo, CA</td>
<td>$18,744</td>
</tr>
<tr>
<td>94506</td>
<td>Alamo, CA</td>
<td>$18,683</td>
</tr>
<tr>
<td>22066</td>
<td>Great Falls, VA</td>
<td>$17,969</td>
</tr>
<tr>
<td>91302</td>
<td>Calabasas, CA</td>
<td>$17,179</td>
</tr>
<tr>
<td>91011</td>
<td>La Cañada Flintridge, CA</td>
<td>$16,912</td>
</tr>
<tr>
<td>90077</td>
<td>Los Angeles (Bel-Air), CA</td>
<td>$16,788</td>
</tr>
<tr>
<td>90210</td>
<td>Beverly Hills, CA</td>
<td>$16,542</td>
</tr>
<tr>
<td>90272</td>
<td>Pacific Palisades, CA</td>
<td>$16,298</td>
</tr>
<tr>
<td>92861</td>
<td>Villa Park, CA (Orange County)</td>
<td>$16,169</td>
</tr>
</tbody>
</table>

# State and Local Tax Deduction

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th># of AGI (average amount per return)</th>
</tr>
</thead>
<tbody>
<tr>
<td>11771</td>
<td>Oyster Bay, NY</td>
<td>15.0% ($70,916)</td>
</tr>
<tr>
<td>10987</td>
<td>Tuxedo Park, NY</td>
<td>13.3% ($42,063)</td>
</tr>
<tr>
<td>11724</td>
<td>Cold Spring Harbor, NY</td>
<td>13.1% ($56,302</td>
</tr>
<tr>
<td>10803</td>
<td>Pelham, NY</td>
<td>12.9% ($43,678)</td>
</tr>
<tr>
<td>11576</td>
<td>Roslyn, NY</td>
<td>12.8% ($47,265)</td>
</tr>
<tr>
<td>10128</td>
<td>NY, NY (Manhattan)</td>
<td>12.7% ($67,800)</td>
</tr>
<tr>
<td>11791</td>
<td>Syosset, NY</td>
<td>12.6% ($38,685)</td>
</tr>
<tr>
<td>07627</td>
<td>Demarest, NJ</td>
<td>12.6% ($40,311)</td>
</tr>
<tr>
<td>07043</td>
<td>Montclair, NJ</td>
<td>12.5% ($39,602)</td>
</tr>
<tr>
<td>10028</td>
<td>NY, NY (Manhattan)</td>
<td>12.5% ($65,258)</td>
</tr>
</tbody>
</table>
## State and Local Tax Deduction

### Top 10 Tax Super ZIPs by State & Local Amount per Itemized Return

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>Amount per Itemizer (% of AGI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>94027</td>
<td>Atherton, CA</td>
<td>$209,846 (10.1%)</td>
</tr>
<tr>
<td>10577</td>
<td>Purchase, NY</td>
<td>$144,215 (10.2%)</td>
</tr>
<tr>
<td>94301</td>
<td>Palo Alto, CA</td>
<td>$139,459 (9.3%)</td>
</tr>
<tr>
<td>10005</td>
<td>NY, NY (Wall Street)</td>
<td>$138,065 (12.0%)</td>
</tr>
<tr>
<td>90067</td>
<td>Los Angeles, CA (Century City)</td>
<td>$137,244 (4.9%)</td>
</tr>
<tr>
<td>23219</td>
<td>Richmond, VA</td>
<td>$121,578 (12.0%)</td>
</tr>
<tr>
<td>11568</td>
<td>Old Westbury, NY</td>
<td>$108,877 (10.0%)</td>
</tr>
<tr>
<td>94111</td>
<td>San Francisco, CA</td>
<td>$105,690 (8.6%)</td>
</tr>
<tr>
<td>06830</td>
<td>Greenwich, CT</td>
<td>$104,896 (11.1%)</td>
</tr>
<tr>
<td>10018</td>
<td>NY, NY (Manhattan)</td>
<td>$101,921 (9.0%)</td>
</tr>
</tbody>
</table>

### Bottom 10 Tax Super ZIPs by State & Local Amount per Itemized Return

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>Amount per Itemizer (% of AGI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>76034</td>
<td>Colleyville, TX (Dallas/Fort Worth)</td>
<td>$13,286 (4.1%)</td>
</tr>
<tr>
<td>77382</td>
<td>Spring, TX (Houston)</td>
<td>$13,255 (4.2%)</td>
</tr>
<tr>
<td>78738</td>
<td>Austin, TX</td>
<td>$13,070 (4.5%)</td>
</tr>
<tr>
<td>32082</td>
<td>Ponte Vedra Beach, FL</td>
<td>$12,621 (3.4%)</td>
</tr>
<tr>
<td>78731</td>
<td>Austin, TX</td>
<td>$12,505 (3.3%)</td>
</tr>
<tr>
<td>77381</td>
<td>Spring TX (Houston)</td>
<td>$11,561 (3.3%)</td>
</tr>
<tr>
<td>37205</td>
<td>Nashville, TN</td>
<td>$11,296 (3.2%)</td>
</tr>
<tr>
<td>34786</td>
<td>Windermere, FL (Tiger Woods)</td>
<td>$11,140 (2.9%)</td>
</tr>
<tr>
<td>37215</td>
<td>Nashville, TN</td>
<td>$10,899 (2.9%)</td>
</tr>
<tr>
<td>38139</td>
<td>Germantown, TN (Memphis)</td>
<td>$10,254 (3.4%)</td>
</tr>
</tbody>
</table>
Charitable Contribution Deduction

### Top 10 Tax Super ZIPS by Charitable Contributions as a Percentage of Itemizers’ AGI

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th># of AGI (average amount per return)</th>
</tr>
</thead>
<tbody>
<tr>
<td>60601</td>
<td>Chicago, IL</td>
<td>15.3% ($70,682)</td>
</tr>
<tr>
<td>94111</td>
<td>San Francisco, CA</td>
<td>10.2% ($111,306)</td>
</tr>
<tr>
<td>74119</td>
<td>Tulsa, OK</td>
<td>9.3% ($68,943)</td>
</tr>
<tr>
<td>76102</td>
<td>Fort Worth, TX</td>
<td>8.7% ($144,068)</td>
</tr>
<tr>
<td>94304</td>
<td>Palo Alto, CA</td>
<td>8.0% ($52,657)</td>
</tr>
<tr>
<td>33480</td>
<td>Miami Beach, FL</td>
<td>7.1% ($41,013)</td>
</tr>
<tr>
<td>11559</td>
<td>Lawrence, NY</td>
<td>6.6% ($50,063)</td>
</tr>
<tr>
<td>10005</td>
<td>NY, NY (Wall Street)</td>
<td>6.4% ($97,875)</td>
</tr>
<tr>
<td>94596</td>
<td>Walnut Creek, CA</td>
<td>6.4% ($25,021)</td>
</tr>
<tr>
<td>34102</td>
<td>Naples, FL</td>
<td>6.3% ($64,790)</td>
</tr>
</tbody>
</table>

Charitable Contribution Deduction

### Top 10 Tax Super ZIPS by Charitable Contribution Amount per Itemized Return

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>Amount per Itemizer (% of AGI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>76102</td>
<td>Fort Worth, TX</td>
<td>$144,068 (8.7%)</td>
</tr>
<tr>
<td>94111</td>
<td>San Francisco, CA</td>
<td>$111,306 (10.2%)</td>
</tr>
<tr>
<td>10005</td>
<td>NY, NY (Wall Street)</td>
<td>$97,875 (6.4%)</td>
</tr>
<tr>
<td>33480</td>
<td>Palm Beach, FL</td>
<td>$85,193 (5.6%)</td>
</tr>
<tr>
<td>94027</td>
<td>Atherton, CA</td>
<td>$82,369 (4.0%)</td>
</tr>
<tr>
<td>77002</td>
<td>Houston, TX</td>
<td>$77,333 (6.2%)</td>
</tr>
<tr>
<td>06830</td>
<td>Greenwich, CT</td>
<td>$73,914 (6.0%)</td>
</tr>
<tr>
<td>94301</td>
<td>Palo Alto, CA</td>
<td>$71,315 (4.7%)</td>
</tr>
<tr>
<td>60601</td>
<td>Chicago, IL</td>
<td>$70,682 (15.3%)</td>
</tr>
<tr>
<td>74119</td>
<td>Tulsa, OK</td>
<td>$68,943 (9.3%)</td>
</tr>
</tbody>
</table>
## Charitable Contribution Deduction

### Bottom 10 Tax Super ZIPS by Charitable Contribution Amount per Itemized Return

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>Amount per Itemizer (% of AGI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>11791</td>
<td>Syosset, NY</td>
<td>$5,243 (1.7%)</td>
</tr>
<tr>
<td>10282</td>
<td>NY, NY (TriBeCa)</td>
<td>$5,097 (1.0%)</td>
</tr>
<tr>
<td>07090</td>
<td>Westfield, NJ</td>
<td>$4,618 (1.6%)</td>
</tr>
<tr>
<td>11747</td>
<td>Melville, NY</td>
<td>$4,606 (1.5%)</td>
</tr>
<tr>
<td>11753</td>
<td>Jericho, NY</td>
<td>$4,565 (1.5%)</td>
</tr>
<tr>
<td>06896</td>
<td>Redding, CT</td>
<td>$4,504 (1.6%)</td>
</tr>
<tr>
<td>10010</td>
<td>NY, NY (Gramercy, Murray Hill)</td>
<td>$4,405 (1.4%)</td>
</tr>
<tr>
<td>94114</td>
<td>San Fran, CA (Castro)</td>
<td>$4,316 (1.3%)</td>
</tr>
<tr>
<td>07930</td>
<td>Chester, NJ</td>
<td>$3,935 (1.3%)</td>
</tr>
<tr>
<td>94158</td>
<td>San Fran, CA (Mission Bay)</td>
<td>$2,603 (0.7%)</td>
</tr>
</tbody>
</table>

## Federal Income Tax Owed

### Top 10 Tax Super ZIPS by Federal Income Tax Owed per Return

<table>
<thead>
<tr>
<th>ZIP Code</th>
<th>City/Place</th>
<th>Federal Income Tax Owed per Return (% of AGI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>94027</td>
<td>Atherton, CA</td>
<td>$283,870 (19.4%)</td>
</tr>
<tr>
<td>10577</td>
<td>Purchase, NY</td>
<td>$193,642 (21.6%)</td>
</tr>
<tr>
<td>90067</td>
<td>LA, CA (Century City)</td>
<td>$191,394 (22.3%)</td>
</tr>
<tr>
<td>19035</td>
<td>Gladwyne, PA</td>
<td>$189,653 (18.0%)</td>
</tr>
<tr>
<td>94301</td>
<td>Palo Alto, CA</td>
<td>$187,064 (19.5%)</td>
</tr>
<tr>
<td>10005</td>
<td>NY, NY (Wall Street)</td>
<td>$184,773 (18.8%)</td>
</tr>
<tr>
<td>33480</td>
<td>Palm Beach, FL</td>
<td>$182,784 (18.9%)</td>
</tr>
<tr>
<td>60043</td>
<td>Kenilworth, IL</td>
<td>$162,703 (22.7%)</td>
</tr>
<tr>
<td>89451</td>
<td>Incline Village, NV</td>
<td>$153,750 (17.4%)</td>
</tr>
<tr>
<td>2493</td>
<td>Weston, MA</td>
<td>$153,063 (21.1%)</td>
</tr>
</tbody>
</table>
A Closer Look @ 94027 (Atherton, CA) returns with > $200k AGI

- Of 3,220 total returns, 1,430 w/ AGI > $200k (44.4 %)
- Of those 1,430 returns, 1,190 (83.2 %) were joint returns
- Average AGI for all > $200k returns = $3.2 million per return
- 49.9 % of that AGI consists of “net capital gain” (i.e., 15% rate)
- Itemized deductions:
  - Home mortgage interest: average of $18,529 per return
  - State & Local Taxes: average of $320,872 per return (10.0%)
  - Charitable contributions: average of $127,155 per return (3.9%)
- Effective Federal Tax Rate: 19.7 percent (as % of AGI)

Atherton (94027) versus Oakland (94603)
## Comparison of Atherton (94027) and Oakland (94603)

<table>
<thead>
<tr>
<th></th>
<th>Atherton</th>
<th>Oakland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total returns filed</td>
<td>3,220</td>
<td>12,970</td>
</tr>
<tr>
<td>Personal exemptions</td>
<td>6,320</td>
<td>32,890</td>
</tr>
<tr>
<td>Income Reported and Tax Paid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AGI per return</td>
<td>$1,464,534</td>
<td>$34,014</td>
</tr>
<tr>
<td>Taxable income per return</td>
<td>$1,206,781</td>
<td>$15,876</td>
</tr>
<tr>
<td>Income tax per return</td>
<td>$283,870</td>
<td>$1,973</td>
</tr>
<tr>
<td>Composition of Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and Wages</td>
<td>29.3%</td>
<td>83.8%</td>
</tr>
<tr>
<td>Interest/Dividends</td>
<td>8.0%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Business Income</td>
<td>2.1%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>48.9%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Retirement Income</td>
<td>2.2%</td>
<td>8.9%</td>
</tr>
<tr>
<td>Other (e.g., Sch. E)</td>
<td>9.6%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Itemize v. Standard Deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage Itemizing</td>
<td>69.3%</td>
<td>21.7%</td>
</tr>
<tr>
<td>Standard Deduction</td>
<td>30.1%</td>
<td>78.3%</td>
</tr>
<tr>
<td>Major Personal Deductions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MID per itemizing return</td>
<td>$14,865</td>
<td>$7,718</td>
</tr>
<tr>
<td>Charitable Contributions per itemizing return</td>
<td>$83,369</td>
<td>$1,122</td>
</tr>
<tr>
<td>SALT per itemizing return</td>
<td>$209,846</td>
<td>$5,632</td>
</tr>
<tr>
<td>Effective tax rates (before EITC)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income tax as % of AGI</td>
<td>19.4%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Income tax as % of TI</td>
<td>23.5%</td>
<td>12.4%</td>
</tr>
</tbody>
</table>

## A Tale of Two 1040s

- “Fiscal segregation” flows from income segregation

- Federal income tax will have more concentrated, differential effects across space—with the potential for changing how the federal tax system is experienced on the ground.

- Communitarian impulses about the federal income tax (if they exist) may erode in the face of fiscal segregation.

- Two very different tax systems in operation in nearby communities (compare to VAT or RST, where the taxpaying experience is more universal).
Final Panel - Takeaways for Businesses

Moderator: Peter Waterstreet

Notes:
2015 Federal Tax Reform Proposals

What’s going on

Calls for
- Comprehensive tax reform (numerous changes including lower rates)
- Tweaks
- Structural changes (Nunes, Rubio, others)
- Address BEPS concerns in some way

Matters that can’t wait:
- Highway Trust Fund fix
- Disability Insurance (SSDI) funding crisis
- 52 provisions that expired at end of 2014
- Expiration of Internet Tax Freedom Act
- ACA, if gov’t loses King case on Premium Tax Credit
Design/reform considerations

How to lower the corporate rate?

- Go to single rate or keep graduated rates?
- Also repeal AMT?
- Expand §199 deduction?
Lower rate versus expensing of assets

- Expensing incentivizes new investment rather than existing investment.
- Favors capital intensive over labor intensive though.
- May be easier, but how to pay for it?

Corporate reform versus reform for all

Corporate reform versus all businesses

- Lower rate only for business income?
  - Difficult to do for individuals.
- Tax all businesses the same?
  - Or lower corporate rate only
    - Likely to lead some other entities to incorporate.
- Corporate integration too?
Revenue Impact

Revenue neutral or not?

How to measure?
- Impact of changes that only involve timing (rather than repealing deductions and credits)?

How to lower rate in revenue neutral manner?
- 1% reduction in corporate tax rate costs about $11 billion per year

Revenue raiser possibilities
(1 year estimate)

Reduce value of certain tax expenditures (itemized deductions, foreign excluded income, tax-exempt interest, employer-provided health insurance, and a few other items) for upper-income individuals
- $53 billion

Tax carried (profits) interests as ordinary income
- $1.6 billion

Repeal LIFO
- $8 billion

Big dollars are tied to
- Exclusion for employer-provided health insurance
- Home mortgage interest deduction
- Lower capital gains rate

On the table?
Obstacles to tax reform

The significance of the changes.
Finding ways to pay for a lower rate.
Reaching compromise.
Issues of top corporate and individual rates differing.
Transition rules – should there be any? Cost?
  ◦ For example, allow phase-out of a deduction, rather than immediate, 100% elimination
Every current provision has a group that will fight to keep it.
Concerns of state and local governments.
  ◦ Such as due to cut-back on exclusion for tax-exempt interest.
Public’s low understanding of current system and its inequities and complexities.
  ◦ Might fight against changes that would help them and economy.

What key players are saying
Congressman Ryan (R-WI) – Chair House Ways and Means Committee

Feb 2015
- Tax reform is a sure thing – by end of summer (!)
  - Per Business Insider, “Paul Ryan: ‘Tax reform is a 2015 thing for sure’”, 2/14/15

April 2015
- 2-step approach
  - Corporate reform now
  - Individual reform later with new President
- Challenge – non-corporate businesses don’t want higher rate than a corporation

House Budget Report – March 2015

Tax Reform
- The U.S. tax code is absurdly complicated, patently unfair, and highly inefficient. It is estimated that individuals, families and employers spend more than 6 billion hours and more than $160 billion a year trying to comply with the current system. All of this makes it an impediment to greater economic growth because it distorts decisions regarding work, savings and investment.

- Our budget proposes to grow the economy and create jobs with tax reform that will make the code simpler and fairer.

- Our budget calls for comprehensive tax reform that would include lower rates for individuals and families as well as large corporations and small businesses who often file their tax returns through the individual side of the tax code.

- We would repeal the Alternative Minimum Tax and transition away from a worldwide tax system to a more competitive international tax system.

- Along with lower rates, we propose broadening the tax base by closing special interest loopholes that distort economic activity.

Annual Cost of Tax Compliance
- 6 Billion Hours
- $160 Billion

Reports and studies

Senate Finance Committee

- 12/11/14 - Republican staff report (300 pages) – *Comprehensive Tax Reform for 2015 and Beyond*, with intro by Senator Hatch.
  - [http://www.finance.senate.gov/newsroom/ranking/release/?id=0df91455-c895-49b4-9044-d8fd9873b1dc](http://www.finance.senate.gov/newsroom/ranking/release/?id=0df91455-c895-49b4-9044-d8fd9873b1dc)
- 1/15/15 - Senators Hatch and Wyden form 5 bipartisan working groups on tax reform
  - Sought public input by 4/15/15
  - [http://www.finance.senate.gov/newsroom/chairman/release/?id=2ea8c8e5-c892-4230-9d1a-db7522a920be](http://www.finance.senate.gov/newsroom/chairman/release/?id=2ea8c8e5-c892-4230-9d1a-db7522a920be)
- 4/29/15 – SFC released 1400+ comment letters received
  - [http://www.finance.senate.gov/newsroom/chairman/release/?id=3b14e94b-69f9-41e2-9fd3-7d191971b7ee](http://www.finance.senate.gov/newsroom/chairman/release/?id=3b14e94b-69f9-41e2-9fd3-7d191971b7ee)
  - [http://www.finance.senate.gov/newsroom/ranking/release/?id=c8de5ec5-13e1-4778-a20e-161f72e1e4f5](http://www.finance.senate.gov/newsroom/ranking/release/?id=c8de5ec5-13e1-4778-a20e-161f72e1e4f5)

SFC Study Groups

The five working groups and their co-chairs are listed below:

**Individual Income Tax Co-Chairs:**
- Senator Chuck Grassley (R-Iowa) & Senator Mike Enzi (R-Wyo.), Senator Debbie Stabenow (D-Mich.)

**Business Income Tax Co-Chairs:**
- Senator John Thune (R-S.D.) & Senator Ben Cardin (D-Md.)

**Savings & Investment Co-Chairs:**
- Senator Mike Crapo (R-Idaho) & Senator Sherrod Brown (D-Ohio)

**International Tax Co-Chairs:**
- Senator Rob Portman (R-Ohio) & Senator Chuck Schumer (D-N.Y.)

**Community Development & Infrastructure Co-Chairs:**
- Senator Dean Heller (R-Nev.) & Senator Michael Bennet (D-Colo.)

[http://www.finance.senate.gov/newsroom/chairman/release/?id=2ea8c8e5-c892-4230-9d1a-db7522a920be](http://www.finance.senate.gov/newsroom/chairman/release/?id=2ea8c8e5-c892-4230-9d1a-db7522a920be)
Senator Hatch, Chair Senate Finance Committee

“I believe that reform is vital and necessary to our nation’s economic well-being. Our tax code is a huge obstacle standing between us and continued prosperity. The costs of compliance alone are staggering. And, those costs are nothing compared to the economic distortions created by a tax system that, far too often, picks winners and losers. I believe this is true of both the individual tax system as well as the business tax system. That is why I have repeatedly called for a comprehensive approach that fixes the tax code for individuals and families as well as corporations and small businesses.”

Introduction to SFC Republican Staff report of 12/11/14.

http://www.finance.senate.gov/newsroom/ranking/release/?id=0df91455-c895-49b4-9044-d8fd9873b1dc

Senator Hatch – 7 Principles for Comprehensive Tax Reform

1. Economic growth
2. Fairness
3. Simplicity
4. Permanence
5. Competitiveness
6. Promote savings and investment
7. Revenue neutrality

http://www.finance.senate.gov/newsroom/ranking/release/?id=77a6f042-c878-452f-8cd2-747905013ce5
Continued hearings

3/18/15 – HWM – Burden of Estate Tax on Family Businesses and Farms
3/10/15 - SFC - Tax Complexity, Compliance, and Administration: The Merits of Simplification in Tax Reform
3/3/15 - SFC - Fairness in Taxation
2/24/15 - SFC - Tax Reform, Growth and Efficiency
+ over 50 held in 113rd and 112th Congresses

Links at [www.cob.sjsu.edu/nellen_a/114th-hearings.htm](http://www.cob.sjsu.edu/nellen_a/114th-hearings.htm)

Proposals include …

Senators Rubio and Lee (3/4/15) - Economic Growth and Family Fairness Tax Reform Plan

◦ Individuals – 15% up to $75K ($150K if married); otherwise 35%
◦ New $2,500 child credit against income and payroll tax
◦ Everyone gets mtg int and charitable deduction
◦ No AMT
◦ Repeal estate tax
◦ 25% corporate rate; same for pass-through business income
◦ Expensing of assets
◦ Territorial system

Proposals include ...

Congressman Nunes (R-CA) – American Business Competitiveness Act of 2014
- Tax all businesses same; 25% rate phased in over 10 years
- Repeal all deductions (other than modified comp and services deduction) and credits for businesses
  - Individuals still deduct mtg interest
- 100% expensing
- Cash method for all businesses
- NOL c/b 5, forward forever
- Territorial system
- Repeals individual and business AMT wrt business items
- Interest income taxed at same rate as dividends and cap gains
- Legislative text available
  - Member House Ways and Means Committee

Proposals ...

Consumption tax:

Nunes’ proposal (see earlier slide) is more a consumption tax than income tax

Senator Cardin (D-MD), S. 3005 (113rd), Progressive Consumption Tax Act
- Member Senate Finance Committee

Senator Paul Rand (R-KY) flat tax – see his budget FY2014 proposal (page 55).

- Some don’t have legislative language.
- Other proposals circulating informally for comment by select groups.

Consumption tax basics – see paper at end of these materials.
More Congressional Tax Activities

SAMPLE OF LEGISLATIVE PROPOSALS THAT MIGHT SHAPE OR BE PART OF TAX REFORM (OR PERHAPS SHOW INSUFFICIENT INTEREST IN TAX REFORM)

Repatriation holiday

Highway Trust Fund and Repatriation –

Senators Barbara Boxer (D-CA) and Rand Paul (R- KY)

- “Invest in Transportation Act” - use repatriation holiday to produce funds for infrastructure projects (Boxer press release of 1/29/15).
- Reduced tax (6.5%) on foreign earnings - use to replenish Highway Trust Fund and infrastructure projects. Additional points (per Boxer-Paul white paper):
  - Restrictions would prevent use of the funds for executive compensation, dividends or stock buyback.
  - If a company that takes advantage of the lower rate inverts within 10 years, it must repay the tax incentive + interest.
  - Corporations would have five years to complete the transfer.
- S. 981, Invest In Transportation Act
Cut back on mortgage interest deduction

H.R. 1662, *Common Sense Housing Investment Act* – 15% credit on QRI (AI and HEI capped at $500K combined; HEI capped at $100K); for PR and 2nd home; use savings to increase LIHC and fund rental assistance programs

H.R. 1823, *Ending Taxpayer Subsidies for Yachts Act* – disallow mtg interest deduction for boat used as second residence

Various credits

Make research credit permanent (HR 1852 and others)
Make WOTC permanent (HR 145)
Supermarket credit for underserved areas (HR 1433)
Veterans back to work (HR 1803)
Apprenticeship programs (S. 959)
Energy credits (S. 913, HR 1901)
Angel investors (S. 973)

Is there interest in base broadening?
Others

Expand EITC and/or child credit (HR 902, and others)
Make sales tax deduction permanent (H.Res. 200)
Repeal estate tax (HR 1105 passed in House)
Remove wage cap on Social Security tax (HR 1984)
Patent Box – Senator Feinstein (2012)
President Obama’s Elements of Business Tax Reform

I. Eliminate dozens of tax loopholes and subsidies, broaden the base and cut the corporate tax rate to spur growth in America: The Framework would eliminate dozens of different tax expenditures and fundamentally reform the business tax base to reduce distortions that hurt productivity and growth. It would reinvest these savings to lower the corporate tax rate to 28 percent, putting the United States in line with major competitor countries and encouraging greater investment in America.

II. Strengthen American manufacturing and innovation: The Framework would refocus the manufacturing deduction and use the savings to reduce the effective rate on manufacturing to no more than 25 percent, while encouraging greater research and development and the production of clean energy.

III. Strengthen the international tax system, including establishing a new minimum tax on foreign earnings, to encourage domestic investment: Our tax system should not give companies an incentive to locate production overseas or engage in accounting games to shift profits abroad, eroding the U.S. tax base. Introducing a minimum tax on foreign earnings would help address these problems and discourage a global race to the bottom in tax rates.

IV. Simplify and cut taxes for America’s small businesses: Tax reform should make tax filing simpler for small businesses and entrepreneurs so that they can focus on growing their businesses rather than filling out tax returns.

V. Restore fiscal responsibility and not add a dime to the deficit: Business tax reform should be fully paid for and lead to greater fiscal responsibility than our current business tax system by either eliminating or making permanent and fully paying for temporary tax provisions now in the tax code.
Greenbooks

General view:
◦ Tax cuts for individuals and families
◦ Tax increases for higher income individuals
  ◦ Cap value of some deductions and exclusions at 28%
  ◦ Buffett rule – 30% of income at minimum for income and employment taxes
  ◦ New minimum tax – Fair Share Tax
◦ Restore estate and gift tax to 2009
◦ Tax relief for small business
◦ Incentives for regional growth
◦ Incentives for manufacturing, research, clean energy, insourcing, job creation
◦ Eliminate oil and gas preferences
◦ International tax reform

http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx

FY2016 Greenbook

RESERVE FOR BUSINESS TAX REFORM THAT IS
REVENUE NEUTRAL IN THE LONG RUN

The number of special deductions, credits, and other tax preferences provided to businesses in the Internal Revenue Code has expanded significantly since the last comprehensive tax reform effort nearly three decades ago. Such tax preferences help well-connected special interests, but do little for economic growth. To be successful in an increasingly competitive global economy, the Nation cannot afford to maintain a tax code burdened with such tax breaks; instead, the tax code needs to ensure that the United States is the most attractive place for entrepreneurship and business growth. Therefore, in the Budget, the President is calling on the Congress to immediately begin work on business tax reform that achieves the following five goals: (1) cut the corporate tax rate and pay for it by making structural reforms and eliminating loopholes and subsidies; (2) strengthen American manufacturing and innovation; (3) strengthen the international tax system; (4) simplify and cut taxes for small businesses; and (5) avoid adding to deficits in the short-term or the long-term.

Consistent with these goals, the Budget includes a detailed set of business proposals that close loopholes and provide incentives for growth in a fiscally responsible manner.

The Administration proposes that these policies be enacted as part of business tax reform that is revenue neutral over the long run. As a result, the net savings from these proposals, which are described below, are not reflected in the budget estimates of receipts and are generally not counted toward meeting the Administration’s deficit reduction goals. However, as part of transitioning to a reformed international tax system, the President's plan would impose a one-time transition toll charge of 14 percent on the $1 to $2 trillion of untaxed foreign earnings that U.S. companies have accumulated overseas. The Budget proposes to use the one-time savings from this toll charge to pay for investment in transportation infrastructure.

Some new items in FY2015 and FY2016 Greenbooks

Conform SE taxes for professional service businesses
Limit §1031 to $1 million of gain (indexed for inflation) per taxpayer per year
Conform control test of §368 with affiliation test of §1504.

See complete list and estimated revenue effect included with today’s materials.

2015 State of the Union included ...

Lower taxes of working families
Concern over corporate loopholes

“And let’s close the loopholes that lead to inequality by allowing the top one percent to avoid paying taxes on their accumulated wealth.”

“We need a tax code that truly helps working Americans trying to get a leg up in the new economy, and we can achieve that together.”

President Obama FY2016 Budget

Reforming the Tax Code to Reward and Support Work – When both spouses work, a family incurs additional costs in the form of commuting costs, professional expenses, child care, and, increasingly, elder care. To address these challenges, the Budget proposes a new $500 “second earner” tax credit, which will benefit 24 million dual-earner couples. It also proposes to expand the Earned Income Tax Credit (EITC) for workers without children and non-custodial parents, promoting employment while reducing poverty and hardship for 13.2 million low-income workers struggling to make ends meet. In addition, the Budget continues to propose making permanent improvements to the EITC and Child Tax Credit that augment wages for 15 million families with 28 million children each year but are scheduled to expire at the end of 2017. Allowing these benefits to expire would result in a roughly $1,700 tax increase for a full-time minimum wage worker with two children.

Rebuilding Our Infrastructure with Transition Revenue from Business Tax Reform – To create jobs, spur economic growth and provide States and localities the certainty they need to plan for the future, the Budget includes a $478 billion, six-year surface transportation reauthorization proposal paid for with transition revenue from pro-growth business tax reform. This transition tax would mean that companies have to pay U.S. tax right now on the $2 trillion they already have overseas, rather than being able to delay paying any U.S. tax indefinitely. The proposal would allow us to repair existing roads and bridges and modernize our infrastructure with new investments in highways, freight networks, and bus, subway, rapid transit, light rail, and passenger rail systems in our cities, fast-growing metropolitan areas, small towns and rural communities across the country.

From White House website

https://www.whitehouse.gov/omb/overview

CLOSING THE TRUST FUND LOOPOHOLE AND RETURNING TO PRESIDENT REAGAN’S CAPITAL GAINS RATE

WILL PAY FOR
- Tripling the child care tax credit
- Free community college
- A new tax cut for working couples

WHO WILL PAY IT
81% TOP 0.1%
18% THE REST OF THE TOP 1%
1% REST OF THE TOP 5%

From White House website

https://www.whitehouse.gov/sotu
What about OECD activities?

**OECD**

Focus on
- Greater transparency as to where taxes are paid and how much is paid.
- Base erosion and profit shifting (BEPS)

Desire to address:
- “Digital disruption”
- Knowledge economy (rather than industrial economy)

Relevance to transfer pricing and more.
Roles for both Congress and Treasury/IRS.

Likely to have some impact on bipartisan tax reform
Is there any common ground on tax reform?

How Tax Reform Can Affect Your Company or Your Clients
Understand current tax situation – international businesses

Effective tax rate – U.S. and worldwide

Tax attributes – identify them, such as:
  ◦ Credit carryovers
  ◦ Undepreciated basis of assets
  ◦ Earnings abroad (unrepatriated)

Review operations
  ◦ Location of assets
  ◦ Branches, subsidiaries, PEs

Look beyond you and your company

Consider effects on
  ◦ Employees
  ◦ Contractors
  ◦ Customers
  ◦ Suppliers
  ◦ Shareholders/owners
  ◦ Choice of entity
  ◦ Fringe benefits
  ◦ State and local governments
How to evaluate proposals

Would the goals of reform effort be satisfied?
◦ Have the goals been identified?

Who pays?
◦ Distributional neutrality?
◦ Business versus individuals
◦ Variations among businesses

Ease of implementation
◦ Consider transition rules

Effect on behavior

Critique using principles of good tax policy.

Tax policy considerations

Can analyze proposals against principles of good tax policy
Tax system with broader base and lower rates more likely to meet principles of equity, simplicity, neutrality, efficiency, minimum tax gap and transparency.

Policy Approach to Analyzing Tax Systems
  • http://www.cob.sjsu.edu/facstaff/nellen_a/TaxReform/PolicyApproachToAnalyzingTaxSystems.pdf
Principles of Good Tax Policy


1. Equity and fairness
2. Certainty
3. Convenience of payment
4. Economy in collection
5. Simplicity
6. Neutrality
7. Economic growth and efficiency
8. Transparency and visibility
9. Minimum tax gap
10. Appropriate government revenues

Reference materials

OVERVIEW TO CAMP PROPOSAL
LINKS TO ADDITIONAL INFORMATION
Formally introduced as H.R. 1 in December 2014.

The Tax Reform Act of 2014

Per Camp, this will ...
- Make the system simpler and fairer!
- Create 1.8 million private sector jobs!
- Grow the economy!
- Put money in your pockets!
- Increase take-home pay!
- Close loopholes!
- Make the tax law more accountable!
- Lower double taxation!

Camp Releases Tax Reform Plan to Strengthen the Economy and Make the Tax Code Simpler, Fairer and Flatter

Plan Closes Loopholes to Lower Tax Rates for Families and Job Creators

Washington, Feb 26 | 0 comments:

Washington, DC - Today, Ways and Means Committee Chairman Dave Camp (R-MI) released draft legislation to fix America’s broken tax code by lowering tax rates while making the code simpler and fairer for families and job creators. Camp’s latest draft, the “Tax Reform Act of 2014,” spurs stronger economic growth, greater job creation and puts more money in the pockets of hardworking taxpayers.

Based on analysis by the independent, non-partisan Joint Committee on Taxation (JCT), without increasing the budget deficit, the Tax Reform Act of 2014:

- Creates up to 1.8 million new private sector jobs.
- Allows roughly 95 percent of filers to get the lowest possible tax rate by simply claiming the standard deduction (no more need to itemize and track receipts).
- Strengthens the economy and increases Gross Domestic Product (GDP) by up to $3.4 trillion (the equivalent of 20 percent of today’s economy).

Based on calculations using data provided by JCT, the average middle class family of four could have an extra $1,300 per year in its pocket from the combination of lower tax rates in the plan and higher wages due to a stronger economy.

Discussing the need to fix America’s broken tax code, Camp said, “It is no secret that Americans are struggling. Far too many families haven’t seen a pay raise in years. Many have lost hope and stopped looking for a job. And too many kids coming out of college are buried under a mountain of debt and have few prospects for a rewarding career. We’ve already lost a decade, and before we lose a generation...
Who pays? JCT distributional analysis of Camp’s proposal for 2015

(3) Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

More - individual

Consolidate education provisions
- Keep a reformed American Opportunity Tax Credit
- Repeal employer-provided educational assistance exclusion

Repeal most credits

EITC – modify to refund employment taxes
- HWM analysis – “Exempting a portion of wages from payroll tax would represent a tax cut, whereas the current EITC constitutes government spending.”

Charitable contributions
- Deduct if pay by April 15 of next year
- Only deduct amount > 2% AGI
- Donation = to adj basis (not FMV), with exceptions
And more - individual

Only deduct state and local taxes for carrying on a trade or business or producing income

No deduction for

- Personal casualty or theft losses
- Medical expenses
- Moving expenses
- Miscellaneous itemized deductions
- Alimony (and not taxable to recipient)

Individuals - homes

Mortgage interest deduction

- Gradually reduce to AI of $500,000
- Phase out home equity rule
- But not for existing debt
- No deduction for new equity loans

Gain exclusion on sale of principal residence

- Own and use 5 of 8 years
- Use once every 5 years
- Phase out exclusion if MAGI > $500,000 (MFJ)
Corporate and Individual AMT repealed

USE MINIMUM TAX CREDIT (MTC) OVER 3 YEARS

---

Selected business reforms

Top corporate rate dropped to flat 25%
- Phased in

Repeal MACRS
- Use system like ADS

§179 expensing
- $250,000 / $800,000 phase-out start
- Includes software and certain real property

NOL deduction limited to 90% TI

SE tax applies to income of p/s, LLC, S corp
- Generally, 70% taxed
R&D and acquired intangibles

Write off R&D over 5 years
  ◦ Includes software development costs
  ◦ Phased in

Research credit modified and made permanent
  ◦ Simplified credit at 15%
  ◦ No supplies
  ◦ No computer software development

Amortization of intangibles – increased to 20 years

More business reforms

Several special deductions repealed
  §199 deduction phased out
  Repeal like-kind exchange deferral (§1031)
  Repeal §1202 QSBS exclusion
  Repeal §1235 on sale of patents
  Most credits repealed
  Tax portion of carried interest as ordinary income
Change to cash method allowance

- Cash method only allowed
  - If avg annual GR of $10 million or less
  - Farming businesses
  - Sole proprietors

- Benefit to C corp with GR between $5 and $10 million
- Detriment to QPSC with GR over $10 million

More method changes

- Repeal MACRS
  - Use system like ADS
- Amortization of intangibles – increased to 20 years
- Write off R&D over 5 years
- Expand LT contract use of % completion
- Repeal LIFO
- Repeal LCM
- Advertising – deduct 50%, amortize balance over 10 years; phased in
  - For large businesses
Observation ...

Issues of “raising revenue” from timing changes

(DOESN’T RAISE REVENUE IN THE LONG RUN)

Additional Links

Professor Nellen Tax Reform links including to hearings:
www.cob.sjsu.edu/nellen_a/txrefupd.html

KPMG comparison of Camp and Administration’s tax proposals:

PwC 2015 Tax Policy Outlook: Opportunities and challenges ahead
This outline was written in the late 1990s as tax reform was an active topic in Congress in the mid-1990s. Given current talk by some politicians for a flat tax, the fair tax (national retail sales tax) or some other variation of a consumption tax, this outline, with only minor modification, is offered. It also indicates, that many of these tax reform topics are not new although the ways of doing business – more global and digital, have changed since the mid-1990s.

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**Consumption Tax Basics**

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

   Consumption tax formula—
   
   \[
   \text{Income} = \text{Consumption} + \text{Savings}
   \]
   
   Thus, \[
   \text{Consumption} = \text{Income} - \text{Savings}
   \]

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

   1) If income is taxed, that means that both consumption and savings are taxed. However, the U.S. tax system does not tax all income. Some types of income, such as most types of fringe benefits are excluded from income, and various deductions, such as for home mortgage interest, limited medical expenses, and charitable contributions are allowed. In addition, the U.S. income tax system has various provisions to encourage savings, such as reduced taxation of capital gain income, exclusion of up to $250,000 gain from sale of a principal residence ($500,000 if married), and personal retirement savings deductions.

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1 For a more detailed discussion comparing the base of the consumption and income taxes, see Congressional Budget Office (CBO), *Comparing Income and Consumption Tax Bases*, July 1997.
2) Ignoring possible deductions and exclusions, a tax base consisting of consumption is smaller than a tax base consisting of income. Thus, for a U.S. consumption tax to raise as much revenue as the current income tax, it would appear that the consumption tax rate would have to be higher than the current income tax rates.

3) If consumption is taxed, it can either be done indirectly (from the payer's perspective), such as with a sales tax, or directly (by taxing Income less Savings). There are two ways to measure consumption as Income less Savings: a) all income less savings ("cash-flow approach"), or b) earned income only ("tax prepayment approach"). Following are some simple examples using a 20% tax rate to illustrate the equality of the cash flow and tax prepayment approaches to taxing consumption.2

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

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

Taxing consumption when it occurs: Instead of computing consumption as Income less Savings, a consumption tax can also be collected by applying the tax to every purchase of goods and services made by the final consumers - a sales tax. This is equivalent to taxing businesses on sales to nonbusinesses.3 And, under a sales tax, it is businesses that complete the tax forms - not the consumers who are the ultimate taxpayers. Thus, it is considered an indirect tax. Currently in the U.S., most state sales tax systems also tax consumption by businesses. Thus, unlike a VAT, sales tax in the U.S. is a cascading tax. Some states have partially alleviated this by exempting manufacturing and R&D equipment from the sales tax. However, the intent behind such exemptions typically is not to alleviate the cascading effect, but to provide an incentive for businesses to locate in that particular state. Also, in the U.S., no state taxes all forms of consumption. Typically, consumption of food, services, intangibles, and real estate are exempt.

Indications that a tax is a consumption tax — An indication that a tax is a consumption tax is that it exempts savings, and for businesses, it allows investment in capital (such as land, building, and equipment) to be deducted when acquired, rather than depreciated over a period of years. Such expensing removes the expected future income from that investment from taxation (under an assumption that the cost of the asset reflects the net present value of its expected future income).

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

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2 From example at JCS-18-95, supra, pages 52 - 54.
3 This is also the approach of a value-added tax. Thus, it is also the approach of the Armey flat tax.
consumption taxes. Thus, the perceived benefit of a consumption tax relative to an income tax is that it will increase savings and investment.

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

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

a. Credit invoice VAT—This type of VAT is computed by charging VAT on all taxable purchases by businesses and consumers. A company's recordkeeping is fairly straightforward because it must just institute a procedure whereby it keeps track of sales invoices showing VAT collected and purchase invoices from other businesses showing VAT paid. At the end of the reporting period, a company merely totals each set of invoices and submits to the government, the excess of VAT collected over VAT paid. Or, if VAT paid exceeds VAT collected, the company would request a refund of the difference from the government. From the government's perspective, the audit trail is also straightforward because it consists of two types of records: sales invoices and purchase invoices. Under credit invoice systems, sellers are generally required to state the VAT charged on the face of the invoice.

b. Subtraction method VAT—Instead of tracking VAT paid and collected on a sale-by-sale and purchase-by-purchase basis, all sales are aggregated and reduced by the aggregate of taxable purchases for the period. The result is the amount of value added by the business on which is pays VAT. A subtraction VAT form looks very much like an income tax return except that no wage deduction is allowed (wages are value added). Also, interest income and expense are not reported and most taxes are not deducted.

c. Addition method VAT—This VAT adds up the value added by a business, such as wages paid and certain taxes paid, plus owner profit and multiples this by the VAT rate. It is the reverse of the subtraction method VAT in that instead of taxable sales less taxable purchases equals VAT base, the elements of the VAT base are added together.

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

Commonly cited benefits of a VAT over an RST include:

- An improved chance of collection because the VAT is collected at each stage of production and distribution, rather than just at the final sale to the retail consumer. Also, under a credit invoice VAT, each purchaser is likely to demand an invoice from a seller in order to claim a credit for

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

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

6 Consumption taxes are typically viewed as regressive meaning that they represent a larger percentage of a lower income taxpayer's income relative to a higher income taxpayer.
the VAT paid. This mechanism can be a self-regulating feature of a credit invoice VAT that is not present with an RST.

• Elimination of the cascading effect of an RST caused by businesses paying the RST on items, such as manufacturing equipment, that are not held for resale. Tax authorities and businesses would no longer need to deal with sales tax exemptions that only apply to specific types of items.

• Elimination of the seller's burden to determine and document whether a buyer is exempt from sales tax. Under a VAT, unless the item transferred is zero-rated or the seller is exempt, VAT is charged on the sale of the good or service; it is up to the buyer to obtain a credit if they are entitled to one. Thus, a VAT can be an easier system for removing the tax on producer goods.

• The above advantages of a VAT may make it a better vehicle than the RST for taxing services.

4. Advantages of the credit invoice VAT over a subtraction VAT

• It is easier to use multiple rates and exemptions.

• It is known to be GATT compatible (not clear for a subtraction VAT).8

• It is not a hidden tax, particularly if the tax is separately stated on invoices provided to the final consumer.

• It provides for separate recordkeeping and an audit trail of sales and purchases invoices all showing the VAT collected or paid.

• It is a simpler mechanism for implementing a destination principle because it is easier to identify export transactions (invoices) and to rebate the tax on them.9

• Many examples exist of this tax in practice.

• Because it is more widely used today than the subtraction VAT, arguably, it would be the more appropriate VAT to adopt when considering what is appropriate for businesses operating in a global economy.

• The tax can more easily be collected closer in time to the transaction.

• For people most familiar with an income tax, the credit invoice method may be easier to understand than the subtraction method because they are less likely to raise the objections that typical income tax deductions, such as wages and interest expense, are eliminated.10

5. Advantages of a subtraction VAT over a credit invoice VAT

• It uses records already maintained for income tax and financial reporting purposes.

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

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


10 Because the subtraction VAT calculation looks so much like the taxable income formula, except that certain deductions are missing, commentators tend to focus on the subtraction VAT as unfavorable because it taxes labor and interest expense. However, this is the purpose of a VAT - to tax value-added, such as wages and interest expense and owner profit. Such criticisms are rarely heard with respect to the credit invoice method because the form of the calculation looks more like a non-cascading sales tax rather than an income tax.
• It would be more compatible with existing income tax recordkeeping, forms and filing procedures.
• It is less likely to cause direct interference with a state's RST because of how this VAT is calculated and assessed.
• It would enable states to increase the RST collected because purchases would likely include the subtraction VAT (while this is also possible with the credit invoice VAT, it is more obvious and may be difficult for the states to implement)\(^\text{11}\) (would likely be viewed as a disadvantage of this VAT by taxpayers).
• It likely involves lower compliance and administrative costs because there is no need for collection of VAT that will ultimately be refunded, as under the credit invoice VAT.
• It is typically viewed as less susceptible to the addition of special rates and exemptions.\(^\text{12}\)

6. Not all consumption taxes operate in the same manner

The following chart shows how various factors affect a business's tax liability under both the Armey flat tax and the USA tax (these two consumption tax proposals are explained in the next section). Notice the differences.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Increases (+) or decreases (-) tax liability under:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Armey</td>
</tr>
<tr>
<td>Wages</td>
<td>-</td>
</tr>
<tr>
<td>Fringe benefits</td>
<td>+</td>
</tr>
<tr>
<td>Pension plan</td>
<td>-</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>+</td>
</tr>
<tr>
<td>Non-cash compensation</td>
<td>+</td>
</tr>
<tr>
<td>Independent contractor costs</td>
<td>-</td>
</tr>
<tr>
<td>Interest expense</td>
<td>+</td>
</tr>
<tr>
<td>State income taxes and property taxes</td>
<td>+</td>
</tr>
<tr>
<td>Imports</td>
<td>-</td>
</tr>
<tr>
<td>Exports</td>
<td>+</td>
</tr>
<tr>
<td>Foreign income and expenses</td>
<td>*</td>
</tr>
<tr>
<td>Inventory at transition date</td>
<td>**</td>
</tr>
<tr>
<td>Undepreciated property at transition date</td>
<td>**</td>
</tr>
<tr>
<td>Sale of assets</td>
<td>+</td>
</tr>
<tr>
<td>Purchase of business assets and inventory</td>
<td>-</td>
</tr>
</tbody>
</table>

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

** The Armey flat tax (H.R. 1040) provides no transitional rules. Unless such rules are added, ending inventory and the adjusted bases of fixed assets at the transition date from the income tax to the Armey flat tax would

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\(^\text{11}\) Alan Schenk, Choosing the Form of a Federal Value-Added Tax: Implications For State and Local Retail Sales Taxes, 22 Cap. Univ. Law Rev. 291 (1993) at 311-12. Professor Schenk notes that it may be "politically difficult" to impose the RST on VAT-inclusive prices under a credit invoice VAT.

\(^\text{12}\) A subtraction VAT is capable, though, of allowing for exempt businesses. In fact, the business activities tax (BAT), a subtraction VAT introduced by Senators Boren and Danforth in 1994, specifically exempts small businesses (those with $100,000 or less of gross receipts). S. 2160, 103d Cong., 2d Sess.
disappear. Similarly, when a business sells inventory or a fixed asset with basis from the income tax system, it is not clear whether they will be allowed to reduce the gross receipts from the sale by the basis in the asset. Under the USA tax proposal, ending inventory and asset bases leftover from the income tax system is to be expensed over 3 to 40 years.

**Flat Tax Proposals**

1. **Hall-Rabushka Flat Tax**

Most of the flat tax proposals are based on the proposal of Robert E. Hall and Alvin Rabushka of the Hoover Institute at Stanford University in Palo Alto. Their proposal and rationale is explained in the 2nd edition of their book, *The Flat Tax*. They propose a two-part tax system—one on businesses and one on individuals, both at a 19% rate. All income would be taxed at the source. For example, businesses would pay tax on their income, but when that income is paid to the owners, a second tax is not owed. The two-part system allows for some progressivity through a wage deduction for businesses that then requires wage income to be reported by individuals, thus allowing for an exemption. However, fringe benefits are not deductible by businesses. To prevent distortions among employees, governments and non-profit organizations would report fringe benefits (apparently including the employer's share of FICA) paid to employees as income [page 120].

Selected points made by Hall and Rabushka in *The Flat Tax*:

- Rationale for not taxing capital gains—"Capital gains are taxed under the flat tax." Proceeds from the sale of business property are included in business taxable income. Gains from sales of stocks are created from "capitalization of after-tax income." Such gains derive from growth in business earnings which are fully taxed. "Another tax on the appreciation of shares would amount to a second tax on a single stream of income." Gains from the sale of owner-occupied housing "arise from capitalization of rental values, which are heavily taxed by state and local governments." Such gains also represent the effects of inflation. [pages 117 - 118]

- Apparently, net operating losses (NOLs) could be acquired by another business. [page 118]

- The flat tax would encourage foreign investment and raise the value of the U.S. dollar in foreign exchange markets. [page 121]

- They project that the flat tax would promote growth in the economy that by the year 2002 would increase each citizen's income by about $1,900, in 1995 dollars. [page 89]

- They suggest a possible transition rule for existing home mortgages to allow 90% of related interest expense to continue to be deductible (and related interest income would be taxable to the lender). [page 99]

2. **Armey Flat Tax (H.R. 1040 - The Freedom and Fairness Restoration Act (106th Cong. 1999))**

   a. History—In June 1994, Congressman Armey first introduced legislation providing for replacement of the current federal income tax system with a 17% flat tax (20% for the first two years); H.R. 4584 (103d Cong. 1994). In July 1995, H.R. 2060 was introduced which is a modified version of the earlier legislation. Congressman Armey introduced H.R. 1040 in 1997 and 1999. The 1999 flat tax proposal is summarized below.

   b. Individual tax system

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13 Information obtained from H.R. 1040 (106th Congress) and Congressman Armey's flat tax Web page at http://flattax.house.gov/.
- Taxable income includes wages, salary and pension income earned for services performed in the U.S., unemployment compensation, and taxable income of each dependent child under age 14 (such child would have no filing obligation).
- Investment income and social security benefits are not taxable.
- Income is reduced by a standard deduction based on filing status and an additional standard deduction of $5,200 for each dependent; both deductions would be indexed for inflation.
- Unlike current law, no additional deduction is provided for the elderly and the blind.
- All tax credits, including the earned income tax credit, childcare credit, and child credit are eliminated.
- The alternative minimum tax (AMT) would be repealed.
- 17% tax rate (19% for the first two years).
- Estate and gift taxes would be repealed (because income is to be taxed only once).

c. Business tax system
- All forms of businesses would be taxed in the same manner.
- Taxable income = gross active income less deductions for cash wages for services performed in the U.S., retirement plan contributions, amounts paid for property sold or used in the business, amounts paid for non-employee services, and excise, sales, customs taxes imposed on deductible purchases.
- "Gross active income" = gross receipts from the sale or exchange of property or services in the U.S. + gross receipts from the export of property or services from the U.S. Thus, the Armey flat tax is an origin-based tax (goods and services are taxed where the value is produced).
- While the legislation is not specific on this point, because the flat tax is intended to be a territorial system, allowable deductions should include only business inputs purchased in the U.S. or imported into the U.S. This is consistent with the Hall & Rabushka approach (The Flat Tax, page 76). They provide an example where a U.S. company sends parts to Mexico for assembly and brings the completed product back to the U.S. for sale. Under this example, the value of the goods is part of gross receipts upon export to Mexico and the value of the import is deductible when returned to the U.S. for sale. Costs incurred in Mexico would not be deductible.
- Investment income is not taxable.
- No deductions are allowed for fringe benefits, interest expense, state and local taxes or payments made to owners.
- Sales proceeds of previously expensed assets would be included in gross active income.
- 17% tax (19% for the first two years).
- All tax credits, such as the research tax credit, are eliminated.
- The alternative minimum tax (AMT) would be repealed.
- A business with a loss would convert it into the equivalent of a credit to be used in future tax years. The excess loss is increased by an interest factor before being converted to a tax credit.
- Changes and simplifications would be made to qualified retirement plan rules.

d. Other changes
- Tax-exempt entities, such as governments, would be subject to tax at 17% (19% for the first two years) on the excludable compensation (such as fringe benefits and compensation paid outside of the U.S.) paid to employees.
- A 60% supermajority of Congress would be necessary to increase any federal income tax rate, create any additional income tax rate, reduce the standard deduction, or provide any exclusion, deduction or credit that results in reduced federal revenues.
e. Benefits as seen by Congressman Armey
   - simplifies the tax law
   - restores fairness by "treating everyone the same" (same tax rate applies to every taxpayer)
   - eliminates abuse by lobbyists
   - eliminates the current double taxation of savings
   - promotes investment and job creation
   - eliminates the marriage penalty
   - reduces compliance costs
   - increase the standard of living for citizens by: 14
     1) reducing compliance costs such as by eliminating the need for Form 1099s (for reporting interest and other types of income);
     2) allowing for more efficient use of resources by eliminating preferences;
     3) ending the bias in the current system against savings and investment by freeing up more funds for investment;
     4) encouraging work by lowering the marginal tax rates; and
     5) cutting taxes and federal spending which will "raise the level of economic growth."

f. Analysis
   i. Apparent goal(s):
      - Simplification (reduced recordkeeping for most individuals, should eliminate the need to issue most Forms 1099 because investment income would not be taxable).
      - Encourage savings.
      - Integration of the corporate and individual tax systems—business income would only be taxed once.
      - "Fairness".
   ii. Name accuracy:
      - The Armey flat tax is a type of subtraction VAT except for the business deduction for wages which are instead taxed to employees (less an exemption). However, Congressman Armey refers to it as an income tax and the tax form looks like an income tax form.
   iii. Missing information - examples:
      - Transitional rules. For example, will businesses be allowed any deduction under the flat tax for the amount of ending inventory they have at the transition date from the income tax to the flat tax? Similarly, will businesses be allowed a deduction for the undepreciated basis of assets, including land? What happens to loss and credit carryovers at the transition date? What about unrealized gains and losses that exist in investment assets of individuals? If transitional rules are added, what will be the impact on the tax rate?
      - Definition of business income (versus hobby or investment income).
      - Accounting method and period rules.
      - Gross active income for businesses is defined as that coming from the sale or exchange of property and services. What about income from the use of property, such as rents and royalties—is this income also included in the business tax base?
      - Rules on treatment and sourcing of royalties and rents (assuming they are taxable).

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14 From Congressman Armey's testimony before House Ways & Means Committee, March 27, 1996, 96 TNT 63-68 (March 29, 1996), Doc. 96-9502.
- What happens if a previously expensed business asset is converted to personal use—will the prior deduction have to be recaptured? Is the conversion to be treated as a disposition of the asset?
- Whether current deduction limitations, such as the current 50% limitation on meals and entertainment, would remain.
- How an owner's basis in partnership and corporate entities is to be tracked. What happens to an owner's loss and credit carryovers related to passthrough entities at the transition date?
- Whether deferral rules, such as the like-kind exchange rules, are intended to remain.

iv. Problem areas - examples:
- Rules will still be needed to distinguish between investment and business property, between businesses and hobbies, etc. For example, assume that an individual (not an art dealer) buys a painting in 2001 for $500 and sells it three years later for $5,000. Is the $4,500 gain considered non-taxable investment income, or taxable business income? If it is considered business income, could an individual combine it with another business activity it has? If not, how will separate businesses be distinguished?
- Rules will be needed to distinguish between deductible business expenses and non-deductible fringe benefits. For example, if an employer pays for a worker's tools of the trade, is that a non-deductible fringe benefit, or a deductible business expense?
- Rules on tax accounting methods, entity formation, liquidations, reorganizations, property exchanges, transfer pricing, pension plans, and compliance rules (such as due dates for filing and paying taxes) would still be needed.
- If interest income is excluded and interest expense is not deductible, rules on imputed interest would still be needed to be sure, for example, that the cost of fixed assets does not include an interest expense element.
- While estate and gift taxes would be eliminated, there is no mention of basis rules when property is transferred by gift or death. Under current law, the recipient of a gift generally takes the same basis in the gift as the donor had. A beneficiary receiving property from inheritance generally takes a basis equal to the fair market value of the property at the decedent's date of death. It would appear that under the flat tax, a beneficiary would have to use the decedent's basis in the property as his basis in order to prevent potentially tremendous windfalls under the tax system. For example, under the flat tax, a sole proprietor would have $0 basis in land acquired for use in her business (because the entire cost would have been expensed in the year of acquisition). If she were to sell the land, the entire sales proceeds would be included in taxable income. If she were to die owning the land, under current law, the beneficiary would take the land with a basis equal to fair market value (also, under current law, the decedent's basis would be cost because no deductions are allowed for land). However, under the flat tax, it makes more sense to write the rule such that the beneficiary takes the land with a $0 basis. This is an important area for estate planning purposes and needs to be addressed so that taxpayers can intelligently evaluate this proposal.
- Some commentators, such as the Treasury Department, state that the rate is too low to maintain revenue neutrality. Treasury has suggested that to prevent a $138.3 billion reduction in tax revenues per year, the tax rate would either have to be 20.8% or the exemption amount would have to be reduced by over 50% (or some combination of these two techniques). This analysis assumes that no transition rules for existing business assets would be included in the tax plan.
- Redistribution of the tax burden: The Treasury Department study concluded that at a 20.8% rate, the Armey proposal would reduce taxes for families with $200,000 or more of income by 28.1%, while increasing federal taxes for families with income under $200,000 by between 5% and 70.7%. At income levels currently entitled to the earned income tax credit,
the large tax increase found by Treasury under the Armey flat tax is primarily due to the repeal of the EITC under the Armey proposal. The calculations of the tax impact to individuals include taxes paid by businesses, but borne by individuals. For example, because FICA taxes and fringe benefits would no longer be deductable by businesses, they in effect, would be taxed at the flat tax rate. The Treasury analysis assumes that these taxes should be considered directly borne by individuals in their analysis. The analysis also includes a portion of business income (as investment income) in the calculations for higher income individuals ($100,000 or more of wage income), even though paid directly by the business.\textsuperscript{15}

v. Potential abuses that could arise—examples:

- A self-employed person or a landlord could pay themselves a salary to maximize use of their personal exemption (this point is made in Hall-Rabushka, \textit{The Flat Tax}, pages 116-117). What about reasonable compensation (although with identical individual and business rates, this is only a problem if "reasonable compensation" would be less than the exemption amount and the individual pays themselves more)? What about parents paying salaries to their children age 14 and over to reduce their business income and maximize use of personal exemptions?

vi. Regressivity observations:

- Taxing of earned income and deduction to payors enables the system to have a mechanism to remove the tax burden from low-income individuals; such a mechanism becomes much more burdensome with a value-added tax or a national sales tax. However, for many low-income taxpayers, the exemption alone is not the equivalent of today's benefit from the earned income tax credit which is a refundable credit designed to offset the impact of non-income taxes on the poor (such as Social Security and excise taxes). In addition, removal of the business deduction for fringe benefits may result in elimination of such employer-provided benefits which would have the greatest impact on low-income workers.

- The large personal exemption (relative to the current tax system) adds some progressivity to the system.

vii. Miscellaneous matters:

- Distributional impact of the proposal—wage earners would directly pay more than those who earn income from savings would. However, Armey points out that investment income is still taxed by taxing businesses on their income, rather than the interest and dividends paid out.\textsuperscript{16} Does this same theory apply to gains realized from sale of stock or collectibles?

- Not allowing a deduction for fringe benefits in effect taxes them; Hall-Rabushka note that not allowing a deduction should encourage businesses to convert fringes to deductible wages and enable workers to buy their own benefits. This would also shift the tax on fringes from the business to the worker, and make the payment subject to Social Security and Medicare taxes. Also, assuming higher level employees (for example upper management) have more control over salary negotiations, they may be likely to get more benefits converted to wages than lower level employees. Also, what is the potential impact on the health care reform debate? If employees eliminate health insurance deductions, will all employees get their own coverage or will the government have to provide a mechanism to subsidize or otherwise encourage purchase of individual health coverage?

- Hall and Rabushka refer to the \textit{value} of an exported product being included in revenue, completed in a foreign country, and the \textit{value} of it treated as a deductible business input when

\textsuperscript{15} The Dec. 20. 1995 Treasury Dept. report can be obtained from the Treasury Dept. or at 70 Tax Notes 451 (January 22, 1996).

\textsuperscript{16} Denying a deduction to businesses for interest expense, in effect, taxes this to the business.
imported back into the U.S. for sale (page 76). What kind of valuation issues might this entail? U.S. transfer pricing issues would not be eliminated under the flat tax.

- The Armey flat tax is not border adjustable per GATT because it is not an indirect tax. Congressman Armey is aware of this, but believes it poses no problem because a border adjustable tax is not an effective tool in reducing the trade deficit. Instead, he says that improving the U.S. savings rate will reduce the need for foreign cash and the trade deficit will drop because we will invest more in the U.S. Is this true?

- Subjecting employees to tax on their wages and taxing governments and tax-exempt organizations on noncash compensation provided to employees broadens the tax base than might otherwise be possible with some forms of VAT. For example, if a VAT instead exempted governments and tax-exempt organizations, no tax would be paid on the value they add in the form of wages.

- Impact of removal of child care credit? (Hall and Rabushka note that the flat tax will generate sufficient revenues to provide for generous welfare programs for childcare, The Flat Tax, pages 114-115).

- While sponsors point to a poll indicating that individuals are not bothered by elimination of the home mortgage deduction, shouldn't the possible impact on home prices and the building industry also be part of that analysis? As well as the potential adverse impact to state and local governments if property values declined (thus eroding their property tax base).

- Is postcard size tax return sufficient? Where do lines go for the presidential election campaign contribution, dependent social security numbers, penalty of perjury statement, and taxpayer and preparer signatures?

- Why is there such an emphasis on a postcard size tax return rather than on further improving the system by having the returns of wage earners completed by the IRS through the use of improved technology?

- A single rate for both individuals and businesses will remove any incentive to try to shift income between entities to try to get a lower tax rate or to convert dividends into other types of payments, such as deductible wages. However, some shifting will still be desirable in order to maximize a family's use of personal exemptions.

  Example: Sam is the 100% shareholder of ABC Corporation (a regular C corporation). Under current law, Sam might be inclined to prevent ABC from ever declaring a dividend and instead, paying a higher salary to Sam in order to maximize ABC's tax deductions. Under the Armey flat tax, Sam might be inclined to have ABC declare a high dividend and pay Sam a lower wage payment because the dividend would not be taxable to Sam. However, the dividend is also not deductible to ABC and the tax not paid by Sam on wages (because they were converted into a non-taxable dividend) would instead be paid by ABC. Because both Sam and ABC are subject to a 17% tax rate, the total tax paid between these two taxpayers would be the same. However, the situation would change if Sam also wants to pay salary to family members to maximize the personal exemption.

viii. Potential adverse impact on state and local governments:

- Examples include (the following are not unique to the Armey flat tax, but also exist under other proposals as well):

  a. New costs for state and local governments. Under the Armey flat tax, governments (and tax-exempt entities) would be subject to tax at 17% (19% for the first two years) on fringe benefits provided to employees. A report by the California Franchise Tax
Board concluded that the annual cost of this tax could be about $375 million for the State of California and about $2.2 billion for local governments in California.\textsuperscript{17} 

b. \textit{Government bond market.} The National League of Cities (NLC) estimates that the removal of the exemption for interest on municipal bonds could cause an increase in capital improvement and borrowing costs of up to 30\%.\textsuperscript{18} The California Franchise Tax Board estimates that if the interest rate on municipal bonds increased by one-half of a percentage point due to removal of the federal exclusion for interest income on municipal bonds, the increased first-year debt service cost to California state and local governments would be about $100 million.\textsuperscript{19} 

ix. Transition considerations:

- A system which continues a wage deduction for businesses may ease the potential adverse transitional impact of switching from an income tax to a consumption tax relative to other proposals that remove a deduction for wages. For example, the Armey flat tax is less likely to lead to a one-time increase in price levels that would likely occur under a national sales tax or pure VAT.\textsuperscript{20} 

- Lack of transitional relief for existing loss and credit carryovers and asset bases will be costly to many businesses and have a varying impact among businesses. Also, taxpayers and assets are not treated similarly in the transition. For example, it appears that pre-flat tax unrealized investment gains and losses will permanently escape tax. For example, if an individual holds stock with an inherent gain of $1,000,000 at the transition date, it will escape tax if it is not sold until the flat tax has replaced the income tax. On the other hand, businesses are penalized for holding assets at the transition date to the extent they receive no tax benefit for the adjusted basis of such business assets at the transition date.

"Tax reform is not for the timid."  
\textit{Congressman Armey} 

3. Other flat tax proposals

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

Other Forms of Consumption Tax

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

\textsuperscript{17} California Franchise Tax Board - Economics and Statistical Research Bureau, \textit{The Impact of the Flat Tax on California}, December 1995, pages 63-64; based on an assumed 22.9\% tax rate.  

\textsuperscript{18} NLC, \textit{Nation's Cities Weekly}, January 22, 1996.  

\textsuperscript{19} FTB Report, \textit{supra}, page 63.  

\textsuperscript{20} For a further discussion of possible changes in prices under tax reform proposals, see CBO, \textit{Comparing Income and Consumption Tax Bases}, July 1997, page 35.

a. Overview

- Senators Nunn, Domenici and Kerrey introduced this proposal in April 1995. Senator Nunn has since retired from Congress. This proposal received a lot of attention because it was the first to provide complete legislation. While the sponsors have not reintroduced this legislation, Congressman English has introduced H.R. 134 (106th Congress) which is a simplified USA tax. Because so much attention has been given to the original USA tax proposal in the tax reform debate, it is described here, followed by a summary of how the English bill modified it.
- A consumption-based tax that would exclude savings and investments from tax.
- USA = Unlimited Savings Allowance - individuals get a deduction for savings.

b. Individual tax system

- Formula:

  Gross Income (all income from whatever source derived including compensation for services, fringe benefits, distributions from business entities, interest, rents, royalties, alimony, child support, pensions, includible social security benefits, income from discharge of debt, and gains from sale of assets; other than savings assets; exclusions exist including, tax-exempt bond interest, some social security benefits, amounts received under accident or health benefit plans, gifts, inheritances)

  plus Deferred income (income attributable to withdrawals of previously saved/deferred gross income; referred to as net includible withdrawal income)

  less Alimony and child support deductions

  less Unlimited Savings Allowance (see explanation below)

  Adjusted gross income

  less Personal and Dependency deduction of $2,550 each

  less Family Living Allowance (for example, $7,400 for married filing joint)

  less Homeowner deduction (on up to $1,000,000 of acquisition indebtedness, no home equity interest deduction allowed)

  less Education deduction (up to $2,000/person for taxpayer, spouse and two dependents; limited to $8,000 deduction per tax year, generally for higher education tuition and fees)

  less Philanthropic transfer deduction (rules similar to current law)

  less Transition basis deduction (optional deduction for taxpayers with aggregate basis in qualified savings assets at 1/1/96 of $50,000 or less; purpose is to prevent later taxation of pre-USA tax system savings when they are later withdrawn and not reinvested; individuals with over $50,000 of qualified savings assets at 1/1/96 will have to follow special rules on tracking basis to avoid later taxation on this pre-USA tax system savings)

  Taxable Income

- A graduated tax structure for individuals with the lowest rate at 8% and the highest at 40% (when fully-phased in after four years); the 40% rate begins at $24,000 of taxable income for married taxpayers filing jointly and at $14,400 for single taxpayers.

21 Because the 1/1/96 effective date for the USA tax is extremely unlikely, the effective date is also referred to as the transition date in the above discussion, although the bill language says 1/1/96.
- Individuals get a refundable tax credit for the FICA/HI withheld from their wages, limited to the FICA wage base (thus, if individual's wages exceed the FICA wage base (for example, $61,200 for 1995), Medicare taxes paid beyond that wage base are not creditable). For self-employed individuals, refundable payroll tax credit equals one-half of the basic SECA tax payable for the tax year.

- The refundable earned income tax credit would continue with modifications.

- Individuals also entitled to foreign tax credit (similar to current law) with respect to foreign taxes paid on amounts included in individual's gross income.

- Kiddie tax remains under which the unearned income of children under age 14 is taxed at the parent's marginal tax rate.

- Unlimited Savings Allowance for Individuals:

  i. Similar in concept to Individual Retirement Accounts (IRAs) under current law. [An IRA is a retirement plan that individuals may establish on their own (rather than through an employer). Low-income taxpayers and those without an employer-provided retirement plan may contribute up to $2,000 annually to their IRA and deduct the contribution from their taxable income. Distributions are taxable when withdrawn at retirement age.]

  ii. "Reflects the amount of current-year gross income that is deferred because it has been placed in the national pool of savings. The Unlimited Savings Allowance is intended to reflect the amount of net new savings other than new savings attributable to borrowing or to tax-exempt interest." (proposed §50(a)).

  iii. Definitions and calculations:

  USA =

  \[ Net \text{ savings in the tax year (excess, if any, of addition to savings in the tax year over taxable withdrawals from savings in the tax year) less Net non-exempt borrowing in the tax year (home mortgage debt and car loans are examples of exempt indebtedness) less Interest received on tax-exempt bonds less Basis of savings withdrawn in the tax year } \]

  Addition to savings - acquisition of savings assets + net additions to savings, money market, checking, credit union, brokerage and other similar accounts during the tax year + payments of premiums on life insurance policies + contributions to retirement accounts.

  Savings assets - stocks, bonds, securities, CDs, investment in partnerships and proprietorships, shares of mutual funds, life insurance policies, annuities, and other similar savings or investment assets. Does NOT include investment in land, cash on hand, collectibles (such as art or coins), investment in any business entity if its purpose is to hold collectibles for appreciation.

  Taxable withdrawals - portion of a withdrawal in excess of the basis of the savings withdrawn; special rules apply to losses (§78).

  Withdrawal - sale, exchange or other disposition of a savings asset + net amount withdrawn from each savings, money market, etc. account during the tax year + amounts paid to the taxpayer under life insurance or annuity policies + amounts withdrawn from retirement accounts and amounts paid pursuant to defined contribution plans.
Basis of savings withdrawn - per proposed §54(c): "The basis of savings withdrawn shall take into account any basis that the taxpayer may have in an asset or account by reason of its acquisition prior to January 1, 1996, or its acquisition by gift or inheritance. Under regulations prescribed by the Secretary, rules similar to the rules under section 72 of the Internal Revenue code of 1986 shall apply for purposes of determining the basis of assets withdrawn in the case of payments under annuities, retirement plans, life insurance contracts, and any other arrangements for which the taxpayer acquired rights in part by payment of amounts that were included in income and not deducted when paid."

Net includible withdrawal income (deferred income includible in taxable income (see earlier formula for taxable income)) - the excess, if any, of the net withdrawal in the tax year over the balance in the taxpayer's general basis account.

Net withdrawal - the excess, if any, of taxable withdrawals from savings in the tax year over additions to savings in the tax year. (Opposite of net savings.)

General basis account - allows a taxpayer to track pre-USA savings and amounts for which no savings deduction was allowed because the savings were treated as made with either borrowed funds, tax-exempt income or from withdrawals of previously taxed savings. Generally, this account starts with a $0 balance which is then increased by the lesser of the taxpayer's net savings or nontaxable sources of funds (when a taxpayer has net savings during the tax year). If instead, the taxpayer has net withdrawals for the tax year, the account is decreased as of the end of the tax year, but not below $0, by the amount of the net withdrawals. If a savings asset is sold at a loss, the loss increases the account. Special rules are provided for sale of a principal residence and a special election exists for bank account balances.

Special rules and definitions exist for bank accounts (checking, savings, money market) and brokerage accounts (proposed §56(a)):

Withdrawal = excess, if any, of taxpayer withdrawals from the account over taxpayer deposits to the account for the tax year.

Additions to savings = excess, if any, of taxpayer deposits to the account over taxpayer withdrawals from the account for the tax year.

Earnings on the account that are credited to the account are not included in gross income or additions to savings, unless they are withdrawn.

Basis in the account - initial basis = basis at 1/1/96 (unless amortized under the transition basis deduction rule during the transition years, then basis = $0). Basis in the account is increased by the amount of tax-exempt bond interest credited to the account and the basis in any savings assets transferred to a brokerage account. Account basis is reduced by the amount by which the withdrawal for the year (see above) exceeds the taxable withdrawal for the year.

Taxable withdrawals - "the basis in an account shall be allocated to the last withdrawals from a bank account or brokerage account. Accordingly, if a taxpayer has a withdrawal ... from a bank account or a brokerage account in a taxable year, the amount of such withdrawal that constitutes a taxable withdrawal equals the excess of (A) the amount of the withdrawal, over (B) the amount by which the basis of the account exceeds the value of the account as of the end of [the] taxable year."

Value of a bank account = cash held in the account as of the last day of the tax year.

Value of brokerage account = cash + cost of other savings assets held in the account.
Special rules exist for basis in business entities, such as partnerships.

USA Example: In this simple example dealing with a bank savings account, assume that this is the only investment Mr. T had at the effective date (assume 1/1/96). Income earned on the account is ignored for simplicity.

1/1/96 balance in bank account $120,000 (saved prior to effective date of USA system)

12/31/96 balance $140,000

Result: T has a $20,000 USA deduction for 1996.

12/31/97 balance $105,000

Query: Does the entire $35,000 withdrawal represent pre-USA savings thus making the entire withdrawal not taxable? Or, does the withdrawal represent withdrawal of the 1996 savings that were previously deducted and are now taxable when withdrawn + the withdrawal of $15,000 of pre-USA savings which would not be included in deferred income?

While the language of the USA and deferred income provisions are somewhat confusing, the definition of "taxable withdrawal" under the special rules for bank accounts, appears to indicate that in 1997, deferred income = $20,000, representing the previously deducted savings that were later withdrawn ($35,000 withdrawal over the $15,000 excess of the $120,000 account basis over the $105,000 account value at year end). The balance of the 1997 withdrawal ($15,000) would not be included in deferred income because it represents pre-USA savings. T's basis in his bank account at the end of 1997 would be $105,000 ($120,000 initial basis - $15,000 excess of withdrawal ($35,000) over the taxable withdrawal ($20,000)).

c. Business tax system

- A flat tax rate for businesses (regardless of form of operations) of 11% on its annual "gross profit" + 11% import tax on the customs value of goods and services brought into the U.S. for consumption, use or warehousing; import tax is due and payable at the time of the import.

- Gross profit tax base = amount received from sales of goods and services - amount paid to other businesses for goods and services. Interest income and other financial receipts are excluded from the tax base, but so are interest expense deductions. Wages paid to employees are not deductible. Plant and equipment would not be depreciated, but would be deducted in full in year acquired, as would inventory items.

- Generally, the accrual method of accounting is to be used. Businesses currently using the cash method could likely continue; the IRS is to provide regulations on methods to be used by new businesses. Long-term contract accounting rules are provided.

- 15-year carryforward provided for business losses.

- New businesses are to use a calendar year or a 52-53 week year ending in December unless they can show a business purpose for a different tax year.

- Consolidated return rules exist.

- Special rules provided for insurance and financial products, financial institutions and tax-exempt organizations. "Financial intermediation businesses" are to include financial receipts, such as interest, in their taxable receipts, and may include the cost of financial instruments and payments for the use of money as business purchases. A financial intermediation business includes one providing lending or insurance services.
- Is a territorial tax rather than our current worldwide system. Excludes exports from the business tax, but taxes imports (example - a foreign business manufacturing outside the U.S., but selling its products in the U.S. will pay the import tax). Sourcing rules with respect to services state that a business would be treated as exporting a service if the benefit of the service will be realized outside of the U.S. and the "benefit will be realized solely in connection with the activities of the purchaser occurring outside" the U.S. A service is imported if its benefit will be realized in the U.S. and will be realized solely in connection with the entity's U.S. business activities. (S. 722, §267).

- Businesses receive a non-refundable tax credit for their share of FICA/HI taxes; credit is not usable against the import tax.

- No loss or credit carryovers from the IRC of 1986 would be allowed; special amortization transition rules are provided for the undepreciated basis of existing property and inventory which allow for write-offs over 3 - 40 years depending on the type of property (proposed §290).

- A transition rule for businesses (§222(h)) requires all businesses to close their fiscal year on the last day of the calendar year that the income tax ends and start a new short tax year under the USA tax system on January 1 of the year the USA system becomes effective. Special rules exist for entities with a 52-53 week year ending in December.

d. Analysis

i. Apparent goal(s):
- Improve savings.
- Simplification.
- Level the international playing field for U.S. companies.
- "Fairness."

ii. Name accuracy:
- Name focuses on a new deduction for net savings that is only available to individual taxpayers. Thus, name does not suggest that businesses will be subject to a modified subtraction method VAT.

iii. Missing information - examples:
- Whether there will be any changes to excise, estate and gift taxes.
- Sourcing rules for rents and royalties.
- Inventory cost flow and valuation rules (for taxpayers using the accrual method).

iv. Problem areas - examples:
- Savings deduction will require additional recordkeeping for savings, borrowings and certain types of investment income adding to the complexity of the proposal. For individuals with over $50,000 of qualified savings assets, additional tracking will also be required. Will individuals be willing to comply with this?
- Will some type of information reporting be needed to document savings before an individual is entitled to a USA deduction? What types of audit problems might arise without such a reporting system?
- Elimination of a deduction for wages will have a harsher impact on service businesses than others; may encourage businesses to use independent contractors rather than employees, leading to increased compliance costs (contractors would file both individual and business returns) and shifts the tax burden.
- For businesses, interest income is excluded and interest expense is not deductible, thus, rules on imputed interest would still be needed to be sure, for example, that the cost of equipment, for example, does not include an interest expense element.

v. Potential abuses that could arise - examples:

- Problems might arise under a system where individuals may deduct charitable contributions, but businesses may not. For example, businesses might try to funnel contributions through employees.

- With businesses and individuals taxed at different rates, is a potential that taxpayers will attempt to shift income between the two types of taxpayers where possible.

- Lack of transitional rules for loss and credit carryovers will penalize some taxpayers and lead to planning techniques to try to utilize such attributes prior to enactment of the new tax system, such as engaging in sales-leaseback transactions that will generate sufficient gain to utilize NOL carryovers.

- The bill addresses some potential abuse areas. For example, §230 provides that the acquisition of unimproved land is not a deductible business purchase if it is not acquired for use in a business activity or if acquired for speculation, development, temporary leasing or other use not commensurate with its value, indefinite future use, or use in compensating employees. Thus, a business will not be able to reduce its current year's tax liability by a year end purchase of unimproved land for future development unless construction begins immediately. If no deduction is allowed upon acquisition of the land under this rule, once the land improvements are placed in service, a deduction will be allowed in that later tax year.

vi. Regressivity observations:

- Earned income tax credit remains.

- FICA credit will provide some relief to lower income taxpayers.

- Appears to be less progressive than current system because the top tax rate kicks in at much lower income levels than under our current system (although the FICA/HI lowers the tax rate by 7.65% up to the FICA wage limit).

- As opposed to a sales tax or VAT consumption tax, the USA system allows for graduated tax rates.

vii. Miscellaneous matters:

- The USA tax was the first plan with complete legislation (covered the basics as well as the difficult issues of international transactions, financial products and transitional rules); this completeness enables more scrutiny to be given to this proposal which may unfairly make it look like the "worst" proposal.

- The individual tax "looks" similar to the current system with some deductions removed (such as state income taxes), and some added, notably, the deduction for net savings and higher education.

- Keeps the current definition of a qualified residence which includes the taxpayer's principal residence as well as a second home; why not eliminate the deduction for interest on a second home?

- Giving a credit for FICA/HI taxes may be viewed as a gimmick - are people really paying into a trust account? Might this mechanism send an erroneous message to wage earners that Social Security and Medicare trust funds are in good shape?

- Integration of the corporate and individual systems does not appear to be achieved because dividends are taxable to individuals (unless saved) and individuals and businesses are taxed at different rates; however, expensing of business assets removes some business income from
taxation (in effect, expensing exempts the expected future income to be earned from the expensed asset). Thus whether integration is fully achieved under the USA tax is not as obvious a determination as under the Armey flat tax where clearly, business income is taxed only once at the source.

- Why is a loss carryover used rather than a tax refund when a taxpayer has negative income? (A subtraction method VAT would allow for a refund.)

- Is it GATT compatible? The USA business tax has some features of an income tax, such as the carryover of net operating losses and the ability to transfer such a loss to an acquirer of the loss business. Also, the computation is similar to an income tax calculation with fewer deductions. 22

- Why is no deduction allowed to businesses for wages, but employees must report wages as income? Thus, wages, in effect, are taxed twice (although businesses receive a FICA/HI credit that will alleviate part of this double tax).

- USA and deferred income calculations are quite complex and do not represent a typical consumption tax due to special rules for certain types of accounts, borrowing and earnings. Why isn't a strict cash flow approach which factors in borrowing and repayment or an approach that exempts all investment income from tax used - wouldn't such approaches be simpler?

- Would some type of FIFO (first-in-first-out) approach be easier to track pre-USA savings? Or, despite the upfront cost to the government, wouldn't it be easier for taxpayers to compute and the IRS to verify some type of write-off of pre-USA savings, regardless of the dollar amount?

e. Comparison to H.R. 134, the Simplified USA Tax—The major change contained in H.R. 134 is that instead of the USA deduction, a deduction for a Roth IRA is allowed. A Roth IRA operates such that neither contributions nor distributions are taxable. In addition, the tax rates for individuals are lower—15%, 25%, and 30%.


a. Basics

- Replaces the federal income tax with 15% federal sales tax (effective rate is at least 17.6% though) which can be administered by the states provided they first conform their sales tax system to the federal one.

- Recommends repeal of the 16th amendment.

- Repeals excise taxes on alcohol, tobacco, gasoline, diesel fuel and some other items, but keeps others to be administered by a new "Excise Tax Bureau." The luxury excise tax on cars is repealed.

- Keeps social security taxes to be administered by the existing Social Security Administration.

- Repeals estate and gift taxes.

- Calls for phase-out of the IRS and creation of a Sales Tax Bureau within the Treasury Department.

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22 In "GATT Treatment of Subtraction Method VAT," ABA Section of Taxation Newsletter, Fall 1994, pg. 28, Stanley Simon raises the question of whether a subtraction method VAT is border adjustable under GATT. The issue is whether a subtraction method VAT looks more like a corporate income tax than a VAT. See earlier discussion under "Terminology" ("Advantages of the credit invoice VAT").
- Tax is imposed on gross payments for the use, consumption or enjoyment in the U.S. of any taxable property or service, whether produced or rendered within or without the U.S. This definition of gross payments leads to an effective rate greater than 15% and the definition of taxable property and services is quite broad, including real property.

- "Gross payments" = the product of the pre-tax factor and payments for the taxable property or service exclusive of state and federal taxes imposed by this subtitle and state taxes in conformity with the federal sales tax. Pre-tax factor = 1 ÷ [1 - 15% - the state tax rate imposed in conformity with the federal tax].

Example: Barbara purchases a car for personal use. The sticker price is $20,000 and she resides in a state that does not conform to the federal sales tax yet imposes its own sales tax at a rate of 7%. The federal sales tax on this purchase:

\[ \$20,000 \times \left[ 1 \div (1 - .15) \right] \times 15\% = \$3,529 \]

Effective tax rate = 17.645%

The state sales tax will likely be assessed on the $20,000, not the $23,529, but may vary depending on state tax law. Assuming the state tax is imposed exclusive of the federal tax, it will be:

\[ \$20,000 \times 7\% = \$1,400 \]

Effective tax rate = 7.0%

Total sales tax = \$4,929

Effective tax rate = 24.645%

If the state sales tax were imposed in conformity with the federal rules, the federal sales tax owed would be:

\[ \$20,000 \times \left[ 1 \div (1 - .15 - .07) \right] \times 15\% = \$3,846 \]

\[ + \quad \$20,000 \times 7\% = \$1,400 \]

Total sales tax = \$5,246

Effective tax rate = 26.23%

Thus, if the transaction takes place in a conforming state, Barbara will owe more tax ($317 additional federal tax).

- Conforming sales tax is defined in conjunction with administering state. An administering state is one that maintains a conforming sales tax and enters into an agreement with the Secretary of the Treasury to collect and remit the federal sales tax. A conforming sales tax is one that conforms in all significant respects (other than the rate, administration credit and family rebate) to the federal tax.

The sales tax is to be charged separately from the purchase price. The vendor is to provide each buyer with a receipt which, for Barbara's purchase above, would show (assuming the sale was not in a conforming state):

1) price exclusive of tax \$20,000
2) tax \$ 3,529
3) price inclusive of tax \$23,529
4) tax rate as defined for these purposes as (2) ÷ (3) 15%
5) date of sale
6) name of vendor
7) vendor's registration number
Possible rationale for the above calculations: The bill sponsors provide no explanation for a stated tax rate of 15%, but an effective tax rate of 17.6% (or higher if the sale is in a conforming state). However, one can conjecture that a possible explanation is as follows:

For Barbara to buy the car in the earlier example (ignoring state sales tax) she must earn $23,529. With her purchase of the car and payment of $3,529 of federal tax, her tax rate on an income tax equivalent basis is 15% [$3,529 ÷ $23,529]. Perhaps the sponsors thought this would be a better way to compare the tax burden of a sales tax to an income tax or the Armey flat tax.

- "Taxable property or service" is defined as any property (including leaseholds and rents) other than intangible property, and any service (including financial intermediation services). Services generally do not include wages unless paid by an employer who is not engaged in an active trade or business. A later section of the bill on allocating tax to the proper state when collected by administering states implies that services also includes telecommunications, and domestic and international transportation services.

- "Tangible personal property" is to be defined based on common law; the Treasury Secretary is to write regulations establishing uniform rules as to this definition.

- Exemptions include (no tax owed): 1) purchases for resale, 2) purchases to produce taxable property or services (such as manufacturing machinery), 3) purchases in furtherance of a bona fide business purpose, 4) exports from the U.S., 5) certain de minimis transfers by individuals not engaged in a trade or business.

- Purchases to produce taxable property or services includes taxable property or services used in an active trade or business for research, experimentation or development purposes.

- Education and job-related training (tuition, but not room and board) are treated as purchased to produce taxable property or services.

- Special rules are provided for mixed personal/business use property.

- Generally, there are no special exemptions for federal, state or local governments.

- A special rule generally requires government employers and certain tax-exempt organizations to pay sales tax on wages by Federal, State and local government employees. [§21(n)]

- Generally, the seller is liability to collect and remit the tax with two key exceptions: 1) buyer must remit tax for taxpayer property or services purchased outside the U.S., but brought into the U.S. (unless "de minimis"), and 2) if buyer of principal residence elects to pay sales tax (plus interest) in installments over 30 years.

- Individuals not engaged in a trade or business must collect tax on casual or isolated sale if the sale exceeds $2,500/year. Individuals must also report use tax on imports exceeding $400/year.

- Credits include:

  1) Used property credit - for previous sales tax paid on the resale of taxable property or services.

  2) Business use conversion credit - when taxable property is converted to business use.

  3) Administration credit - available to taxpayers filing timely monthly reports and is equal to the greater of $200, or .5% of the tax remitted (but not to exceed 20% of the tax due).

  4) Compliance equipment cost credit - equal to 50% of the cost of equipment required to be purchased by vendors to enable them to comply with the requirement to report tax and purchase price separately on invoices.
5) Transitional inventory credit - equal to 15% x the cost of qualified inventory held prior to the effective date of the sales tax.

- To address the regressivity of the tax, a "family consumption refund" (rebate) is allowed for individuals. The rebate is equal to 15% of the lesser of,
  1) 117.6% of the poverty level for their family size, or
  2) the wage income for the family unit.

The family rebate is administered by a family member's employer (or split among wage earners in the family) by additions to each paycheck. Family members include spouses, children, grandchildren, parents and grandparents who have a bona fide social security number (if over age two) and are a lawful resident of the U.S. The relevance of whether a person is a family member is in determining the poverty level for that family to determine the family rebate amount (particularly where the family's wages exceeds the poverty level amounts).

- For non-wage earners, such as retired individuals receiving Social Security benefits, a "compensating payment" equal to the product of their qualified fixed income payment amount and the excess inflation rate, may be obtained. Such individuals are required to apply for these payments and they are added to their monthly Social Security benefit. Also, Social Security benefits are to be indexed on a sales tax inclusive basis.

- Vendors are to remit the tax based on the cash method (as payments are received by them), unless the accrual method is elected.

- Monthly reporting is required with tax to be paid by the 20th day of the succeeding month; interest and penalties for late payments and late filing are provided for.

- Persons liable to collect and remit taxes who are engaged in an active trade or business must register with the federal or state taxing authorities. Penalties are provided for failure to register.

- Administering states (see earlier explanation):
  - have no less than 15 days after receipt to remit the federal tax to the U.S.
  - may keep a fee equal to 1% of the federal tax required to be remitted.

- If a state is not an administering state, the Secretary of the Treasury will administer the federal tax in that state; the Secretary will also administer the tax if an administering state fails to properly collect and remit the federal tax.

- A conforming state may contract with another conforming state to administer its sales tax for an agreed fee.

- The federal government will administer a program to allow for information sharing among the States.

- Vendors with retail establishments in five or more conforming states may elect to have their sales tax obligations administered (including audits) by the federal government under the multistate vendor program. Under this program, the federal government will collect the federal and state sales taxes and remit the state tax to the states within 10 days of receipt.

- The U.S. Tax Court has jurisdiction over federal tax disputes.

- A new federal "Office of Revenue Allocation" will be created to arbitrate disputes among administering states as to which state is entitled to the tax collected in certain instances. Apparently the purpose of these rules it to enable administering states to adopt rules in conformance with other administering states. Guidance is provided as follows to determine the destination state:
  - Tangible personal property - where first delivered to buyer;
  - Real property - location of property;
Other property - residence of buyer;
Services - generally, the state in which the use, consumption or enjoyment of the services occurred; may be allocated to more than one state based on time;
Telecommunications services (including cable television, and computer on-line or network services) - residence of purchaser;
Domestic transportation services - final trip destination;
International transportation services - deemed that 50% of the service is attributable to the U.S. destination or origin;
Financial intermediation services - residence of the purchaser;
Rents and royalties for the lease of tangible property - location of the property;
Vehicle rentals of one month or less - where vehicle was originally delivered; and
Vehicle rentals exceeding one month - residence of lessee.

- Self-employment tax: IRC §1402 is amended to define self-employment income as gross payments received in a calendar year from the sale of taxable property or services (without regard to exemption) less the sum of 1) purchases of taxable property or services in furtherance of a business purpose, 2) any wages paid (whether to the self-employed person or others); 3) unused transition amounts, and 4) undeducted negative self-employment income amounts from prior periods. The transition amount is the unrecovered basis of depreciable property and inventory at the transition date divided by 10 years.

- A 2/3 majority vote in the House and Senate is required to raise the federal sales tax rate, or to provide any exemption, deduction, credit or other benefit resulting in reduced federal revenues.

b. Analysis

i. Apparent goal(s): Per Sec. 2 of the bill:
- to replace the income tax which "retards economic growth" and impedes international competitiveness, reduces savings and investment, lowers productivity, is unfair, costly and "unnecessarily intrudes upon the privacy and civil rights" of U.S. citizens;
- a national sales tax is familiar because it would be similar to the sales tax in 45 states
- a national sales tax will promote savings, fairness and economic growth, raise the living standard, enhance productivity and international competitiveness, reduce administrative burdens for taxpayers and respect privacy interest and civil rights of taxpayers
- "it is desirable to harmonize Federal and State collection and enforcement efforts to the maximum extent possible"

ii. Name accuracy
- May be more accurate to call it a tangible property sales and rental and services tax because most taxpayers don't equate sales tax with real property purchases or leases, or with services.

iii. Missing information - examples
- Whether any business will get any transition relief for loss and credit carryovers existing at the transition date.

iv. Problems areas - examples
- Additional costs for governments: Governments would be required to pay tax on its consumption, including wages paid to employees.
- While compliance burdens for individuals not engaged in a business are generally eliminated, some new compliance burdens are created, such as:
- family consumption rebate (while the employer administers, individuals will need to pay attention to this rebate, particularly if they changes jobs or have more than one wage earner in the household)
- payment of use tax on imports, unless the de minimis exception is met
- collection of sales tax on casual or isolated sale, unless the de minimis exception is met (example - must collect tax on sale of used car for $6,000 to an individual for non-business use; apparently, would receive a "used property credit")
- dealing with the used property credit when they resell property
- principal residence installment election to pay the sales tax (+ interest) over 30 years.

- The definition of gross payments and its effect on making the effective tax rate greater than 15% is misleading and will likely lead states not to conform because if they do, their residents will pay a higher federal sales tax (see earlier example). There appears to be no justifiable reason for this definition and calculation. Administration would be easier if the rate were just applied to the tax exclusive purchase price of taxable property and services.
- Is the administrative credit of 0.5% of the tax collected (limited to 20% of the tax due) sufficient to compensate retailers who will bear the bulk of all compliance burdens under a national retail sales tax? A 1990 study determined that compliance costs for retailers was, on average, almost 3.5% of the total sales tax liability.\(^{23}\)

- Transition to national sales tax:
  - What is to prevent individuals from borrowing as much as they can prior to the effective date to make purchases, particularly large ticket items, so as to avoid paying the sales tax? What will be the impact of such likely actions on the revenue estimates for this new tax?
  - When people buy taxable property and services using funds previously taxed under the income tax, they are in effect paying tax on that money again. Will any transition relief be provided? If yes, at what cost?

v. Potential abuses that could arise - examples
- Apparently, if intangible property is licensed, it is subject to tax as a service, unless exempt; if intangible property is sold outright it is not subject to tax. How are licenses of off-the-shelf software to consumers to be treated - based on substance (probably a sale) or form (royalty) and is software tangible or intangible (how will this be viewed under common law)? Some transactions, such as transfers of software to non-business individuals, might be labeled as the sale of intangible property and exempt from sales tax (depends on regulations to be drafted by Treasury).
- Services might be difficult to tax and evasion might increase.
- The exemption for tuition, but not for books and supplies, might encourage institutions to bundle more items under the category of tuition, such as stating that tuition includes a computer.

vi. Regressivity observations
- Because the family rebate is tied to the poverty level tables and family size, there is no need to know a family's income amount in order to determine the amount of the rebate. Thus, this

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\(^{23}\) Per a 1990 study by Price Waterhouse, as reported by the Tax Foundation in their March 20, 1996 testimony before House Ways & Means; 96 TNT 57-82 (March 21, 1996), Doc. 96-8577 [33].
system eliminates the need for 1099s and W-2s (except for state income tax and social security tax purposes).

- Because all wage earners are eligible for the rebate (as opposed to only low-income taxpayers), the administrative burden associated with the rebate may be overwhelming for the federal government, and the compliance burden overwhelming for employers.

- For a family with wages below the poverty level, the family rebate should eliminate their federal tax liability assuming they do not live in a conforming state and they do not spend more than their gross wage amount. Under current law, exemptions would also likely eliminate federal income tax for a taxpayer with wages below the poverty level. However, under current law, such a taxpayer might also be eligible for the refundable earned income tax credit. Because the EITC is eliminated under H.R. 1467, very low-income taxpayers might see their federal tax liability increase under. A possible solution would be to exempt a taxpayer's first $5,000 (or other appropriate amount) of wages from payroll taxes (and to increase the social security wage limit to compensate for such a rule applying to all levels of wage earners).

- The exemption for tuition should be helpful, but should be capped as to the total exemption available each year if its purpose is to address regressivity concerns.

vii. Miscellaneous matters

- Taxpayers must still deal with state income and franchise tax rules, which, if based on federal income tax rules, will continue to be complex, will require each state to adopt (because the federal income tax rules will no longer exist for reference), will require states that rely on federal audit results to expand their audit workforce, and will unlikely reduce compliance burdens of taxpayers (records must still be kept and filing obligations met).

- How willing will states be to conform their sales tax systems to that of the federal government and accept the 1% fee as a good deal? There is no payment for the states to get organized legislatively and administratively to conform to the federal sales tax and become an "administering state."

- While the IRS is to be phased out, if most states do not become administering states, the workforce at the IRS probably won't shrink by much, but will just become the direct workforce of the Treasury Department. Federal regulations and forms will be needed, administration will be needed, etc. While the "IRS" will be eliminated, new agencies will be created (Office of Revenue Allocation and Excise Tax Bureau) and the Treasury Dept. will still have to administer the tax for retailers operating in states that are not administering states, or for retailers that elect to have federal administration (those with retail establishments in 5 or more conforming states).

- Due to the long audit cycles for large case examinations, a 2 to 3 year phase-out period for the IRS is not sufficient for income tax examinations to be completed.

- With phase-out of the IRS, will non-filers under the income tax system ever be found? In fact, might phase out of the IRS encourage non-filers to continue not to file between the enactment of the sales tax and the end of the income tax? An income tax administrative branch probably should be kept (and publicized) for a long period (at least ten years) to address both this problem and long-term examinations still in progress at the transition date.

- Because the IRS really cannot be phased out and H.R. 1467 would create new agencies (see above), it is misleading to the public to tout elimination of the IRS. It would be more appropriate to state that most individuals would no longer have a yearly filing obligation.

- Excise taxes on alcohol, tobacco and gasoline currently serve more than just a revenue generating purpose. Should these taxes remain in addition to the sales tax? This is an important policy issue that needs to be addressed. Keeping the excise taxes on these items does not cause any compliance burden to individuals.
- What would be the impact on savings and consumption rates in both the short term and long term? Might purchases decline in the short term because goods look much more expensive with a 17.6% tax added on?
- Is 15% the revenue neutral rate?
- Would a VAT be more effective at taxing services and reducing possible evasion of the tax?

3. Other proposals for a national retail sales tax

a. Senator Lugar has repeatedly introduced a sense of the Senate resolution calling for replacement of the income tax and estate and gift taxes be replaced with a sales tax that will raise as much revenue as the income tax. [S. Res. 24, 106th Congress]

b. "The Fair Tax"—Americans for Fair Taxation are calling for a 23% national sales tax on goods and services. This tax would replace income taxes, payroll taxes, estate and gift taxes. It also calls for repeal of the 16th Amendment. See www.fairtax.org/.
<table>
<thead>
<tr>
<th>Issue/Concern</th>
<th>Proposal:</th>
<th>Flat</th>
<th>USA</th>
<th>VAT</th>
<th>NST</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Wages not deductible, thus, reduced R&amp;E (research &amp; experimental) deduction.</td>
<td>x x n/a*</td>
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<tr>
<td>• Credit for increasing research activities eliminated.</td>
<td>x x x n/a*</td>
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<tr>
<td>• Research tax credit and foreign tax credit carryovers at transition date eliminated.</td>
<td>x</td>
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<tr>
<td>• No guidance on what happens to research tax credit or foreign tax credit carryovers at transition date.</td>
<td>x x x</td>
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<tr>
<td>• Generally, favors capital intensive companies (such as chip manufacturers) over labor-intensive companies (such as software).</td>
<td>x x</td>
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<td></td>
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<tr>
<td>• Whether property is tangible or intangible is likely to be relevant.</td>
<td>x</td>
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<tr>
<td>• Employee stock options might have to be valued and included in employee compensation when received, whether or not exercised.</td>
<td>x** ?? ?? n/a</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Opportunity</td>
<td></td>
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<tr>
<td>• If R&amp;E creates net operating loss, will carryforward indefinitely adjusted by an interest factor.</td>
<td>x † † n/a</td>
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</tr>
<tr>
<td>• Generally, simplified recordkeeping because R&amp;E treated no differently than other business expenditures (no need to distinguish R&amp;E from non-R&amp;E activities for tax purposes).</td>
<td>x x x x</td>
<td></td>
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</tr>
<tr>
<td>• Special sourcing rules for R&amp;E expenditures between U.S. and foreign eliminated (should just be able to look to where expenditure was incurred).</td>
<td>x x x n/a</td>
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<tr>
<td>• Generally, depreciation rules eliminated; business inputs deducted when acquired.</td>
<td>x x x n/a</td>
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<tr>
<td>• Semiconductor manufacturer's desire for 3-year depreciable life of equipment (rather than 5) would be more than satisfied.</td>
<td>x x x n/a</td>
<td></td>
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<tr>
<td>• Whether an asset is tangible or intangible is likely not relevant.</td>
<td>x x x</td>
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</tr>
<tr>
<td>• Loss carryover of an acquired business generally allowed to be used by acquirer.</td>
<td>silent^ x24 n/a*** n/a</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>• Intercompany transfer pricing issues less relevant.</td>
<td>x~ x n/a</td>
<td></td>
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<tr>
<td>• Potential opportunity for improving the compliance side of taxes by considering new technologies and new ways of doing business.</td>
<td>x x x x</td>
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</tbody>
</table>

* not applicable because businesses would owe no income tax and likely no sales tax, thus, deductions and credits not important
** under Armey flat tax, H.R. 1040, only cash wages are deductible; however, Hall-Rabushka flat tax book states that full market value of the options is included in compensation in the year received, whether or not exercised (pg. 115)
*** operating losses do not exist because business instead obtains a tax refund
?? under USA tax, treatment not entirely clear; under subtraction VAT, individuals likely not subject to income taxes
† because wages are typically a large part of R&E expenditures, it is unlikely that R&E expenditures would create an NOL under the USA tax or a tax credit situation under a pure subtraction VAT
^ While the Armey proposal is silent on this matter, Hall and Rabushka imply that such transfers of carryovers are allowed (pg. 118 of their Flat Tax book).
~ for example, if business overstates imports to obtain larger deduction, import tax will offset any savings; however, because import tax is due upon entry and accrual required for deductions, may be some incentive to understatement of import

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24 USA tax proposed §207(d)(2).
## Sample Issues/Opportunities For Professional Service Companies

<table>
<thead>
<tr>
<th>Proposal:</th>
<th>Flat</th>
<th>USA</th>
<th>VAT</th>
<th>NST</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Increase in tax liability because employee wages are no longer deductible.</td>
<td>x</td>
<td>x</td>
<td>n/a*</td>
<td></td>
</tr>
<tr>
<td>* Increase in tax liability because payroll taxes and fringe benefits are no longer deductible.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>n/a*</td>
</tr>
<tr>
<td>* Tends to favor capital intensive business rather than labor business because inventory, equipment and real property are currently expensed.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>n/a*</td>
</tr>
<tr>
<td>* Would have new administrative burden to collect tax.</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>* Self-employed person would pay a wage to themselves and complete both a personal and a business return.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>* Some purchases might be directly subject to tax.</td>
<td>x&lt;sup&gt;25&lt;/sup&gt;</td>
<td>x&lt;sup&gt;26&lt;/sup&gt;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>* If company involved in tax compliance and planning work, business likely to decline, particularly with respect to individual clients.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunity</th>
<th>Flat</th>
<th>USA</th>
<th>VAT</th>
<th>NST</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Form of business would no longer matter for federal tax purposes.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>* Partnerships, S corporations, and LLCs taxed as partnerships would no longer have to prepare and file federal K-1 forms.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>* All equipment and supplies would be currently deductible, issues of capitalization versus expensing would be eliminated.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>* Single rate for all taxpayers or all businesses (elimination of the requirement for using the highest marginal rate (35%) for personal service corporations)</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>n/a*</td>
</tr>
<tr>
<td>* If company involved in tax compliance and planning work, reduced client need for tax work will allow more time for business planning and consulting work.</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
</tbody>
</table>

* not applicable because businesses would owe no income tax and likely no sales tax, thus, deductions and credits not important

? some type of reporting may still be required for purposes of an individual owner being able to determine their family rebate amount

^ no deduction allowed because income tax eliminated; business likely to owe no sales tax on purchases of supplies or equipment because used in the business activity to produce taxable services

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<sup>25</sup> Imported goods and services would be subject to the import tax.

<sup>26</sup> H.R. 3039 is not clear on how broad the exemption is for purchases to produce taxable property or services. For example, would janitorial services purchased by an accounting or law firm and coffee and food purchased for consumption by customers and employees be subject to tax or would they be an exempt purchase to produce taxable property or services?
Evaluating and Understanding the Various Proposals—Some Considerations

• "Buy-in." How will policymakers get buy-in from the public? Most individuals do not understand our current tax system; thus, it will be difficult to explain why the new system would be better and why it would better encourage economic growth than under our current tax system. Also, we have had deductions, a progressive tax system and double taxation of certain investment income for decades - the public is used to it and it is hard to change perceptions of what a proper tax system should include.

• How to predict levels of economic growth? Several economists and sponsors of reform proposals state that a consumption tax will increase levels of economic growth, job creation and increase in wages. Given the complexity and significance of the prospect of replacing the federal income tax with a consumption tax, how can all the effects be predicted? What if savings increases in the short run, but results in a decline in consumer spending? While economic models may suggest economic growth in the long run, what happens in the short run?

• Employment tax reform. Can federal income tax reform realistically occur without reform of employment taxes. For example, if federal income taxes are reformed first and later employment taxes are reformed by raising the tax rate for social security and Medicare taxes, would public outcry follow?

• Concerns of low-income taxpayers. How will the tax system deal with low-income taxpayers? The current system provides for an earned income tax credit received through filing of an income tax return. How could relief be provided under a value-added tax or a national sales tax? Would new bureaucracies be needed to address such an issue? Under a system where only businesses directly pay taxes, would some type of individual income reporting mechanism still be required in order to determine which taxpayers should be given some type of relief under a regressive tax, such as a sales tax? How will regressivity be addressed if revenue neutrality is obtained for any of the current proposals by reducing the personal exemption amount rather than increasing the tax rate? Also, for many low-income wage earners, their significant tax liability is the payroll tax of 15.3% of wages. How will income tax reform help these individuals?

• Taxation of fringe benefits. What will be the impact of taxing fringe benefits? Will employers stop providing them? Will they be converted into taxable wages? Will current rules aimed at preventing favoritism in benefit plans towards highly-compensated employees, in effect by nullified if fringes are converted to wages? Can the subjective reasonable compensation rules replace anti-discriminatory rules that currently apply to some fringe benefits?

• The tax gap. How will the new tax affect the tax gap? Can the tax effectively reach the underground economy? Can any tax reach the underground economy? What new evasion techniques might arise under a particular proposal? What enforcement rules would be appropriate under the proposed tax system?

• Simplification. Will the new system by simpler than the present system? Perhaps some complexities, such as international issues and those involving innovative financing cannot easily be removed. In addition, some current complexities might become more problematic; for example, under a system where wages are not deductible, but cost of other services are deductible, the distinction between employee and independent contractor becomes a bigger issue than under our current system. Another complexity that

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

It may fairly be urged that our present system of Federal income taxation is unduly complex. At any rate, little in the way of simplification has thus far been accomplished by revision. Each successive act has been more elaborate than its predecessor; and the maze of administrative and judicial technicalities surrounding the taxpayer has been steadily thickening.
could arise is where a system requires non-cash employee benefits to be valued. For example, the Hall-Rabushka flat tax book notes that an employee would be required to include the market value of stock options received from the employer, when received, and whether or not exercised (page 115). The valuation of stock options when received is difficult and has already been a major issue with respect to financial accounting rules.

Are the touted simplifications of the proposal legitimate? For example, a single tax rate does not necessarily make a tax system simple because taxpayers use tax tables and computers. Also, removal of the mortgage interest deduction is not simplification because little recordkeeping is involved. (However, removal of the deduction does remove federal income taxes from the home-buying decision.)

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

• **Global competitiveness.** How would the new system affect the ability of businesses to compete globally? How does the system compare to that of other countries? Would a territorial system encourage businesses to locate to lower tax countries?

• **Tax treaties.** Current tax treaties deal with income taxes, not consumption taxes. Thus, the treaties will need to be renegotiated if the income tax is replaced. The time frame needed for this task, as well whether other countries would be willing and interested in renegotiating treaties with the U.S., must be considered in the tax reform debate.

• **What can the U.S. learn from other countries?** What have been the experiences in other countries that have reformed their tax systems? Did savings rates increase? Was the system still in place five year later? What changes had been made?

• **Adequacy of information for the public.** How can the public effectively evaluate proposals? Most proposals are not complete in that they do not specify what happens to other parts of the tax law, and definitions and transition rules are lacking. Also, it will be easier to evaluate short-term effects than long-term effects, but without the long-term evaluation, the public may not give a complete look at tax reform. Also, it is difficult to evaluate proposals due to uncertainties about prices, interest rates, Federal Reserve actions, impact on the economy, short-term versus long-term impacts, etc. How can the government effectively provide enough information to the public to allow for an appropriate discussion of the issues?

• **The Changing U.S. Economy**—The current U.S. tax system is based on the industrial age where most transactions were easy to identify and crossing borders of states and countries was obvious. The tax laws were designed to deal with tangible goods and easy to identify transactions. In today's economy, services are becoming more important. Also, intangibles, such as software and information, are commonly transferred between taxpayers and easily transferred across borders. For example, the Department of Commerce reports that by the 21st century, telecommunications and information-based industries will represent about 20% of the U.S. economy.

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28 Tax incentives available to homeowners include the deduction of mortgage interest on up to $1.1 million of debt, the deduction for real estate taxes, deferral of gain upon sale if the proceeds are timely invested in another principal residence, and the $125,000 gain exclusion upon sale of a principal residence by a taxpayer age 55 or older (once in a lifetime exclusion).
Politics versus economics. Will the debate be driven by politics or economics? For example, will certain preferences be put in a system (such as a home mortgage deduction), even though it does not make economic sense under the new type of tax (such as a consumption-based flat tax)? For example, compare the Armey and Spector flat tax proposals, both based on the Hall-Rabushka plan, but with differing deductions.

Refocus—How will tax reform change investment activities, tax strategies and expectations, and government operations as we know them? For example, will removal of incentives for real estate, including the home mortgage interest deduction, affect real estate markets? Will removal of a deduction for charitable contributions lead to a decrease in contributions? How will estate planning change if estate and gift taxes are repealed?

Relevance of business form. How will removal of the relevance of the type of business entity affect current businesses and new businesses?

Existing debt. How will removal of the current tax system's preference for debt over equity affect companies that are currently heavily debt laden? How will it affect the capital formation markets?

Owing tax in downturns. In a system where assets are not depreciated over several years and inventory get expensed prior to its sale, businesses may be surprised when during a downturn in their business or the economy, they still owe federal tax. During a downturn, key business deductions will not exist or will be reduced, such as equipment and inventory purchases, and there will be no depreciation and cost of goods sold to reduce the tax base. And, if the new tax system is one where employee wages are not deductible, the business is even more likely to owe tax during a downturn.

Recordkeeping changes. How will recordkeeping change? For example, businesses have many records which are only kept for tax purposes, such as those to track inventory figures for tax purposes. What new records will be needed? Will current recordkeeping systems be capable of tracking or producing any new data or reports?29

State conformity. How likely is it that states would or should conform to any new federal tax system? Would they need additional time to determine how to adapt and to set a tax rate? Will its citizens demand conformity to the federal system to achieve simplification?

Reliance on federal tax mechanism. If the federal income tax system were eliminated, could states realistically keep their income tax systems in place? Many state income tax systems are based on the federal tax system, including terminology and rules. In addition, many states rely on federal tax audits for identifying adjustments to state tax returns. How much time would states need to reform their tax systems to any federal changes? Will Congress factor this time into the transitional period for federal reform?

Potential double consumption tax for states. If a state were to abolish its income/franchise system in response to repeal of the federal income tax and adopt a version of the federal consumption tax in its place, most states would then have two consumption tax systems in place - the new one and the sales tax. As noted earlier, most federal proposals call for some type of a VAT which is just a mechanism for collecting a sales and use tax. If a state were to have a subtraction VAT and a sales tax, it would have increased the regressivity of its overall tax system and eliminated one possible form of relief, namely, exemptions and credits available through the income tax system (which also helps to identify who is a "low-income" taxpayer).

New costs for the states. Under the Armey flat tax, governments (and tax-exempt entities) would be subject to tax at 17% (19% for the first two years) on fringe benefits provided to workers. The goal of

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29 For example, there have occasionally been suggestions that compliance among independent contractors could be improved by requiring service-recipients to withhold taxes on payments made to contractors. Businesses have typically responded to such proposals by noting that their current accounts payable systems cannot accommodate such withholding.
this provision is to equalize the costs to both the private and public sector of hiring employees. How will states and cities bear the burden of this tax?

- **Subnational e-commerce concerns**: Today, state and local governments have concerns over further erosion of their sales tax base as e-commerce grows. Today, a state may only impose sales tax collection obligations on a vendor if that vendor has a physical presence in the state. Using e-commerce, it is very easy for a company to only have a physical presence in a single state, yet have customers in all states. For example, Amazon.com only has physical presence in three states (one of which does not impose sales tax (Delaware)), yet sells to customers in all 50 states. Can federal tax reform assist the states with their sales taxation concerns? For example, would a national sales tax better enable states to unify and simplify their sales tax such that they would be able to impose collection obligations on all vendors without impeding interstate commerce?

- **What type of transitional relief, if any, will be provided?** For example, if we change from an income tax to a consumption tax, will individuals with savings consisting of previously taxed income be able to exempt that savings from the consumption tax on the theory that it has already been taxed once? What happens to carryovers such as net operating losses, capital losses and foreign tax credits? What types of complexities will transitional rules present?

- **Changed behavior during the transition period.** In the period preceding the effective date of a new tax system, what will be the impact of changed behavior on the new system? For example, if consumption will be taxed, how will revenue projections be affected by individuals buying cars, prepaying college tuition, etc., immediately prior to the effective date of the new system?
## Comparative Critique of Proposals for Major Federal Tax Reform

The following chart uses various criteria to evaluate how the proposals for major reform address problems of our current tax system. Several factors are not listed because they are difficult to assess. Additional evaluation criteria include: effect on size and operation of the IRS; impact on decision-making, such as choice of business entity, investment choices and estate planning; possibility of reducing the tax gap and reaching the underground economy; impact on global competition; treatment of financial institutions, governments and non-profits; and "fairness" (to some people, this subjective concept means a single tax rate rather than progressive rates, to others it means just the opposite; also to some it means taxing all types of income similarly). Senator Nunn (S. 722) and Congressman Gibbons (H.R. 4050) retired at the end of the 104th Congress. Both H.R. 1040 and H.R. 1325 are bills of the 105th Congress and the others are from the 104th Congress.

<table>
<thead>
<tr>
<th>Tax: What happens to these issues:</th>
<th>Flat tax (Armey - H.R. 1040)</th>
<th>USA tax (Nunn/Domenici S. 722)</th>
<th>Subtraction VAT (Gibbons - H.R. 4050)</th>
<th>National Sales Tax (H.R. 1325)</th>
<th>10% Tax Plan (Gephardt)</th>
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<tbody>
<tr>
<td>Compliance burden</td>
<td>postcard-size tax returns; reduced recordkeeping for individuals; most 1099s eliminated</td>
<td>possibly increased for individuals due to need to track savings and borrowing activity</td>
<td>businesses only file postcard size tax return; &quot;small businesses&quot; exempt; to maintain current distribution of tax burden, high income individuals remain as direct taxpayers</td>
<td>bulk of burden falls on retail businesses. Individuals must collect tax on casual or isolated sale if gross payments exceed $2,500 per year. Must report use tax on imports exceeding $400 per year. Individuals electing to pay tax on home in installments (+ interest) must file form.</td>
<td>removal of most individual deductions likely to simplify compliance; sponsor notes that majority of individuals will not have to file</td>
</tr>
<tr>
<td>Capital versus ordinary distinction</td>
<td>not relevant; capital gains and losses not taxed</td>
<td>apparently no longer relevant; no special tax rate or rules provided; generally, loss from disposition of savings assets not deductible, but increases general basis account</td>
<td>not relevant</td>
<td>not relevant</td>
<td>all income to be taxed the same, but capital loss limitation likely remains</td>
</tr>
<tr>
<td>Imputed interest</td>
<td>remains</td>
<td>remains</td>
<td>remains</td>
<td>remains</td>
<td>remains</td>
</tr>
<tr>
<td>Employee versus independent contractor</td>
<td>remains</td>
<td>enhanced importance - businesses cannot deduct wages</td>
<td>enhanced importance - businesses cannot deduct wages</td>
<td>issue remains for employment tax purposes and apparently, handling of family rebate (employer handles for employee)</td>
<td>remains</td>
</tr>
<tr>
<td>Tax: What happens to these issues:</td>
<td>Flat tax (H.R. 1040)</td>
<td>USA tax (Nunn/Domenici; S. 722)</td>
<td>Subtraction VAT (H.R. 4050)</td>
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<td>10% Tax Plan (Gephardt)</td>
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<tr>
<td>Alternative minimum tax (AMT)</td>
<td>eliminated</td>
<td>eliminated</td>
<td>eliminated</td>
<td>eliminated</td>
<td>likely not eliminated</td>
</tr>
<tr>
<td>Corporate integration</td>
<td>achieved</td>
<td>not obvious</td>
<td>achieved</td>
<td>achieved</td>
<td>not achieved</td>
</tr>
<tr>
<td>Highest marginal tax rate for individuals</td>
<td>17% (once fully phased in; 20% in first 2 years)</td>
<td>40%</td>
<td>17% (only for high-income individuals)</td>
<td>17.6% on purchase or use of non-exempt property and services</td>
<td>34%</td>
</tr>
<tr>
<td>Highest marginal tax rate for business</td>
<td>17% (once fully phased in; 20% in first 2 years)</td>
<td>11%</td>
<td>20% (if this proves to be the revenue neutral rate)</td>
<td>17.6% on purchase or use of non-exempt property and services</td>
<td>likely continues to be 35% for corporations</td>
</tr>
<tr>
<td>Regressivity of individual tax</td>
<td>large personal exemption provides relief for low-income taxpayers, but additional relief of the refundable EITC eliminated</td>
<td>refundable FICA/HI credit; EITC; progressive rate structure, but maximum rate starts at low level; ages double taxed (but business gets FICA/HI credit)</td>
<td>rebate for low-income individuals</td>
<td>family rebate, but apparently, only for families with wage income. Compensating payments available to certain people on fixed income and entitled to social security benefits. Apparently no tax on tuition.</td>
<td>rates reduced, but base expanded; EITC remains</td>
</tr>
<tr>
<td>Border adjustable?</td>
<td>no; per Armey (and others), is not a concern because ability to adjust at border is not effective in reducing trade deficit</td>
<td>potential concern that only credit invoice VAT is border adjustable</td>
<td>potential concern that only credit invoice VAT is border adjustable; some of the problems of the USA subtraction VAT (such as NOL carryover and payroll credit) not present here</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Other taxes, such as employment, estate and gift, and excise taxes?</td>
<td>estate and gift taxes repealed; employment taxes remain; excise taxes not addressed</td>
<td>funds continue to go into FICA/HI, but then refunded through income tax (except that HI above FICA wage base is not refundable); other taxes not addressed</td>
<td>income and payroll taxes repealed; funds still to go into Social Security &amp; Hospital Insurance trust funds; excise taxes apparently remain</td>
<td>employment taxes remain; estate and gift taxes eliminated; many excise taxes eliminated (including alcohol and tobacco taxes)</td>
<td>other taxes likely remain</td>
</tr>
</tbody>
</table>