TAX FOUNDATION

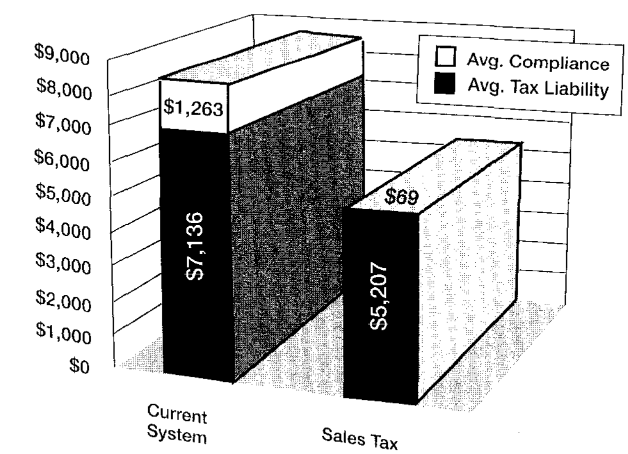
TAX FEATURES©

March 1996 Volume 40, Number 3

National Sales Tax Proposal Adds Variety to Debate Over Extent of Tax Reform

The flat tax and Uniform Savings Allowance (USA) tax bills in Congress must now share the reform spotlight with a new plan that goes far beyond what either of the earlier proposals recommend. The National Retail Sales Tax Act, introduced by Reps. Dan Schaefer (R-Colo.) and Billy Tauzin (R-La.), would replace the federal income tax system, the estate and gift tax, and all non-trust fund federal excise taxes with a sales tax on all goods and services. In an effort to offset the tax burden on low-income taxpayers, the Act proposes a refund mechanism (administered through the payroll tax system) based on officially designated poverty levels for families of different sizes. The tax rate is set at 15 percent.

Chart 1: Total Individual Tax Burden under Current Income Tax System and Proposed National Sales Tax System



Source: TaxFoundation.

In the Tax Foundation's latest *Special Report*, "Analysis and Summary of the National Retail Sales Tax of 1996," Senior Economist Arthur P. Hall demonstrates that if the Schaefer-Tauzin sales tax plan were the law in 1997, it could reduce the tax-related burden for the average taxpayer by an estimated 37 percent — from $8,399 to $5,276 (see *Chart 1*). The reduction results from both a lower tax bill and the taxpayer savings that would result from reducing the high paperwork cost associated with the income tax. The lower tax bill results from the fact that government expenditures would be subject to the sales tax under the Schaefer-Tauzin plan.

A major element of the tax reform debate in general, and the Schaefer-Tauzin sales tax plan in particular, is the desire for a more simple, less IRS-intrusive tax system, and the reduced compliance costs that would accompany such a system. Dr. Hall has estimated that the Schaefer-Tauzin sales tax plan could reduce the current cost of compliance — estimated to be about $157 million for the federal income tax — by about 95 percent, to $8.5 billion. The bill

Sales Tax *continued on page 6*

FRONT & CENTER

Democratic Principles of Tax Reform

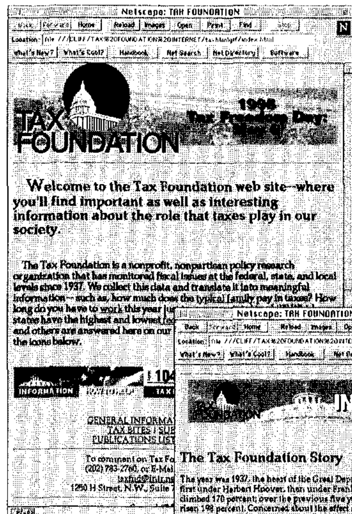
Rep. Jim McDermott (D-Washington)

4-5

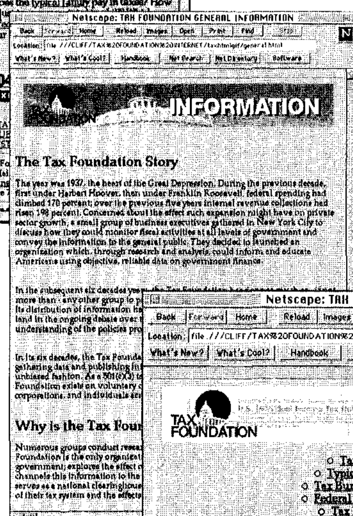
Tax Foundation Increases Outreach with New Web Site

http://www.taxfoundation.org marks the spot

Almost six decades ago, the Tax Foundation was launched to help disseminate useful information about tax and budget policy to the American public. Distributing publications and relying on media publicity were the Foundation's primary methods of educating the public, along with occasional conferences and seminars.

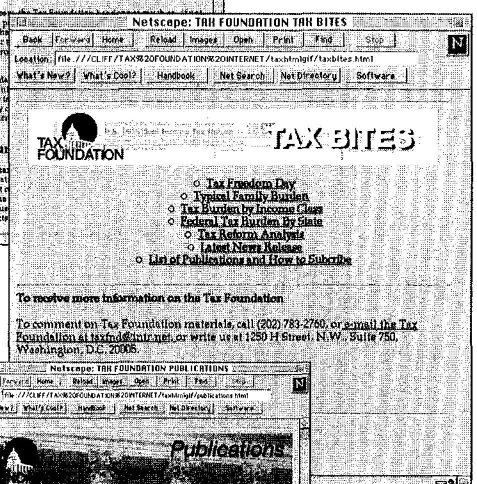


Now a new era in the organization's history has been launched, with the introduction of the Tax Foundation's first official World Wide Web site on the internet. While the internet—which links millions of personal computers around the globe—may in decades to come completely alter the way information is disseminated, for the time being it provides a practical supplement to the way the Tax Foundation publicizes its research.

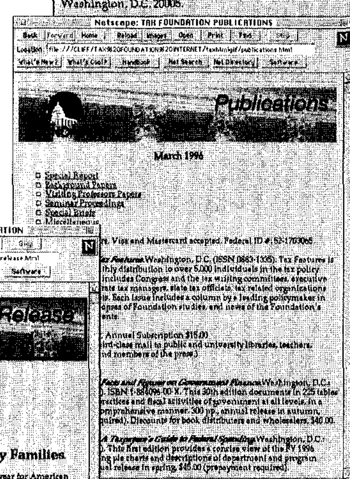


The address for the Tax Foundation's web site is http://www.taxfoundation.org. The Foundation's e-mail address is taxfnd@intr.net.

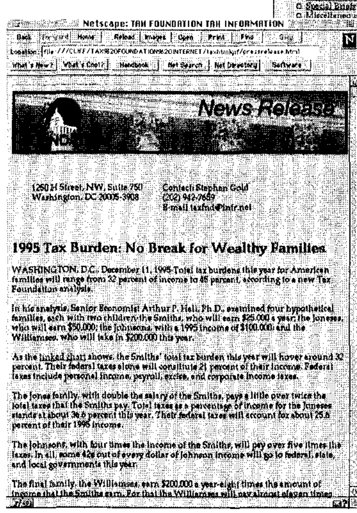
For those unfamiliar with this new area of communications, the World Wide Web is the graphic portion of the internet, which provides the public direct access to information directly over computer lines from public and private organizations. Organizations like the Tax Foundation establish "web sites," which have permanent addresses.



Visitors to the Foundation web site will immediately be greeted with last year's Tax Freedom Day, featured prominently on the home page. (The 1996 date will not be posted until after the annual April 15 Tax Freedom Day announcement.) A brief overview of who we are follows, and then the home page provides visitors with five options:



- An "Information" page, offering general information about the Tax Foundation for visitors who are not especially familiar with the organization. This includes sections explaining "The Tax Foundation Story," "Why is the Tax Foundation unique?", and "What does the Tax Foundation stand for?" This last section includes a listing of the Foundation's long-established "Principles of Taxation."



- A "How to Help" page, which provides visitors information about how contributions can be made to the Tax Foundation, to further our educational efforts. Included on this page is a list of publications which can be purchased individually or by subscription. (Each publication cite is "linked" to the "Publication List" page, discussed below.) The page also includes a form, which — for individuals interested in more information about how to help — can be filled out and e-mailed instantaneously to the Tax Foundation.
- A "Tax Bites" page, which provides the latest and most requested research data published by the Tax Foundation. For example, visitors can pull up the Foundation's latest information about such issues as Tax Freedom Day, the typical family's tax burden, and tax reform by simply clicking on a highlighted phrase. Each of these issues comes with its own set of colorful graphs, which can be instantly downloaded. The Tax Bites page also features recent news releases. For individuals seeking interesting and informative data on how taxes affect Americans, this particular site will prove very useful.
- A "Publications List" page, which features a comprehensive listing of the various Tax Foundation publications available, from Tax Features to Facts & Figures and Background Papers.
- A "Subscribers Page," which — though currently under construction — will allow people to subscribe to Special Reports and Tax Features. Then, instead of waiting for their delivery via the mail, the publications can be pulled right off the internet, as soon as they are published.

Federal Tax Compliance Costs Climb to $225 Billion

Tax Foundation Testifies Before House Ways & Means Committee

Complying with the federal tax system will cost the American public almost $225 billion in 1996, according to the Tax Foundation's latest analysis of the nation's tax compliance costs. The rules and regulations for the federal income tax alone account for about $157 billion of this.

In testimony before the House Ways & Means Committee on March 20, Tax Foundation Senior Economist Arthur P. Hall observed that the cost of compliance is tantamount to a tax surcharge on all taxpayers. "One way to comprehend the magnitude...of the $157 billion federal income tax surcharge is to imagine wantonly destroying every vehicle produced by Ford Motor Company and more than one-third of the vehicles produced by the Chrysler Corporation," Dr. Hall told members of the committee.

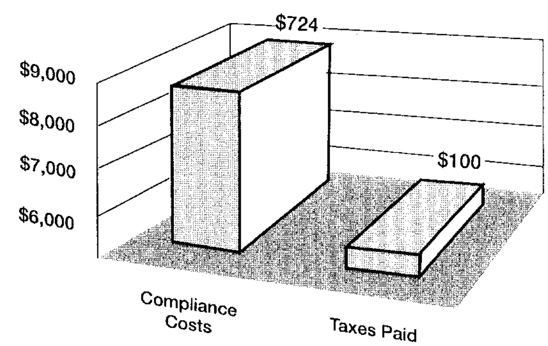
Dr. Hall's calculations show that two-thirds of the federal income tax compliance costs are borne by U.S. businesses. Relative to asset size, small corporations (those with up to $1 million in assets—90 percent of all U.S. corporations) bear a compliance cost burden at least 27 times greater than the largest U.S. corporations (those with $10 billion or more in assets). In fact, in 1992, the most recent year that complete income tax revenue data is available, small corporations on average had to pay at a minimum $724 in compliance costs for every $100 they paid in income tax. (Dr. Hall notes that, for those small corporations that did not end the year in the red, the figure was $377 for every $100.)

Dr. Hall told the Ways & Means Committee that replacing the federal income tax with any one of the three predominant alternative tax systems being discussed — the Armey-Shelby Flat Tax, the USA Tax System, or the National Retail Sales Tax Act — would dramatically reduce America's tax-related burden without necessarily sacrificing any federal revenue. (See chart.)

The flat tax that Rep. Dick Armey (R-Texas) and Sen. Richard Shelby (R-Ala.) introduced could reduce compliance costs by 94 percent, to $9.4 billion, according to Dr. Hall. The USA Tax System, sponsored by Sens. Sam Nunn (D-Ga.) and Pete Domenici (R-N.M.), could lower the surcharge by 77 percent, to $36 billion. And a national sales tax such as that introduced by Reps. Dan Schaefer (R-Colo.) and Billy Tauzin (R-La.) could reduce compliance costs by about 95 percent, to $8.2 billion — although the entire burden of this sum would fall on retail and service businesses. (As written, the Schaefer-Tauzin bill would compensate businesses for over half this cost.)

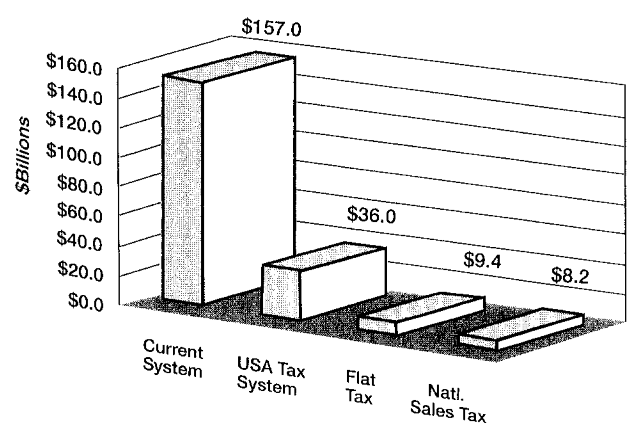
Dr. Hall's testimony detailed how compliance costs stem directly from the complexity of the tax system. For example, in 1954 the federal income tax law comprised 103 code sections. Today, that law comprises 698 code sections, a 578 percent increase. More to the point, the number of words detailing income tax laws has grown 370 percent since 1954, and the words detailing income tax regulations — which provide taxpayers with the guidance they need to calculate their taxable income — have grown 753 percent.

Average Costs of Tax Compliance for Small Business Relative to Taxes Paid, 1992



Source: Tax Foundation.

Projected Compliance Costs for Current Income Tax System and Alternative Tax Systems, 1996



Source: Tax Foundation.

On the other hand, the Flat Tax and the USA Tax eliminate the timing-related complexities associated with determining when to recognize business income and expenses for tax purposes. Both plans accomplish this by moving to a cashflow tax base, rather than an accrued income tax base. This simply calls for the totaling of business receipts and then subtracting off purchases from other businesses.

Democratic Principles of Tax Reform

By Rep. Jim McDermott (D-Wash.)

No one in Congress disputes the need to reform our current tax code and everyone wishes their taxes were simpler and fairer. But, Congress should not rush to replace our current tax system just because it's not perfect. We should not let perfection be the enemy of the good. Our tax system works reasonably well for most Americans. The changes which need to be made can be done without destroying the integrity of the system or resorting to election year politics.

The Chairman of the House Ways and Means Committee, Rep. Bill Archer (R-Texas), recently announced that the Committee will hold as many as 20 hearings this year on the need for fundamental tax reform. I hope these hearings will be conducted with bipartisan support and will be an unbiased evaluation of all the tax reform options and issues. Although I believe that there is a need for tax reform, irresponsibly trashing our current tax code by holding hearings which pander for political votes could be dangerous.

In debating tax reform, we need to remember that this is a debate about how to raise tax dollars and not aobut the appropriate size of government. Tax reform should not be misused as a vehicle to reduce the size of government by decreasing the revenue available to run the government.

Our current tax system has an 86 percent rate of voluntary compliance — a level that is the envy of the rest of the world. A congressionally created atmosphere of hostility toward the Internal Revenue Service is misguided and may lead to potentially harmful consequences. We must remember that for any new tax system to be successful, it will always need to rely upon the voluntary compliance of individuals and businesses.

Tearing our current tax code out by the roots and replacing it with a new system is easier said than done. Comprehensive reform of the tax code should aim to achieve a set of principles that will create a new tax system that is simpler to administer, fairer to all who pay taxes, and invigorates the economy. The four principles of tax reform that any new tax system must embrace are: revenue neutrality, distributional neutrality, simplicity, and competitiveness. Any new tax system that does not adhere to these four basic principles cannot honestly be called tax reform.

In debating tax reform, we need to remember that this is a debate about how to raise tax dollars and not aobut the appropriate size of government. As the ongoing budget negotiations have illustrated, Congress and the President cannot even agree on how to eliminate the deficit in seven years with our current revenue stream. Tax reform should not be misused as a vehicle to reduce the size of government by decreasing the revenue available to run the government.

Not one Republican tax reform proposal has been introduced that is revenue neutral. The Treasury Department estimates that Rep. Dick Armey's (R-Texas) flat tax would add $186 billion per year to the deficit. Congressional proposals calling for a national sales tax also offer false promises. A recent report released by Senator Connie Mack (R-Fla.), Chairman of the Joint Economic Committee, states that for a national retail sales tax to be revenue neutral, it would require, at a minimum, a tax rate of 32 percent to 50 percent on all goods and services. Senator Mack's report directly contradicts the claims of Members of the House of Representatives who have introduced National Retail Sales Tax legislation with a 15 percent tax rate on all goods and services.

Even more important than revenue neutrality for tax reform is distributional neutrality. Democrats firmly believe that each income

category should continue to pay the same proportion of taxes under any new tax system as they do now. The concerns about distribution of the tax burden are particularly sensitive since middle-income taxpayers have seen an 11 percent erosion on their real wages since the late 1970s. Any proposal which would exempt all interest, dividends and capital gains from taxation is unfair to working Americans who are supported by salaries, wages, or tips. Even Senator Bob Dole (R-Kan.) has stated that tax reform will not be used as a vehicle to redistribute the tax burden among income classes.

The third required element of any new tax system is simplicit. Although many of the tax reform proposals embrace simplicity, they do so by eliminating all of the personal adjustments, deductions and credits currently in the tax code. Furthermore, under a flat tax, all simplicity vanishes unless the states adopt a similar flat tax. The unlikeliness of this happening means that taxpayers will still have all of the complications of the current federal income tax to deal with, plus two new federal taxes: the flat tax on individuals and the flat tax on businesses.

Democrats firmly believe that each income category should continue to pay the same proportion of taxes under any new tax system as they do now. Any proposal which would exempt all interest, dividends and capital gains from taxation is unfair to working Americans who are supported by salaries, wages, or tips.

Adoption of any new tax system will require a set of complicated transition rules in order to provide relief for both individuals and businesses. To avoid huge losses, individual taxpayers will need transition relief for home mortgage interest, which may no longer be deductible, and businesses will need transition relief to deal with the trillions of dollars of unused tax credits and loss carryforwards. In addition to being very costly, transition rules by their nature are anything but simple. Inadequate transition relief for any one segment of the economy has the potential to doom any effort to adopt a new tax system.

The final principle that any new tax system must embrace is competitiveness. Our current tax system does nothing to enhance the competitiveness of American companies in global markets. Under the rules of the World Trade Organization, only indirect taxes, like a value-added tax (VAT), can be adjusted at the border. As the U.S. economy becomes more closely linked with the global marketplace, only a border-adjustable tax system will promote the competitiveness of American companies and invigorate American exports.

Under a flat tax, U.S. exports would be disadvantaged overseas because they would bear the costs of the flat tax in addition to the foreign VAT. Some proponents of the flat tax have argued that the currency exchange rates would adjust themselves to avoid disadvantaging U.S. products. Whether or not this would in fact occur is anyone's guess, but in my view, it is not good public policy because it assumes a decline in the value of the dollar.

Real tax reform is possible, but it will involve a lot of hard choices and not political gimmicks. I am confident that if Congress embraces the four essential principles of tax reform—revenue neutrality, distributional neutrality, simplicity, and competitiveness—we can all work together to successfully reform the nation's tax system in a way which is beneficial to both taxpayers and our nation's economy.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed in these columns are not necessarily those of the Tax Foundation.*

What Generates Goodwill? New Study Examines Role of Advertising, Research and Development

A newly published Ernst & Young/ Tax Foundation Visiting Professor study concludes that advertising and research expenditures contribute significantly to goodwill of companies acquired in purchase transactions. For acquired firms that do not spend on these items, however, the source of goodwill remains unknown.

In their study—titled "What Generates Goodwill?"—Professors Frances L. Ayres of the University of Oklahoma and Betty R. Jackson of the University of Colorado examine the relation between purchased goodwill and acquired firms' expenditures on advertising and research and development. The authors recognize that the problem with goodwill, from both a tax and a financial accounting perspective, stems largely from the fact that the transactions leading to recognition of goodwill are limited to those in which an existing company is purchased in its entirety. From a tax perspective, the issues relate to whether the current rules regarding amortization of goodwill achieve an economically efficient result as measured by tax rates on goodwill and other intangibles relative to rates on other assets. Determination of the appropriate tax treatment depends in-

Goodwill *continued on page 7*

Sales Tax

Continued from page 1

would reimburse businesses for over 50 percent of their compliance costs.

The estimated 1997 sales tax base under the Schaefer-Tauzin bill amounts to $6.4 trillion. With this tax base, a 13.82 percent sales tax rate could replace the revenue generated by the individual and corporate income tax, the estate and gift tax, and all non-trust fund excise taxes, assuming that there was no refund mechanism associated with the sales tax system. However, the Schaefer-Tauzin includes a refund mechanism that increases the revenue-neutral sales tax rate to 16.42 percent. Reps. Schaefer and Tauzin chose a flat rate of 15 percent.

The national sales tax proposal provides for a rebate for individuals and families, calculated by multiplying the sales tax rate by the official poverty level for families of different sizes. For example, a family of four would earn a rebate of $2,410 — the 15% tax rate multiplied by the estimated $16,070 poverty level for a family of rour. In all, wage earners would receive a total refund of an estimated $153 billion if the plan were in effect in 1997.

The intent of the Family Consumption Refund is to generate a progressive distribution of the sales tax burden. *Chart 2* demonstrates the result. The Schaefer-Tauzin sales tax plan has a progressive tax burden distribution, but it is far more proportional than the distribution of the current system, which mainly represents the income tax system.

The most striking aspect of *Chart 2*, however, is the reduction in the individual tax burden under the sales tax system. The key reason for this reduction is the fact that the tax on government expenditures accounts for almost 20 percent of the revenue generated by the sales tax plan. This result implies that the purchasing power of the government is reduced by 20 percent. If

Sales Tax *continued on page 8*

Chart 2: Comparison of Total and Average Tax Burdens Under Current Tax System Versus Schaefer-Tauzin National Retail Sales Tax Plan

Adjusted Gross Income	Current System: Total Tax Burden* ($Million)	Sales Tax System: Total Tax Burden** ($Million)	Current System: Average Tax Burden	Sales Tax System: Average Tax Burden	Current System: Average Tax Rate	Sales Tax System: Average Tax Rate
$1 under $25,000	$60,519	$61,422	$939	$953	6.7%	6.7%
$25,000 under $50,000	175,386	141,544	5,616	4,532	13.0	9.6
$50,000 under $75,000	162,092	129,475	10,445	8,343	14.2	10.3
$75,000 under $100,000	106,472	78,305	17,144	12,609	16.5	10.7
$100,000 under $200,000	131,636	94,290	29,513	21,140	18.3	11.4
$200,000 or more	242,046	143,099	174,440	103,130	27.5	12.9
All Taxpayers	$886,847	$647,054	$7,136	$5,207	15.9%	10.4%

* Includes income taxes, estate and gift tax, non-trust fund excise taxes, capital/labor split distribution of business tax burden.
** Includes tax liability net of Family Consumption Refund. Government consumption expenditures account for $162,958 million in sales tax revenue.
Source: Tax Foundation.

Goodwill

Continued from page 6

trinsically upon the tax treatment given to the expenditures that create intangibles. From a financial accounting perspective the issues relate to determination of an appropriate amortization period for goodwill.

Using mergers from the 1975-1992 period, the authors examined the relationship between purchased goodwill and preacquisition expenditures by the purchased firms on advertising and research and development. Intangible assets generally are ignored during development, say Professors Ayres and Jackson, because the conservatism bias reflected in financial reporting, coupled with a desire to find tax write-offs, provides little incentive for a company to try to value or report in any way self-developed intangibles. This bias causes management to be largely unaware of the level and value of a company's intangible assets until it becomes involved in a potential business combination. Goodwill often is attributed to a variety of factors, including location, management quality, and proprietary knowledge, which may or may not relate to costs that are typically expensed for tax purposes.

The results of this research strongly suggest that advertising and R&D expenditures are a significant source of purchased goodwill. The authors also found many firms that report no expenditures on either advertising or R&D report significant goodwill.

From a tax perspective the findings support the assumptions that all costs that create and maintain intangible assets are tax deductible as incurred, at least for some firms. It may be appropriate to examine the source of purchased goodwill in determining the tax treatment to the purchasing firm. Goodwill generated by other expenditures should be evaluated and perhaps treated differently.

The results also indicate that capitalization of advertising and R&D may be theoretically superior to existing accounting practices. The issue then becomes one of determining the appropriate amortization period. A third issue, observe the authors, is whether this suggests alternative tax treatments of advertising or R&E.

FOUNDATION MESSAGE

Riding the Tax Reform Fence

J.D. Foster
Executive Director
& Chief Economist

Assorted groups are deciding at this early date whether they favor tax reform or not. This, before the year's hearings in the tax writing committees have occurred, before any proposal has enough flesh on the bones to assess its effects even provisionally. With so little information available, deciding yea or nay on tax reform is either Medal of Honor courageous or very premature.

This rush to judgement is all the more amazing when positions are developed based on transition issues about which next to nothing has been said by most tax reform proponents.

Most, though certainly not all, of the current crop of tax reformers barely pay lip service to transition. This is a mistake. Transition is important politically and economically. Even if the basic outline of the current system is maintained and reform occurs within that framework, transition will still be vital to thousands of taxpayers. If the new system is radically different, the transition will likely be that much more complicated and that much more important.

Many opponents of tax reform have latched on to the absence of transition rules as their cause celebré. They choose to characterize the absence of transition as opposition to transition by the flat tax's advocates. Flat tax advocates have said little about transition for two main reasons—they're still trying to explain the benefits of the basic system, and they don't have the expertise to identify problems and solutions. Even in the case of the USA Tax proposal, which makes an honest attempt to deal with important transition issues, the imperfections in the suggested transition rules and the absence of others are deemed by some to be sufficient reasons to oppose the plan.

A lack of proper transition rules could impose great and capricious hardships on both individual and business taxpayers. Of course, these rules are often expensive, but to the greatest extent possible taxpayers should be protected against significant and unexpected tax burdens based on previous transactions. It would be wrong to penalize one group of taxpayers solely on the basis of prior transactions.

Some transition rules are fairly easy, and cost less than you might expect. Others are going to be a real problem. An example of the former is the interest expense on previously incurred debt, whether issued by a business or individual. Even with a flat tax that prospectively exempts interest income and denies a deduction for interest expense, is there really any question that home mortgage or business interest expense won't be grandfathered? Of course not. Fortunately, as interest income on previously issued debt would probably continue to be taxable even under a flat tax, the revenue costs of this transition would probably be slight.

Likewise, transition relief will be available to taxpayers who haven't yet taken all the depreciation available on existing plant and equipment. Past tax reforms have allowed taxpayers to continue to use the system in place when the asset was purchased. Is there any reason to believe businesses won't be able to continue to take these deductions on existing assets? Of course not. And yet, opponents of the flat tax in particular, and tax reform in general, have used the lack of explicit transition in some proposals to scare groups of taxpayers into opposition to tax reform overall.

There is a strong tendency, particularly among the experts who make their living sorting through the details, to focus on the details at the expense of the big picture. The devil is in the details, but it's too early for an inquisition. Economic growth has been stunted for decades. Our national saving rate is low. We must invest more and more wisely to remain competitive in the world economy. Our tax system costs an unreasonable amount to administer and comply with. A sensible tax reform bill won't solve these problems, but there may be no other single change in public policy that can have a more beneficial effect sooner.

TAX FEATURES

Tax Features (ISSN 0883-1335) is published monthly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. Annual subscriptions to the newsletter are $15.

Tax Foundation
(202) 783-2760 Tel
(202) 942-7675 Fax

Sales Tax

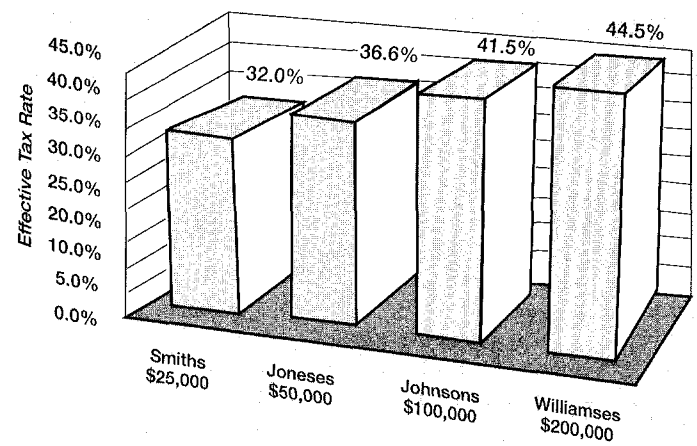
Continued from page 6

taxpayers became dissatisfied by the resulting reduction in government "services" and desired to hold government purchasing power at current levels, the result would be like exempting the government sector from taxation. Such an outcome would mean a 25 percent increase in the sales tax rate to 18.8 percent .

The current system includes the burdens of the individual and corporate income taxes, estates and gift taxes, and non-trust fund excise taxes. In order to make distributional comparisons between the income tax-dominated current system and the sales tax, Dr. Hall had sales tax burden calculations start with taxpayers' income. Rather than estimating consumption expenditures directly, income that would be used for consumption was estimated instead. The tacit assumption underlying this estimation approach is that taxpayers will use all of their income for consumption once they have put some of their income into savings and made certain untaxed payments. The primary list of untaxed payments include: federal payroll taxes, state and local income taxes, state and local property taxes, mortgage interest payments, and charitable contributions. (Mortgage interest payments and charitable contributions are explicitly left untaxed by the Schaefer-Tauzin legislation. Home purchases are subject to the sales tax. But the legislation specifies that the tax on home purchases may be amortized over a 30-year period.)

TAX BITE

Effective Total Tax Rates for Four Typical American Families, 1995



Source: Tax Foundation.

Tax Foundation
1250 H Street, NW
Suite 750
Washington, DC 20005-3908

First Class
U.S. Postage
PAID
Washington, DC
Permit No. 5229

Please Note:
We use multiple mailing lists to distribute our publications and it's not always possible to avoid duplications.
If you receive an extra, please forward it to an interested colleague.