A VALUE ADDED TAX IN THE UNITED STATES: WHAT IT COULD MEAN FOR SMALL BUSINESS OWNERS

JEREMY M. PANNO*

The current state of the economy has led many experts to doubt the current method of generating revenue through taxing income. Recent tax reform discussions have considered the potential implementation of a Value Added Tax ("VAT") as a successor. This Note focuses on the effect a VAT may have on a small business owner. This Note begins with an overview of the current state of the economy and the present fiscal imbalance facing the United States. Specific consideration is given to the United States' budget deficit, budget debt, government spending, future tax revenue stream and international trade imbalances. Next, this Note details the disadvantages of the current Internal Revenue Code ("IRC"). This Note then examines the VAT as a proposed solution to the problems facing the United States. This is followed by a detailed analysis of the different styles of a VAT along with the various methods of computation of tax liability under each style. After this, this Note examines the potential preferential treatment of small businesses under a VAT with the conclusion being that the effect on small business owners will be dependent on the style of VAT implemented, the computation method chosen, and whether special treatment will be afforded to small business owners.

I. THE CURRENT STATE OF THE ECONOMY

The United States continues to be bogged down by the lingering effects of one of the deepest recession in decades.[1] The present-day "Great Recession" has exacerbated the preexisting problems that the United States

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* Juris Doctor, The Ohio State University, Moritz College of Law, expected 2012.

[1] Alan J. Auerbach & William G. Gale, *The Economic Crisis and the Fiscal Crisis: 2009 and Beyond,* TAX POLICY CTR. (2009), http://www.taxpolicycenter.org/uploadedPDF/411843_economic_crisis.pdf (Alan J. Auerbach is Robert D. Burch Professor of Economics and Law and Director of the Burch Center for Tax Policy and Public Finance at the University of California, Berkeley, and a research associate at the National Bureau of Economic Research. William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution and Co-Director of the Urban-Brookings Tax Policy Center).

faced with regard to its long-term federal budgetary outlook.[2] The recent drop in economic activity,[3] "compounded by continuing mortgage defaults,[4] a historic decline in housing prices,[5] falling equity values,[6] illiquid credit markets,[7] declining consumer confidence,[8] and enormous and rapid job losses . . . has shifted" [9] government attention away from the problem of fiscal imbalance.[10]

A. *Budget Deficit*

Recent budget deficits have reached unprecedented levels.[11] In 2010, the number was estimated to be $1.171 trillion dollars.[12] The 2011 fiscal

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[2] Reuven S. Avi-Yonah, *Symposium on Designing a Federal VAT: Part I: Summary and Recommendations*, 63 TAX L. REV. 285, 286 (2010) (Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and Director of the International Tax LLM program at the University of Michigan).

[3] *See* CONGRESSIONAL BUDGET OFFICE, POLICY OPTIONS FOR THE HOUSING AND FINANCIAL MARKETS, CHAPTER 2: THE CURRENT ECONOMIC SITUATION (Apr. 2008), *available at* http://www.cbo.gov/ftpdocs/90xx/doc9078/Chapter2.4.1.shtml.

[4] *See* Felix Salmon, *How Mortgage Default Could Get Much Worse*, REUTERS (June 8, 2010, 3:19 PM), http://blogs.reuters.com/felix-salmon/2010/06/08/how-mortgage-default-could-get-much-worse.

[5] *See* Press Release, Standard & Poor's/Case-Shiller Home Price Indices, U.S. Home Prices Weaken Further as Six Cities Make New Lows According to S&P/Chase-Shiller Home Price Indices (Dec. 28, 2010), http://www.realestateindustrynews.com/october-2010-case-shiller.pdf. (the S&P/Case-Shiller Home Price Indices are calculated monthly using a three month moving average and published with a two month lag).

[6] *See* Stephanie Armour, *Falling Home Values Drain Equity and Safety Nets*, USA TODAY, Mar. 26, 2010, http://www.usatoday.com/money/economy/housing/2010-03-25-1Aunderwater25_CV_N.htm.

[7] *See* Steve Matthews & Vivien Lou Chen, *Fed May Keep Rates Low as Tight Credit Impedes Small Businesses*, BLOOMBERG BUSINESSWEEK (Apr. 26, 2010, 12:31AM), http://www.businessweek.com/news/2010-04-26/fed-may-keep-rates-low-as-tight-credit-impedes-small-businesses.html.

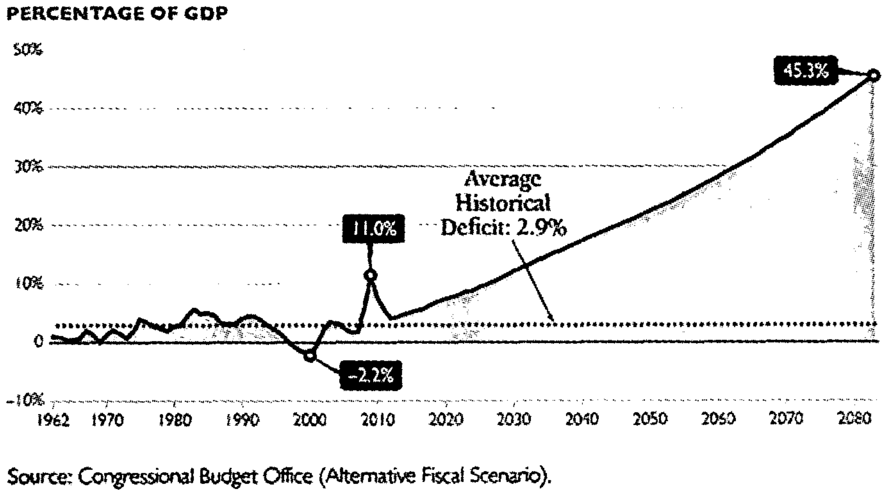
[8] *See* Wanfeng Zhou, *Consumer Confidence Slips as Home Prices Decline*, REUTERS (Dec. 28, 2010, 6:48 PM), http://www.reuters.com/article/idUSTRE6BM24V20101228.

[9] BUREAU OF LABOR STAT., U.S. DEPT. OF LABOR, NO. USDL-11-0271, ECONOMIC NEWS RELEASE: EMPLOYMENT SITUATION SUMMARY (Mar. 4, 2011), *available at* http://www.bls.gov/news.release/empsit.nr0.htm (stating that the unemployment rate for December 2010 was 9.4%).

[10] Auerbach & Gale, *supra* note 1.

[11] *See* OFFICE OF MGMT. & BUDGET, A NEW ERA OF RESPONSIBILITY: RENEWING AMERICA'S PROMISE (2009); *see also* Auerbach & Gale, *supra* note 1.
CBO's baseline projects 2009 revenues of 16.5% of GDP and expenditures of 24.9% of GDP. Incorporating the stimulus package, these percentages would be 16.1%and 25.7%, respectively. This represents the highest expenditure share of GDP since 1945, and a revenue share that has been lower only once since 1950.

year budget deficit is estimated to be $1.267 trillion dollars.[13] If proper changes are not made, the future will be even worse.[14] The Congressional Budget Office ("CBO") predicts that if entitlements are not reformed that spending on Social Security, Medicare and Medicaid could drive budget deficits to unsustainable levels.[15]



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These large budget deficits would have a ripple effect across the economy. The CBO predicts that these deficits would "reduce national saving, leading to higher interest rates, more borrowing from abroad and less domestic investment—which in turn would lower income growth in the

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The gap between revenues and expenditures, the deficit, will be the highest as a share of GDP since the end of World War II. *Id.*

[12] OFFICE OF MGMT. & BUDGET, *supra* note 11.

[13] OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE U.S. GOVERNMENT: FISCAL YEAR 2011 (2010).

[14] Avi-Yonah, *supra* note 2, at 286 (citing Auerbach & Gale, *supra* note 1).

> [It has been] estimated that without any new spending programs being enacted, the United States [will face] deficits of over $1 trillion in each of the next ten years . . . Over the longer term, [it is estimated that] the United States [will face] deficits (in 2009 dollar terms) of $1 to $1.3 trillion each year, or seven to nine percent of GDP.

Id.

[15] *See* CONG. BUDGET OFFICE, Pub. No. 4130, THE LONG-TERM BUDGET OUTLOOK (2010), http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf.

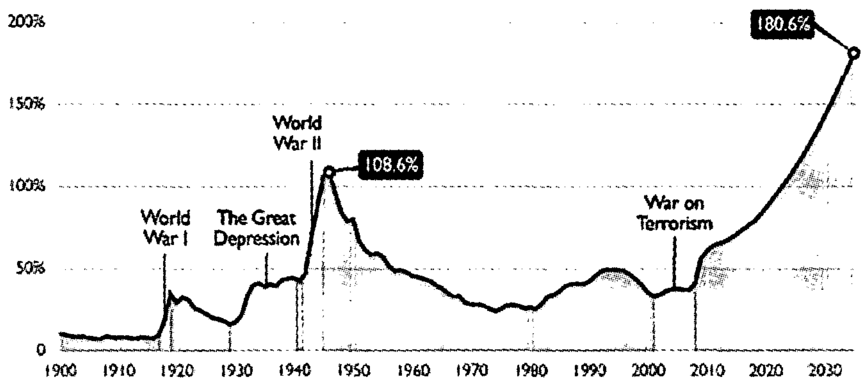
[16] *2010 Budget Chart Book: Federal Budget Deficits Will Reach Levels Never Seen Before in the U.S.*, THE HERITAGE FOUND., http://www.heritage.org/BudgetChartbook/federal-budget-deficits (last visited Mar. 28, 2011).

United States."[17] The CBO predicts that another effect of this growing debt would be a reduction in the United States' "ability to respond to economic downturns and other challenges."[18] Which would, over time, "increase the probability of a fiscal crisis in which investors would lose confidence in the government's ability to manage its budget, and [would lead to a situation in which] the government would be forced to pay much more to borrow money."[19]

B. *Budget Debt*

The federal budget deficit only reflects the amount that government expenditures exceed tax revenues in a given year.[20] The more daunting number with regard to the U.S. economy is the U.S. budget debt.[21]

DEBT AS A PERCENTAGE OF GDP



Source: Heritage Foundation compilations of data from U.S. Department of the Treasury, Institute for the Measurement of Worth (Alternative Fiscal Scenario), Congressional Budget Office, and White House Office of Management and Budget

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[17] CONG. BUDGET OFFICE, *supra* note 15, at XI.
[18] *Id.*
[19] *Id.*
[20] Definition of *Federal Deficit*, INVESTORWORDS.COM, http://www.investorwords.com/1899/Federal_Deficit.html (last visited Mar. 28, 2011).
[21] *See Budget* Deficit, BROOKINGS INST., http://www.brookings.edu/topics/budget-deficit.aspx (In-Brief Section) (last visited Mar. 31, 2011); *see also* Rudolph G. Penner, *Symposium on Designing a Federal VAT: Part I: Do We Need a VAT to Solve Our Long-Run Budget Problems?*, 63 TAX L. REV. 301 (2010) (Rudolph G. Penner is the Arjay and Frances Miller Chair in Public Policy at the Urban Institute).

According to the U.S. Department of Treasury on January 14, 2011, the "total public debt outstanding" was $14,007,943,536,871.15.[23] The United States has more public debt outstanding than any other country.[24] The United States is able to borrow such a significant amount because "foreign lenders have been willing to hold US dollar denominated debt instruments [since] they view the dollar as the world's reserve currency."[25] However, a simple switch to a different currency for reserves, or a reduction in its sovereign credit rating, could potentially spell the end for the United States in terms of its ability to have such an alarming amount of public debt with little or no effect on its cost of capital. Prior to the recent European financial crisis, the European Union's currency, the Euro, was considered to be a potential successor to the dollar as the world's favorite reserve currency.[26]

The total public debt outstanding consists of debt held by the public and intergovernmental holdings.[27] On January 14, 2011, the Treasury estimated the amount of "debt held by the public"[28] as $9,377,350,492,041.16.[29] The remaining amount of total public debt outstanding, consisting of intra-

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[22] *2010 Budget Chart Book: National Debt Set to Skyrocket*, THE HERITAGE FOUND., http://www.heritage.org/BudgetChartbook/national-debt-skyrocket (last visited Mar. 28, 2011).
[23] Bureau of the Pub. Debt, U.S. Dep't of Treasury, *The Debt to the Penny and Who Holds It*, TREASURYDIRECT, http://www.treasurydirect.gov/NP/BPDLogin?application=np (enter Jan. 14, 2011; follow "Find History" hyperlink) (last visited Mar. 28, 2011).
[24] *The World Factbook Country*, CENT. INTELLIGENCE AGENCY, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2079rank.html?countryName=United%20States&countryCode=us&regionCode=na&rank=1#us (last visited Mar. 28, 2011).
[25] *The World* Factbook, CENT. INTELLIGENCE AGENCY, https://www.cia.gov/library/publications/the-world-factbook/geos/us.html (last updated Mar. 23, 2011).
[26] Constance Faivre d'Arcier, *The Future Reserve Currency is the Euro: Strategist*, CNBC (Jan. 14, 2010 4:06 AM), http://www.cnbc.com/id/34855822.
[27] Bureau of the Pub. Debt, *supra* note 23.
[28] *The World Factbook*, *supra* note 25 The Treasury considers "debt held by the public," to include "all debt instruments issued by the Treasury that are owned by non-US Government entities." This number consists of Treasury debt held by foreign entities and excludes both debt issued by individual U.S. states and intra-governmental debt.
[29] Bureau of the Pub. Debt, *supra* note 23.

governmental holdings,[30] was estimated by the Treasury Department as $4,630,593,044,829.99.[31]

In order to understand the magnitude of these numbers it is essential to view them in relation to the amount of current-dollar Gross Domestic Product ("GDP"). "Current-dollar GDP—the market value of the nation's output of goods and services—in the third quarter 2010 was estimated to be $14,745.1 billion."[32] The total public debt outstanding in 2010 according to the numbers above represents over ninety-five percent of the United States annual GDP.[33] The amount of debt held by the public represents over 63.5% of the United States annual GDP.[34] The amount of intra-governmental holdings of debt represents over 31.4% of the United States annual GDP.[35]

C. *Increased Government Spending*

The United States Federal Budget for Fiscal Year 2010, titled "*A New Era of Responsibility: Renewing America's Promise*" is a spending request by President Barack Obama to fund government operations for October 2009–September 2010.[36] President Obama's budget for 2010 totaled $3.552 trillion.[37] Given the estimated fiscal year 2009 budget of $3.107 trillion dollars, this marks an increase in government spending of $445

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[30] *The World Factbook*, *supra* note 25 ("Intra-governmental debt consists of Treasury borrowings from surpluses in the trusts for Federal Social Security, Federal Employees, Hospital Insurance (Medicare and Medicaid), Disability and Unemployment, and several other smaller trusts.").

[31] Bureau of the Pub. Debt. *supra* note 23.

[32] News Release, Bureau of Econ. Analysis, Gross Domestic Product: Third Quarter 2010 (Third Estimate) (Dec. 22, 2010), http://www.bea.gov/newsreleases/national/gdp/2010/pdf/gdp3q10_3rd.pdf.

[33] Total Public Debt Outstanding/United States Current Dollar GDP=14,007,943,536,871.15/14,745,100,000,000=0.950006682685852. *See* Bureau of the Pub. Debt, U.S. Dep't of Treasury, *supra* note 23. For Total Public Debt Outstanding *see* News Release, Bureau of Econ. Analysis, *supra* note 32, for United States Current Dollar GDP.

[34] Debt Held by the Public/United States Current Dollar GDP= 9,377,350,492,041.16/14,745,100,000,000=0.635963845076748). For Debt Held by the public see Bureau of the Pub. Debt, U.S. Dep't of Treasury *supra* note 23. For United States Current Dollar GDP see News Release, Bureau of Econ. Analysis, *supra* note 32.

[35] Intra-governmental Holdings of Debt/United States Current Dollar GDP=4,630,593,044,829.99/14,745,100,000,000=0.314042837609103.For Intra-governmental Holdings of Debt see Bureau of the Pub. Debt, U.S. Dep't of Treasury, *supra* note 23; for United States Current Dollar GDP see News Release, Bureau of Econ. Analysis, *supra* note 32.

[36] OFFICE OF MGMT. & BUDGET, *supra* note 11.

[37] *Id.*

billion.[38] This trend of increased government spending will continue as the federal budget for fiscal year 2011 is estimated at $3.834 trillion, which represents an increase of $282 billion.[39]

There are three programs on the spending side, which are to blame: Social Security, Medicare and Medicaid.[40] Prior to the Obama Administration's recent increase in government spending related to the recession, these three programs constituted almost half of non-interest government spending and were climbing faster than tax revenues.[41] Further, the CBO projects that Social Security, Medicare and Medicaid spending will continue to soar as millions of baby boomers retire and health care costs climb.[42] It is estimated that Medicaid spending will more than double, while Medicare spending will more than triple.[43] Collectively, government spending on the three entitlement programs—Social Security, Medicare and Medicaid—is estimated to more than double by 2050.[44]

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[38] United States Federal Government Budget 2010- United States Federal Government Budget 2009 = $3.552 trillion dollars- $3.107 dollars= $445 billion dollars. For United States Federal Government Budget 2010, see OFFICE OF MGMT & BUDGET, *supra* note 11. *See also* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2009 (2010).

[39] United States Federal Government Budget 2011- United States Federal Government Budget 2010 = $3.834 trillion dollars- $3.552 dollars= $228 billion dollars. For United States Federal Government Budget 2011 see OFFICE OF MGMT. & BUDGET, *supra* note 13. For United States Federal Government Budget 2010 see OFFICE OF MGMT. AND BUDGET, *supra* note 11.

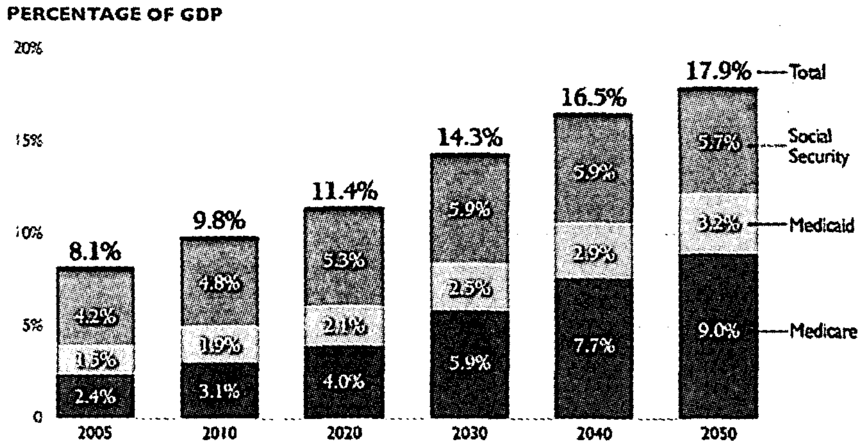
[40] Penner, *supra* note 21, at 301 (citing Leonard E. Burman, *A Blueprint for Tax Reform and Health Reform*, 28 VA. TAX REV. 287, 294 (2008)).

[41] *Id.* (citing MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 10 fig.1.1. (2008)).

[42] *See* CONG. BUDGET OFFICE, *supra* note 15.

[43] *Id.*

[44] *Id.*



Source: Congressional Budget Office.

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While recent spikes in healthcare costs have increased Medicare and Medicaid expenditures, Social Security expenditures will be a main concern for the future. Despite Social Security spending remaining relatively constant between 1984 and 2008, only fluctuating between 4.2% and 4.6% of GDP, the approaching wave of retiring baby boomers will cause Social Security spending to increase significantly in relation to its historical levels.[46]

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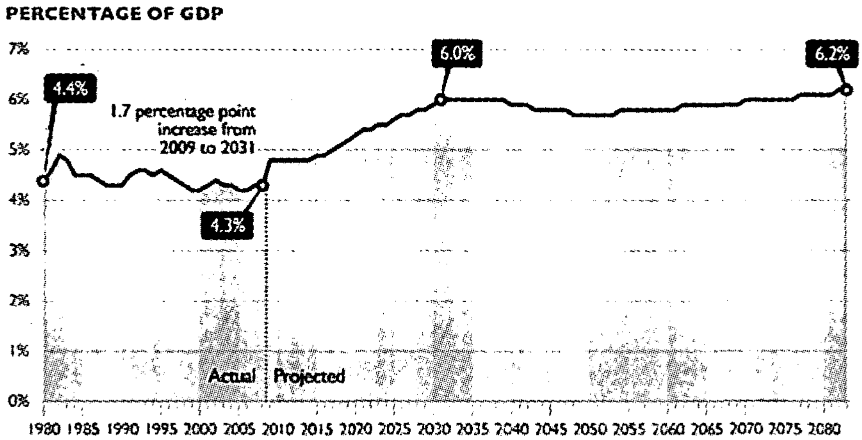
[45] *2010 Budget Chart Book*, THE HERITAGE FOUND., 35 (2010), http://www.heritage.org/budgetchartbook/PDF/All-Budget-chart-book-2010.pdf.
[46] *See* CONG. BUDGET OFFICE, *supra* note 15.



Source: Congressional Budget Office.

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In fiscal year 2010, $695 billion is allocated for Social Security[48] while this number is estimated to increase in fiscal year 2011 to $730 billion.[49] This represents over 19.5% of President Obama's budget for 2010.[50] In relation, to current-dollar GDP in third quarter 2010, that number represents over 4.7%.[51] In fiscal year 2010, $453 billion is allocated for Medicare[52] while this number is estimated to increase in fiscal year 2011 to $492 billion.[53] This represents over 12.75% of President Obama's budget for 2010.[54] In relation to current-dollar GDP in third quarter 2010, that number

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[47] *2010 Budget Chart Book: Social Security Spending Soon to Rise Rapidly*, THE HERITAGE FOUND. (2010), http://www.heritage.org/BudgetChartBook/social-security-spending.

[48] OFFICE OF MGMT. & BUDGET, *supra* note 11.

[49] OFFICE OF MGMT. & BUDGET, *supra* note 13.

[50] Social Security Expenditures Fiscal Year 2010/ United States Federal Government Budget 2010= 695,000,000,000/3,552,000,000,000=0.195664414414414; *see* OFFICE OF MGMT & BUDGET, *supra* note 11, for Social Security Expenditures Fiscal Year 2010 and United States Federal Government Budget.

[51] Social Security Expenditures Fiscal Year 2010/2010 United States Current Dollar GDP= 695,000,000,000/14,745,100,000,000=0.047134302242779; *see* OFFICE OF MGMT. & BUDGET, *supra* note 11, for Social Security Expenditures Fiscal Year 2010; *see* News Release, Bureau of Econ. Analysis, *supra* note 32, for 2010 United States Current Dollar GDP.

[52] OFFICE OF MGMT. & BUDGET, *supra* note 11.

[53] OFFICE OF MGMT. & BUDGET, *supra* note 13.

[54] *See* OFFICE OF MGMT. & BUDGET, *supra* note 11. Medicare Expenditures Fiscal Year 2010/ United States Federal Government Budget 2010=453,000,000,000/3,552,000,000,000=0.127533783783784.

represents over three percent.[55] In fiscal year 2010, $290 billion is allocated for Medicaid[56] while this number is estimated to decrease in fiscal year 2011 to $271 billion.[57] This represents over eight percent of President Obama's budget for fiscal year 2010.[58] In relation, to current-dollar GDP in third quarter 2010, that number almost represents two percent.[59]

When the spending amounts for the three programs are considered in the aggregate they combined represent almost 40.5% of President Obama's budget for fiscal year 2010.[60] In relation to current-dollar GDP in third quarter 2010 this represents more than 9.75%.[61] If spending on these three entitlement programs is not reformed, the expenditures could represent as much as 18.7% of GDP by 2055.[62]

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55 Medicare Expenditures Fiscal Year 2010/2010 United States Current Dollar GDP= 453,000,000,000/14,745,100,000,000= 0.030722070382703. *See* OFFICE OF MGMT. & BUDGET, *supra* note 11; News Release, Bureau of Econ. Analysis, *supra* note 32 (2010 United States Current Dollar GDP).

56 OFFICE OF MGMT. & BUDGET, *supra* note 11.

57 OFFICE OF MGMT. & BUDGET, *supra* note 13.

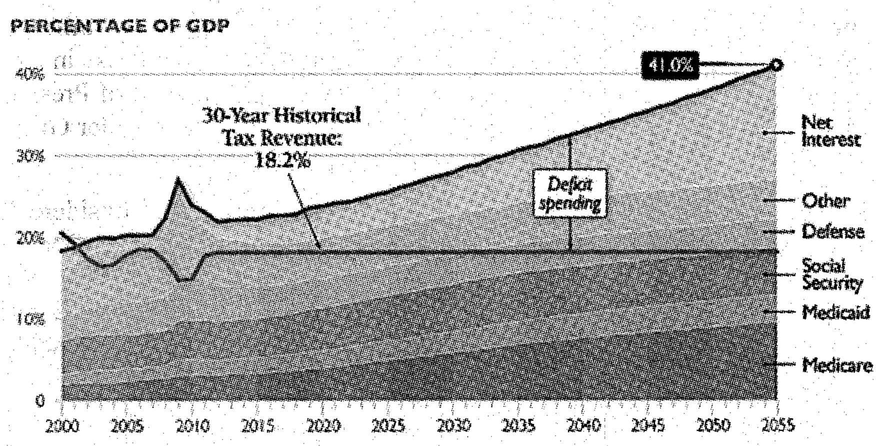
58 Medicaid Expenditures Fiscal Year 2010/ United States Federal Government Budget 2010= 290,000,000,000/3,552,000,000,000= 0.081644144144144. *See* OFFICE OF MGMT. & BUDGET, *supra* note 11. (Medicaid Expenditures Fiscal Year 2010 and United States Federal Government Budget).

59 Medicaid Expenditures Fiscal Year 2010/2010 United States Current Dollar GDP= 290,000,000,000/14,745,100,000,000= 0.0196675505761240. *See* OFFICE OF MGMT. & BUDGET, *supra* note 11 (Medicaid Expenditures Fiscal Year 2010); News Release, Bureau of Econ. Analysis, *supra* note 32 (2010 United States Current Dollar GDP).

60 (Social Security Expenditures Fiscal Year 2010 + Medicare Expenditures Fiscal 2010 + Medicaid Expenditures Fiscal Year 2010)/United States Federal Government Budget 2010= 1,438,000,000,000/3,552,000,000,000= 0.404842342342342. *See* OFFICE OF MGMT. & BUDGET, *supra* note 11.

61 (Social Security Expenditures Fiscal Year 2010 + Medicare Expenditures Fiscal 2010 + Medicaid Expenditures Fiscal Year 2010)/2010 United States Current Dollar GDP= 1,438,000,000,000/14,745,100,000,000=0.097523923201606. *See* OFFICE OF MGMT. & BUDGET, *supra* note 11; News Release, Bureau of Econ. Analysis, *supra* note 32 (2010 United States Current Dollar GDP).

62 *2010 Budget Chart Book*, *supra* note 45, at 39. (Estimates assume that taxes are held at their historical average in the future).



Source: Heritage Foundation calculations based on Congressional Budget Office data.

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D. *Insufficient Future Tax Revenue Stream*

The problems that lie ahead for the United States become quite clear when government spending on the three entitlement programs is considered in conjunction with historical tax revenues.[64] Based on CBO data, The Heritage Foundation estimates that "if future taxes are held at the historical average, spending on Medicare, Medicaid, and Social Security will consume all revenues by 2052."[65] As a result, there will not be any tax revenue left to pay for other government spending, including constitutional functions such as defense, unless changes are made to either increase tax revenue or decrease government spending in the future.[66]

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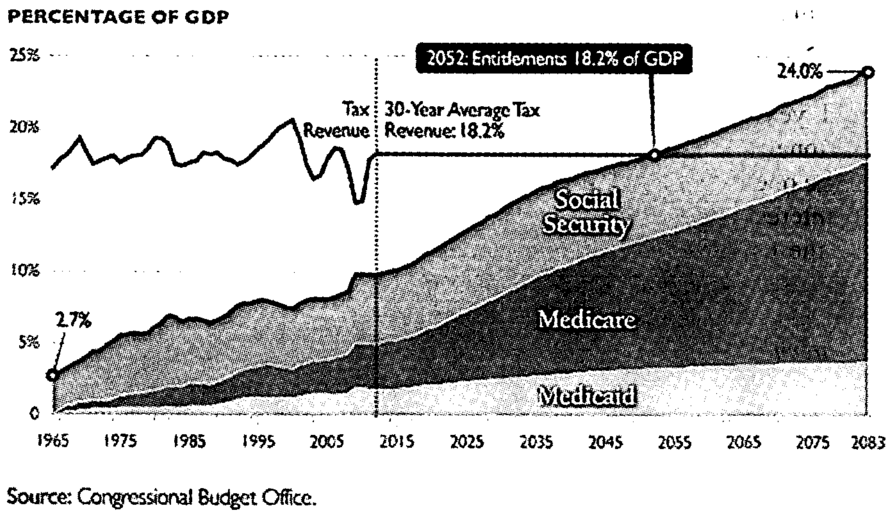
[63] *Id.*

[64] *See* Penner, *supra* note 21, at 30 (citing Burman, *supra* note 39, at 294) (stating that "If the total tax burden remains constant at its fifty-year average of slightly more than 18% of GDP and if we devote the same fraction of GDP to defense, nondefense appropriations, and other entitlements, and if Social Security, Medicare, and Medicaid are not reformed, deficits are bound to soar.").

[65] *2010 Budget Chart Book*, *supra* note 45, at 34. (This will occur because entitlement spending is funded on autopilot).

[66] *Id.*



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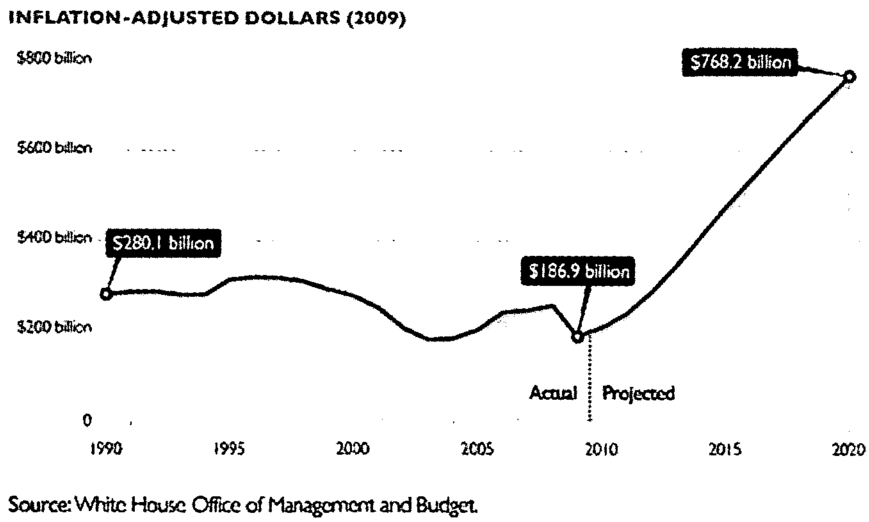
Interest payments will consume more and more of the federal budget as the national debt grows.[68] Under President Obama's Fiscal Budget 2011, over the next decade the national debt is set to nearly double, while real net interest costs will quadruple.[69]



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[67] *Id.*
[68] *2010 Budget Chart Book*, *supra* note 45, at 30.
[69] *Id.; see also* OFFICE OF MGMT. & BUDGET, *supra* note 13.
[70] *2010 Budget Chart Book*, *supra* note 45, at 30.

Unless changes are made, the United States' budget deficits will burst because the total public debt outstanding will rise so rapidly that the interest bill on that debt will dominate total government spending in any given fiscal year.[71] As a result, the United States will be forced to borrow additional funds in order to meet its interest bill.[72] The resultant scenario will be one in which the United States will be borrowing additional funds to pay interest on interest.[73] Under this situation it is not difficult to imagine how the United States' budget deficit, total spending and budget debt will skyrocket unless changes are made.[74]

E. *International Trade Imbalances*

The recent demise of our economic stability will only be exacerbated by the global nature of our economy. Globalization, of which the United States is one of the leading proponents, will likely cause the United States to face problems prior to 2052. It has been predicted that "foreign and domestic public and private investors will stop buying our debt long before deficits explode."[75]

The CIA World Factbook estimate of the United States current account balance[76] in 2010 was negative $561 billion.[77] Of the 190 countries surveyed, the United States ranked last with regard to current account balance.[78] The CIA World Factbook estimate of the United States amount of exports[79] in 2010 is 1.27 trillion dollars.[80] The United States ranked fourth in number of exports.[81] The CIA World Factbook estimates of the

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71 Penner, *supra* note 21, at 302.
72 *Id.*
73 *Id.*
74 *Id.*
75 *Id.*
76 *The World Factbook, Country Comparison: Current Account Balance,* CENT. INTELLIGENCE AGENCY, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2187rank.html (last visited Feb. 8, 2011) (Current account balance measures a "country's net trade in goods and services, plus net earnings from rents, interest, profits, and dividends, and net transfer payments (such as pension funds and worker remittances) to and from the rest of the world during the period specified.").
77 *Id.*
78 *Id.*
79 *The World Factbook, Country Comparison: Exports,* CENT. INTELLIGENCE AGENCY, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2078rank.html?countryName=United%20States&countryCode=us&regionCode=na&rank=4#us (last visited Feb. 8, 2011) (The amount of exports is "the total US dollar amount of merchandise exports on an f.o.b. (free on board) basis.").
80 *Id.*
81 *Id.*

United States amount of imports[82] in 2010 is 1.903 trillion dollars.[83] The United States had a larger amount of imports than any other country.[84] With the United States economy so heavily reliant on foreign produced goods it is not inconceivable that foreign trade relations could quickly become impaired if the United States was no longer able to pay the interest bill on its immense federal budget deficit.

II. THE INTERNAL REVENUE CODE

The Taxpayer Advocate Service ("TAS"), in a report conducted for the Internal Revenue System ("IRS"), concluded, "the most serious problem facing taxpayers is the complexity of the Internal Revenue Code."[85] Also noted by the TAS was that "the complexity of the Code leads to perverse results"[86] and places taxpayers into a catch-22 situation.

> On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them either to overpay their tax or to become subject to IRS enforcement action for mistaken underpayments of tax. On the other hand, sophisticated taxpayers [are] often [able to] find loopholes that enable them to reduce or eliminate their tax liabilities.[87]

This perversion is made possible because the IRC is such a daunting piece of legislation. Even a simple task like determining its length has become quite challenging and has led to varying results over the years.[88] A 2001 Joint Committee on Taxation study put the number of words in the Code at 1,395,000.[89] Only a few years later, a 2005 Tax Foundation report

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[82] *The World Factbook, Country Comparison: Imports,* CENT. INTELLIGENCE AGENCY, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2087rank.html?countryName=United%20States&countryCode=us&regionCode=na&rank (last visited Feb. 8, 2011) (The amount of imports is "the total US dollar amount of merchandise imports on a c.i.f. (cost, insurance, and freight) or f.o.b. (free on board) basis.").

[83] *Id.*

[84] *Id.*

[85] 1 TAX ADVOCATE SER., INTERNAL REV. SER., 2008 ANNUAL REPORT TO CONGRESS 1 (2008), *available at* http://www.irs.gov/pub/irs-utl/08_tas_arc_msp_1.pdf.

[86] *Id.* at 5.

[87] *Id.*

[88] *Id.* at 4.

[89] 1 STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 4 (2001).

put the number of words at 2.1 million.[90] In her most recent report to Congress, Nina E. Olson, the National Tax Advocate who acts as an ombudsman for the IRS, stated that the "volume of the tax code had nearly tripled in size during the last decade—to 3.8 million words in February 2010 from 1.4 million in 2001."[91] This drastic increase represents more than 3,250 changes to the tax code since the beginning of 2001, leading to an average of more than one per day.[92]

The IRC's overwhelming complexity creates compliance burdens for the taxpayer. A TAS analysis of IRS data found that "U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with the filing requirements of the Internal Revenue Code."[93] This number does not encompass all time spent complying with the IRC because it does not take into consideration the millions of additional hours that taxpayers must spend each year in response to an IRS notice or audit.[94] Due to the large amount of hours expended each year, tax compliance, "if [it] were an industry, [it] would be one of the largest in the United States."[95] By comparison, the "tax industry" requires more than 1.7 times the amount of full-time workers on the federal payroll.[96] The costs of compliance are quite substantial when considered "both in absolute terms and relative to the amount of tax revenue collected."[97]

Small business taxpayers must navigate a complex assortment of laws. There exists a potpourri of rules governing the depreciation and expensing of equipment,[98] which will be detailed at length *infa*. Along with this, small business taxpayers face numerous and overlapping filing requirements for

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[90] J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax*, TAX FOUNDATION (2005), http://www.taxfoundation.org/research/show/1281.html.
[91] David Kocieniewski, *I.R.S. Watchdog Calls for Tax Code Overhaul*, N.Y. TIMES, Jan. 5, 2011, http://www.nytimes.com/2011/01/06/business/economy/06tax.html?emc=eta1.
[92] TAX ADVOCATE SER., *supra* note 85, at 1.
[93] *Id.* at 3.
[94] *Id.*
[95] *Id.*
[96] *Id.* (stating that: "To consume 7.6 billion hours, the 'tax industry' requires the equivalent of 3.8 million full-time workers. This calculation assumes each employee works 2,000 hours per year (i.e., fifty weeks, with two weeks off for vacation, at forty hours per week). By comparison, the federal payroll has 2.1 million full-time workers.").
[97] TAX ADVOCATE SER., *supra* note 85, at 3. ("Based on Bureau of Labor Statistics (BLS) data on the hourly cost of an employee, TAS estimates that the costs of complying with the individual and corporate income tax requirements in 2006 amounted to $193 billion—or a staggering fourteen percent of aggregate income tax receipts.").
[98] I.R.C. §§ 167, 168, 179, 261, 263, 263A (2006).

employment taxes[99] coupled with an amorphous set of factors that control the classification of workers as either employees[100] or independent contractors.[101] Frequently recurring discrepancies over these matters can result in legal battles[102] between businesses and the IRS, which last for years with the "correct answer" ultimately found in the form of a judicial decree.[103]

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99 *Written Statement of Nina E. Olson*, SMALL BUS. EXCH., http://www.sbeinc.com/news/article.cfm?content_id=1275 (last visited Mar. 28, 2011).

> Combined Annual Waged Reporting ("CAWR") Reconciliation 20- The IRS and the Social Security Administration ("SSA") jointly administer the CAWR program, which matches earning and withholding statements from Form 941 (Employer's Quarterly Tax Return) and Form W-2 (Wage and Earnings Statements) for each employee and Form W-3 (Transmittal of Income Tax Statements). Ideally, all information reported on Form 941 should match the information on Forms W-2 for a given year, but this is not always the case. The IRS and SSA try to resolve discrepancies and may contact the employer. If the employer does not respond or does not file the correct forms, the IRS can assess a penalty against the employer for intentionally disregarding its filing requirements. In FY 2004, the IRS assessed 91,602 CAWR related penalties totaling about $2.2 billion, while abating 28,347 of these penalties totaling nearly $1.4 billion (Thirty-one percent of total assessments and sixty-four percent of total dollars assessed). The frequent abatement of penalties indicates a serious problem with the administration of this program that adversely and unnecessarily affects small business.

Id.

100 *See Employee (Common-Law Employee)*, IRS.GOV, http://www.irs.gov/businesses/small/article/0,,id=179112,00.html (last visited Mar. 28, 2011); *Statutory Employees*, IRS.GOV, http://www.irs.gov/businesses/small/article/0,,id=179118,00.html (last visited Mar. 28, 2011); *Statutory Nonemployees*, IRS.GOV, http://www.irs.gov/businesses/small/article/0,,id=179119,00.html (last visited Mar. 28, 2011).

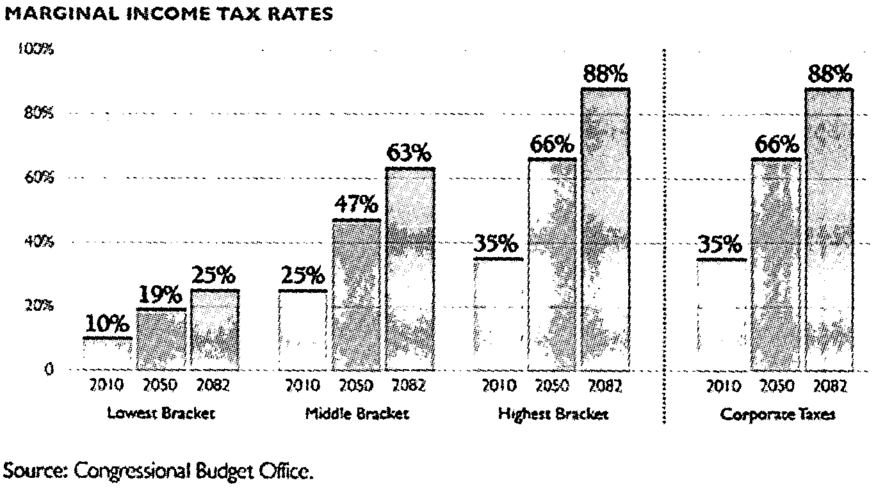
101 *See* Definition of *Independent Contractor*, IRS.GOV, http://www.irs.gov/businesses/small/article/0,,id=179115,00.html (last visited Mar. 5, 2011).

102 I.R.C. § 3509 (2006).

103 TAX ADVOCATE SER., *supra* note 85, at 10.

III. TIME TO FOLLOW THE INTERNATIONAL TREND: A VAT FOR THE U.S.

Ms. Olson, current National Tax Advocate, in her 2010 Annual Report to Congress declared that, "the time for tax reform and tax simplification is now."[104] As stated earlier, the costs of Medicare, Medicaid and Social Security are set to continuously rise in the future. Based on CBO data, The Heritage Foundation estimates that it would require more than a two-fold increase in current tax rates in order to meet the projected upsurge in government spending on entitlement programs in the future.[105]



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However, doubling tax rates in order to meet these fiscal demands is not the only option. There are several alternative routes to accomplishing the arduous task of putting the United States back on a more sustainable path with reduced budget deficits. One possibility that has been recommended is a balanced budget requirement. However, a balanced budget requirement, unaccompanied by spending cuts or entitlement reform, would force the United States to tax citizens at European levels in order to produce sufficient government revenue according to CBO

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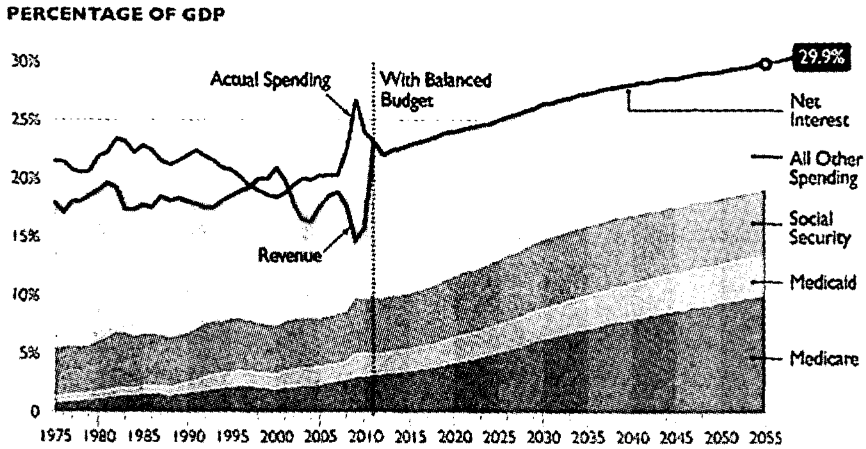
104 David Kocieniewski, *I.R.S. Watchdog Calls for Tax Code Overhaul*, N.Y. TIMES, Jan. 5, 2011, http://www.nytimes.com/2011/01/06/business/economy/06tax.html?emc=eta1.

105 *2010 Budget Chart Book, supra* note *45*, at 41. *Budget Chart Book: Paying for Entitlements with Tax Increases Would Cause Tax Rates to* Double, THE HERITAGE FOUND., http://www.heritage.org/BudgetChartBook/entitlements-double-tax-rates (last visited Apr. 2, 2011).

106 *Id.*

projections.[107] This would likely be met with widespread political opposition so it may not be a viable option for the United States.



Source: Heritage Foundation calculations based on Congressional Budget Office data (Alternative Fiscal Scenario).

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Another of the recently suggested routes is the implementation of a VAT.[109] James M. Bickley, Specialist in Public Finance at the Congressional Research Services notes that "the feasibility of levying a value-added tax to reduce large forecast budget deficits seems to never go away."[110] The implementation of a VAT would involve major tax reform, as the United States does not currently rely on a broad-based, national level consumption tax despite its prevalence abroad.[111] Michael J. Graetz, Justus

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[107] *Budget Chart Book: Balancing the Budget Would Cause Taxes to Skyrocket*, THE HERITAGE FOUND. (2010), http://www.heritage.org/BudgetChartBook/balancing-budget (last visited Mar. 28, 2011).

[108] *Id.*

[109] *See* Curtis Dubay, *Obama Calls for a VAT*, THE HERITAGE FOUND., (April 22, 2010, 12:57 EST), http://blog.heritage.org/2010/04/22/obama-calls-for-a-vat/.

[110] James M. Bickley, *Value Added Tax: Concepts, Policy Issues, and OECD Experiences*, at Preface (Susan Boriotti & Donna Dennis eds. 2003).

[111] William G. Gale & Benjamin H. Harris, *A Value-Added Tax for the United States: Part of the Solution*, BROOKINGS INST. AND TAX POLICY CTR. 1–2 (2010), http://www.taxpolicycenter.org/UploadedPDF/1001418_VAT_solution.pdf. (stating that: "The VAT is in place in about 150 countries worldwide and in every OECD country other than the United States."). William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy and co-director of the Urban-Brookings Tax Policy Center. Benjamin J. Harris is an Senior Research Associate. Both authors are members of the Economic Studies Program at the Brookings Institution.

S. Hotchkiss Professor Emeritus of Law and Professorial Lecturer in Law at Yale, believes that by implementing a VAT the United States could simplify its current tax system and achieve relatively low tax rates in the process.[112] Through its use in other countries the VAT has been proven as an effective means to increase government revenue.[113] Given its proven ability to generate revenue, along with its widespread use outside of the United States, implementation of a VAT seems attractive for those who wish to generate increased amounts of revenue in a predictable fashion. The remaining portion of the paper will evaluate the different type of VATS along with the potential methods of calculation. The potential manners in which small business could be treated under a VAT will also be examined.

IV. DIFFERENT VALUE ADDED TAX STYLES

A VAT is a form of tax that is collected at each stage of production on a firms' "value added."[114] "The value added of a firm is the difference between a firm's sales and a firm's purchases of inputs from other firms."[115] Put more simply, "a firm's value added is the amount of value a firm contributes to a good or service by applying its factors of production (land, labor, capital and entrepreneurial ability)."[116]

There are three different forms of VAT: Gross Domestic Product-Style VAT, a National Income-Style VAT, and a Consumption-Style VAT.[117] The principal difference among them is their tax treatment of purchases of capital goods.[118] The disparate treatment of capital inputs each VAT-type affords is reflected in the resultant "tax base" under each VAT. The mechanisms of each will be considered in turn.

A. *Gross Domestic Product-Style ("GDP") VAT*

The tax base of a GDP-style VAT is goods and services included in GDP, which for relevant purposes includes personal purchases of capital inputs.[119] With regard to a GDP VAT, for the purpose of determining a firm's VAT liability, no present deduction will be available for purchases of

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[112] Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System,* 112 YALE L.J. 262, 283 (2002).
[113] Gale & Harris, *supra* note 111, at 1.
[114] Bickley, *supra* note 110, at 3.
[115] *Id.*
[116] *Id.*
[117] Alan Schenk, *Choosing the Form of A Federal Value-Added Tax: Implications for State and Local Retail Sales Taxes,* 22 CAP. U. L. REV. 291, 307 (1993).
[118] *See* Bickley, *supra* note 110, at 3–4.
[119] ALAN SCHENK & OLIVER OLDMAN, VALUE ADDED TAX: A COMPARATIVE APPROACH 21 (2007).

capital goods.[120] In comparison to the other forms of VAT, a small business owner will not be allowed to claim an input credit[121] for the amount of VAT paid on capital goods used in connection with their taxable business activity.[122]

B. *National Income-Style ("NI") VAT*

The tax base of a National Income-style ("NI") VAT is the net national income in the tax jurisdiction.[123] With regard to a NI VAT, for the purpose of determining a firm's VAT liability, the VAT paid on the purchases of capital inputs must be amortized over the expected lives of the capital inputs.[124] Under this approach, a small business owner will be allowed to claim an input credit for the amount of VAT paid on inputs, including capital goods used in connection with their taxable business activity, but the credit must be spread over the useful lives of the capital inputs.[125]

C. *Consumption Style ("C") VAT*

"The tax base of a C-style VAT is the value of goods and services sold or transferred for personal consumption."[126] With regard to a C VAT, for the purpose of determining a firm's VAT liability, purchases of capital inputs are presently deductible.[127] "This tax treatment is equivalent to expensing."[128] Under this approach, a small business owner will be allowed to claim an input credit for the amount of VAT paid on capital goods used in connection with their taxable business activity in the present tax period.[129]

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[120] Bickley, *supra* note 110, at 3.
[121] SCHENK & OLDMAN, *supra* note 119, at 21. ("An input credit is a credit that the taxpayers may take against output tax for the VAT that was paid (or is deemed to have been paid) on the purchases that qualify for credit under that type of VAT.").
[122] *Id.*
[123] *Id.* at 21. The primary difference between GPA and NI is their treatment of capital goods. Under the GDP approach Capital Goods are included in the tax base, whereas under the NI Capital Goods are amortized over the life of the good such that during the amortization period a certain amount of the Capital Good will be included in the tax base but not the entire amount of the Capital Good.
[124] Bickley, *supra* note 110, at 3.
[125] SCHENK & OLDMAN, *supra* note 119, at 21.
[126] *Id.* at 20.
[127] Bickley, *supra* note 110, at 3–4.
[128] *Id.*
[129] SCHENK & OLDMAN, *supra* note 119, at 20.

D. *What VAT Advocates Prescribe*

The Consumption style VAT has garnered the most support from VAT advocates and is the form of VAT usually recommended for the United States.[130] Currently, "almost all existing VATs are consumption VATs."[131] This is because most VAT advocates believe that shifting tax burdens from capital income to consumption is beneficial.[132] However, a broad based consumption tax may not have much popularity in the United States political arena. Due to this, it is not clear which type of VAT may be proposed for the United States. Since any of the three forms of VAT mentioned above are possible, it is important to for small business owners to understand their differences in order to grasp the effect it will have on their business.

E. *Different Treatment of Capital Goods Under Each Approach*

As stated above, the treatment of capital inputs varies depending on the VAT. An example of a baker will be utilized to be representative of a small business owner in these varying systems. The following example will be used in order to illustrate the differences between the different forms of VAT. In the 2011 tax period, a baker purchases capital inputs for $220,000, including a ten percent ($20,000) VAT. The baker also purchases ordinary and necessary items for the bakery for $55,000 including a ten percent ($5000) VAT. The baker pays $15,000 compensation to workers, $3000 in rent payments, and has a $15,000 profit for VAT purposes. The baker then produces cupcakes and sells them to a local organic grocery store for $88,000 including a ten percent ($8000) VAT. The local organic grocery store resells all of the cupcakes purchased from the baker for $110,000 including a VAT of $10,000.

1. *Gross Domestic Product VAT*

Under a GDP-Style VAT, the baker purchasing capital inputs for use in the baker's business would not receive any input credit for the $20,000 VAT paid on the equipment. This would result in the baker bearing the full $20,000 VAT. The baker will likely try to shift this tax to its buyer, here the local organic grocery store, by increasing the price of its cupcakes by $20,000. If the baker was successfully able to charge the local organic grocery store $110,000 including a ten percent ($10,000) VAT, then this non-deductibility would have no effect on the baker. The effect of this is that the $20,000 VAT on the capital inputs would be taxed again when the baker sells the cupcakes to the local organic grocery store. In this example,

130 Bickley, *supra* note 110, at 3–4.
131 SCHENK & OLDMAN, *supra* note 119, at 20.
132 *Id.*

the $20,000 VAT now included in the pre-tax price of the baker's cupcakes would be subject to another $2000 VAT (ten percent of $20,000) when they are sold to the local organic grocery store. However, it is important to understand that if the full amount of the VAT is not able to be passed on to the local organic grocery store the result will be a reduced profit for the baker in this instance since the baker must bear the burden of the VAT on capital inputs.

2. *National Income VAT*

Under the NI-style VAT the baker purchasing capital inputs for use in the baker's business can recover the VAT component ($20,000) in the price of its capital purchases through a depreciation-like credit or deduction. If it is a depreciation-like credit system the baker can claim input credits for the $20,000 VAT paid on the purchase of the capital inputs over the life of the capital inputs. If it is a purely deduction system then the baker can deduct a portion of the $220,000 tax inclusive price of the capital inputs each year over the life of the equipment. In either case, a portion of the $20,000 VAT will be included in the pre-tax price of the baker's cupcakes, and therefore will be taxed again when the baker sells the cupcakes to the local organic grocery store.

The introduction of depreciation-like credits and deductions creates expensive compliance costs for small businesses. With regard to the small business owner operating within the United States, in the event that current income tax rules for capitalizing and depreciating capital inputs[133] are not adopted from the present IRC, these costs would be even higher. The introduction of a new set of capitalization and depreciation guidelines would result in the small business owner losing any imputed savings they may have previously received under the prior IRC due to their familiarity with the current Code provisions. However, if the current tax rules for capitalization and depreciation are adopted then the baker, or small business owner, will find themselves facing the same compliance costs they previously were under the current IRC. Due to this, there would be no change in the small business owner's position.

3. *Consumption VAT*

Under the C-style VAT, the baker will be able to recover the $20,000 VAT paid on the purchase of the capital inputs in the tax period in which the capital inputs are acquired. If it is a depreciation-like credit system the baker can claim an input credit of $20,000 for the full $20,000 VAT paid on the purchase of the capital inputs in the present tax period. If it is a purely deduction system then the baker can deduct the $220,000 tax inclusive price

[133] *See* I.R.C. §§ 162, 167, 168, 179, 195, 263, 263A, 1221, 1231 (2006).

of the capital inputs in the present tax period. As a result, purchases of capital goods will not be accounted for any differently than the baker accounts for non-capital goods. In either scenario, the $20,000 VAT will not be included in the pre-tax price of the baker's cupcakes.

V. METHODS OF CALCULATING VAT LIABILITY

There are three potential methods of calculating VAT: the credit method, the subtraction method and the addition method.[134] Either way, the amount of VAT calculated under each approach will be the same.[135] However, what a firm must do to calculate their VAT liability is different under each method. For instance, under the addition method, "a Value Added Tax can be implemented by adding up all payments of factor incomes, rather than by subtracting purchases from sales [under the subtraction method], or crediting taxes on purchases against taxes on sales [under the credit method]."[136]

Of those countries other than Japan that have adopted a VAT, the credit-invoice method is the method that has been implemented.[137] This leads VAT advocates to believe "the best [option for the United States] is a credit- or invoice-method VAT of the sort used predominantly throughout OECD nations."[138] In a credit-invoice system, sellers collect taxes on their sales and receive credit for the amount of VAT paid on purchases.[139] The benefit of this is that it allows the government to collect tax revenues in regular intervals throughout the year at every stage rather than just at the retail stage.[140] This is just one of many reasons why a C Style VAT is used predominantly throughout the world.

Regardless, it is still important to understand the practical differences between the various methods of calculating a VAT in order to be able to estimate the effect each method will have on a small business owner. Therefore, each method will be evaluated in turn. However, more attention will be given to the credit method of calculating VAT because it seems most likely to be adopted if a consumption style VAT is chosen for the United States. Consequently, the addition and subtraction method will only be touched upon briefly.

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[134] Bickley, *supra* note 110, at 4.
[135] *See* Graetz, *supra* note 112, at 288.
[136] Charles E. McLure, Jr., *State and Local Implications of a Federal Value-Added Tax,* 38 TAX NOTES 1517, 1533 (1988).
[137] *See* Avi-Yonah, *supra* note 2, at 290.
[138] *See* Graetz, *supra* note 112, at 288.
[139] *Id.*
[140] *Id.*

A. *Addition Method*

Under an addition-method VAT, a small business owner will calculate VAT liability in a two-step process. First, the small business owner must total all payments for wages, rents, profit calculated for VAT purposes and interest that it uses in its trade or business.[141] This amount is the value added of the small business owner under the addition method. Next, the small business owner will multiply this amount by the applicable VAT rate in order calculate the amount of VAT that must be reimbursed to the government.[142] In the above example, the baker hired employees at a cost of $15,000 to process his cupcakes, paid rent for the bakery of $3000, and sold the cupcakes to the local organic grocery store at a profit for VAT purposes of $15,000. The valued added by this firm, given the assumed information above, and thus the amount subject to the VAT, would be $33,000 ($15,000 + $3000 +$15,000). Since the amount subject to the VAT was determined using tax inclusive amounts, VAT liability computation will need to be adjusted. The amount subject to the VAT will need to be multiplied by the following coefficient: [tax rate/(100+tax rate)].[143] When VAT liability for the baker is calculated in this manner, the baker's VAT liability is $3000.

B. *Subtraction Method*

There are two forms of subtraction method VATs: the sales-subtraction VAT and the credit-subtraction VAT.[144] "In a subtraction-method VAT, a taxpayer pays tax either on the difference between taxable sales and allowable taxable purchases, or on the difference between the tax on taxable sales less the tax on taxable purchases."[145] The latter method is typical of the credit-subtraction VAT, which will, for organization purposes, be considered in the credit method section. As a result, the focus of this section will be on the sales subtraction VAT.

Under a sales subtraction-method VAT, a small business owner calculates VAT liability in a two-step process. First, the small business owner subtracts its costs of taxed inputs from its taxable sales.[146] This amount is the value added of the small business owner under the sales subtraction method. Next, the small business owner will multiply this

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[141] *See* Bickley, *supra* note 110, at 4.
[142] *See id.*
[143] 33,000 x [10/110]= 3000
[144] SCHENK & OLDMAN, *supra* note 119, at 22.
[145] *Id.*
[146] *See* Bickley, *supra* note 110, at 4.

amount by the applicable VAT rate in order to calculate the amount of VAT that must be reimbursed to the government.[147]

The appeal of the sales-subtraction method is its reduced compliance costs for small business owners. In theory, all necessary data should be obtainable from records that are already being kept by the small business owner for other purposes.[148] However, the small business owner must still make the aforementioned calculations on this data in order to calculate the amount of VAT that must be remitted to the government.[149]

As stated above, the small business owner pays tax at the applicable VAT rate on its value added.[150] In the above example, the baker purchased the necessary supplies for his bakery for $55,000 inclusive of a $5000 VAT. The baker used these supplies to bake the cupcakes, and then sold the cupcakes to the local organic grocery store for a price of $88,000 inclusive of an $8000 VAT. The value added by the baker, given this information, would be $33,000 ($88,000-$55,000). Since the amount subject to the VAT was determined using tax inclusive amounts, VAT liability computation will need to be adjusted. The amount subject to the VAT will need to be multiplied by the following coefficient: [tax rate/(100+tax rate)].[151] When VAT liability for the baker is calculated in this manner, the baker's VAT liability is $3000.

C. *Credit Method*

Under a credit method VAT, a small business owner calculates value added tax liability in a two-step process.[152] First, the small business owner will multiply its sale by the tax rate in order to calculate VAT collected on sales.[153] Second, the small business owner will credit the amount of VAT paid on its purchases against the amount of VAT collected on its sales.[154] The remainder will be the amount that must be remitted to the government.[155]

As stated above, in a credit-subtraction VAT, the small business determines VAT liability by subtracting the amount of VAT paid on its purchases from the amount of VAT collected on its sales.[156] The two types of credit-subtraction VATs are: the credit-invoice VAT and the credit-

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147 *See id.*
148 *See id.* at 5.
149 *See id.*
150 SCHENK & OLDMAN, *supra* note 119, at 22.
151 33,000 x [10/110]= 3,000
152 Bickley, *supra* note 110, at 4.
153 *Id.*
154 *Id.*
155 *Id.*
156 SCHENK & OLDMAN, *supra* note 119, at 20.

subtraction VAT without invoices.[157] With the exception of the Japanese Consumption Tax, VATs worldwide are credit-invoice VATs.[158] Each will be considered in turn below.

1. *Credit Invoice Method (European-Style Credit-Subtractive VAT)*

A credit-invoice VAT is a type of credit-subtraction VAT that relies on invoices produced in the course of business dealings as its verification mechanism. The invoices are used by the government to verify the amount of tax collected by sellers on taxable sales and the amount of input credit claimed by purchasers on taxable purchases.[159] Under a credit invoice method, a small business owner is required to show VAT separately on all sales invoices.[160] Also, a small business owner is required to calculate the amount of input credit it may claim by adding all VAT shown on purchase invoices.[161] Therefore, a small business owner must ensure that the VAT shown on its sales invoice is identical to the VAT shown on its purchase order.[162] In order for this to work effectively, the small business owner must maintain detailed records that are cross-referenced with all necessary supporting documentation.[163] Due to these factors, compliance and recordkeeping costs can become quite costly for the small business owners.[164] Simple mistakes may, in some instances, prove fatal for the vitality of a small business owner.

Below is an example of how calculation of VAT would be accomplished using the credit invoice method VAT and the bakery example from above.

Example of Credit Invoice Method (European-Style Credit-Subtractive VAT) Using Bakery Example:	
BAKERY	
Cupcake sales by Baker	$80,000
Output Tax on Taxable Sales ($80,000 x 10%)	$8000
Input Credit on Taxable Purchases (50,000 x 10%)	($5000)
Net Tax Payable to Government	$3000
LOCAL ORGANIC GROCERY STORE	
Sales by Local Organic Grocery Store	$110,000

157 *Id.*
158 *Id.*
159 *Id.*
160 Bickley, *supra* note 110, at 4.
161 Id.
162 *Id.*
163 *Id.*
164 *Id.* at 5.

Output Tax on Taxable Sales (100,000 x 10%)	$10,000
Input Credit on Taxable Purchases (80,000 x 10%)	($8000)
Net Tax Payable to Government	$2000
Costs to Consumers ($100,000+$10,000 Tax)	$110,000
TAX COLLECTED BY GOVERNMENT:	
From Suppliers on Taxable Sales to the Baker	$5000
From Baker on Taxable Sales to Local Organic Grocery Store	$3000
From Local Organic Grocery Store on Taxable Sales to Consumers	$2000
Total Tax Collected by Government	**$10,000**

2. *Credit-Subtractive VAT That Does Not Rely on Invoices (Japanese Consumption Tax)*

As mentioned above, The Japanese Consumption Tax is the only credit-subtraction VAT in use that does not utilize the credit-invoice method.[165] Under the Japanese Consumption Tax, the seller applies the applicable tax rate to his taxable sales to calculate the amount of VAT collected on sales.[166] The seller is then able to claim a credit against this amount for the amount of VAT paid on taxable purchases.[167] The difference between the Japanese Consumption Tax and the Credit-Invoice Method is that the amount of the credit that may be claimed is calculated from the tax-inclusive cost of the purchases taken directly from the seller's records, rather than from the amount separately stated on a purchase order or sales invoice.[168] However, Japan still requires firms to maintain sufficient documentation, but not to the level required by the credit-invoice method.[169]

Below is an example of how calculation of VAT would be accomplished using the Credit Subtractive VAT when invoices are not relied upon given the bakery example from above.

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[165] Schenk, *supra* note 117, at 297.
[166] *Id.* at 297–98.
[167] *Id.*
[168] *Id.*
[169] SCHENK & OLDMAN, *supra* note 119.

Example of Credit-Subtractive VAT That Does Not Rely on Invoices Using Bakery Example:	
BAKERY	
Cupcake sales by Baker	$80,000
Output Tax on Taxable Sales ($80,000 x 10%)	$8000
Input Credit on $55,000 Tax inclusive purchases taken from purchases records x 10/110	($5000)
Net Tax Payable to Government	$3000
LOCAL ORGANIC GROCERY STORE	
Sales by Local Organic Grocery Store	$100,000
Output Tax on Taxable Sales (100,000 x 10%)	$10,000
Input Credit on $88,000 Tax inclusive purchases taken from purchase records x 10/110	($8000)
Net Tax Payable to Government	$2000
Costs to Consumers ($100,000+$10,000 Tax)	$110,000
TAX COLLECTED BY GOVERNMENT:	
From Suppliers on Taxable Sales to the Baker	$5000
From Baker on Taxable Sales to Local Organic Grocery Store	$3000

From Local Organic Grocery Store on Taxable Sales to Consumers	$2000
Total Tax Collected by Government	**$10,000**

VI. SMALL BUSINESS TREATMENT

Small businesses are typically afforded special treatment under a VAT.[170] The two common methods of giving small businesses preferential tax treatment under a VAT are by exemption and zero-rating.[171] Each of these will be discussed in turn.

A. *Small Business Exemption*

If a small business were exempt, then it would not collect VAT on its sales and would be able to claim an input credit for VAT paid on its purchases.[172] An exempt business would not be a part of the VAT system and thus, would not be required to register with the VAT tax authority.[173] As a result, an exempt business would not incur any VAT compliance costs.[174] However, an exempt business' costs would include any VAT paid on taxable purchases, as it will not be allowed to claim an input credit.[175]

Some VAT advocates believe a "VAT should . . . contain an exemption for small businesses, relieving them from the costs of compliance and the tax collector from chasing after small amounts of tax."[176] There are three principal economic reasons for this belief: "(1) the relatively high compliance costs of small businesses; (2) the higher costs that taxing authorities incur in administering a VAT on small businesses; and (3) the relatively small amount of VAT collected from small businesses."[177]

It is estimated that "if all businesses were required to collect VAT and file returns, about 25 million businesses would be required to file."[178]

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[170] William J. Turnier, *Accommodating to the Small Business Problem Under A VAT*, 47 TAX L. 963, 963 (1994) ("All countries that impose a value added tax (VAT) give small businesses special treatment under their VAT, ranging from complete exemption to special means for calculating tax liability.").
[171] Bickley, *supra* note 110.
[172] *Id.*
[173] *Id.*
[174] *Id.*
[175] *Id.* at 5–6.
[176] Graetz, *supra* note 112, at 287.
[177] Turnier, *supra* note 170, at 963.
[178] Graetz, *supra* note 112, at 287.

Michael J. Graetz estimates that "an exemption for businesses with gross receipts of $100,000 or less would reduce the number of VAT returns to about 5.5 million."[179] Given the information above, it is clear that the level at which the exemption is set is critical. There is a potential disadvantage to an exemption that is important to note. If the exemption is not clearly designed[180] or rather quite complicated, then the costs of compliance with the exemption could outweigh the benefits the taxpayer receives from the exemption itself. Therefore, design of the exemption is important and will be a determining factor in the inherent value of the exemption. The small business owner should consider these factors before determining whether the exemption will provide value to its operation.

It will also be critical for a small business owner to monitor the cut-off points in order to stay compliant. This could affect firm behavior if the exemption scheme in place is not adequately suited to the small business environment. If a small business owner falls within the available exemption then necessarily they would have a competitive advantage over those firms competing within their industry who do not receive such treatment. However, this benefit may already be minimized given the "economy of scale" advantages enjoyed by most industry leaders in today's economy. But, in the absence of such an industry, the competitive advantage of exemption could prove to be quite valuable. Thus, exemptions could quickly become the object of potential political manipulation. Because of this, the small business owner should also monitor the exemption status of competitors within its industry.

B. *Small Business Zero-Rating*

If a small business were zero-rated, then it would not collect VAT on its sales but would still be allowed to claim an input credit for the amount of VAT paid on taxable purchases.[181] The practical effect being that the business is being charged a tax rate of zero.[182] A zero-rated business would be a part of the VAT system and thus, would be required to register with the VAT tax authority.[183] As a result, a zero-rated business would incur VAT compliance costs.[184] However, a zero-rated business's costs would not include VAT paid on taxable purchases since it will be allowed to claim an input credit.[185] Due to this, if both zero-rated firms and exempt firms operate at the time same level of production in the same industry, the zero-

[179] Graetz, *supra* note 112, at 287–88.
[180] For a detailed guide on exemption design *see* Turnier, *supra* note 170.
[181] Bickley, *supra* note 110, at 6.
[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] *Id.*

rated firm would have a competitive advantage because their costs would be lower by the amount of the VAT paid on purchases.[186]

Small-business zero-rating is currently not in place in any VAT system.[187] This is because zero-rating, since it leaves a small business within the tax system, provides little net benefit.[188] The effect of zero rating is a reduction in government revenue without any savings in administrative and compliance costs.[189] Due to this, it does not appear that zero-rating will be a viable option for the United States.

VII. CONCLUSION

What a VAT in the United States could mean for small business owners is largely dependent upon the choice of not only the type of VAT but also the method chosen for calculation of VAT liability. Rather than highlight the various types of VAT and VAT liability calculation methods, this section will outline what is likely to be the VAT that gives small business owners the greatest benefit. That VAT would be the consumption style VAT calculated using the credit-subtraction method that does not rely on invoices.

The consumption style VAT would be most beneficial to small business owners because it would remove the present requirement of treating capital inputs different under the current IRC. Under the C VAT, the small business owner would no longer have to go through the hassle of determining whether a good is presently deductible or whether it must be capitalized over the term of its useful life for tax calculation purposes. Under the C VAT, the small business owner would be able to immediately expense capital costs rather than needing to take a depreciation deduction. This would provide a present deduction that would better reflect cash flow and would free the small business owner of the shackles of IRC compliance with regard to capital asset capitalization and depreciation.

If the C VAT were to be calculated using the credit-subtraction method that does not rely on invoices this would provide the most benefit to small business owners. This style of VAT using this calculation method provides the least amount of compliance costs. In comparison to the credit invoice method of VAT calculation there are no rigorous and costly record keeping requirements. Rather, the small business owner would calculate VAT liability using forms that are readily used in their business and that would naturally be kept for business purposes: the receipt and sales invoice. This would drastically lower costs as VAT would not need to be calculated for

[186] *Id.* at 7.
[187] Turnier, *supra* note 170, at 970.
[188] *Id.*
[189] *Id.*

each individual transaction and then matched in order for the appropriate deductions to be applicable.

Even if the C VAT were to be calculated using the credit-invoice method the small business owner would likely receive benefit through the absence of capitalization requirements mentioned above. The addition and subtraction methods have their value as well since they do not require additional record keeping requirements in most instances. However, since these calculation methods generally do not correspond with the consumption style-VAT their value will not be considered.

All things considered, it is hard to say whether or not a VAT will adversely affect the small business owner. It is possible for the VAT to be beneficial to the small business owner, especially given the reduced compliance costs, if the VAT rate is set at the proper level. For the VAT to be beneficial the VAT tax bill must be lower than the small business owner's current tax bill under the present IRC. This would be accomplished where the tax liability for the small business owner, as a result of the increase in VAT rate, would not be greater than the cost savings associated with reduced compliance costs. Once the increased tax liability exceeds the cost savings associated with reduced compliance costs the VAT will no longer be beneficial to small business owners.

Therefore, it is necessary that the small business owner understand the system of taxation that will be put into place if the United States chooses to implement a VAT. This note detailed the intricate differences and mundane difficulties of each type of VAT. It will be important for the small business owner to follow the tax proposals in order to identify not only the VAT type but also the method for calculating VAT liability. This may prove to be an arduous task if the present IRC is any indicator.