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# Incorporating Tax Reform into Tax Courses

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# TaxEducation

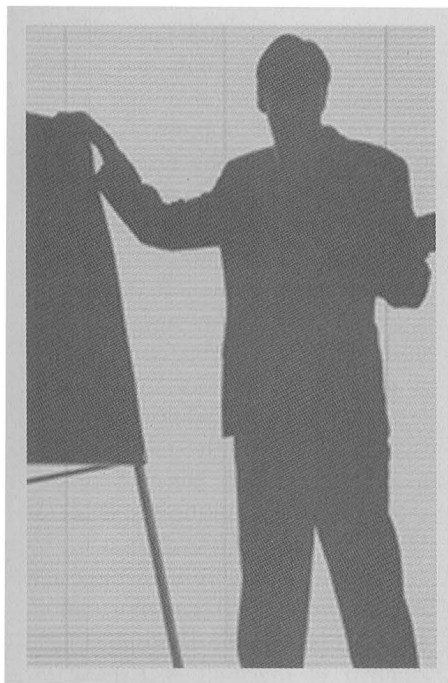
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## How to Incorporate Tax Reform into Tax Courses



**Editor's note: Professor Nellen is a former member of the AICPA Tax Division Task Force that produced the tax policy concept statement cited in the exhibit on p. 303 of this column, and the Tax Executive Committee. For more information about this column, contact Prof. Nellen at [anellen@sjsu.edu](mailto:anellen@sjsu.edu).**

**A**bout once every decade, fundamental tax reform returns to the national political agenda. Discussions about replacing the Federal income tax with a sales tax, a value-added tax (VAT) or a flat tax often become front-page news. Unfortunately, the vastness of introductory tax courses and the intricacies of tax reform preclude coverage of reform in most tax textbooks. But, in overlooking it, tax educators miss an opportunity to help students understand and appreciate tax policies and get involved in a national debate of wide interest.

This column offers an approach for including tax reform in an introductory tax course—whether at the undergraduate or graduate level. It provides a structure, basic content and student assignments. This course module will enable students to:

1. Identify key reasons why fundamental tax reform has been suggested.
2. Define “fundamental” tax reform.
3. Explain the difference between an income tax and a consumption tax.
4. Explain the basics of the flat tax, national sales tax and VAT.
5. Evaluate tax reform proposals.

### **Why Is Tax Reform on the National Political Agenda?**

Typical reasons for revamping or replacing the Federal income tax include simplification and economic growth. Specific concerns often cited are that the income tax discourages savings, taxes corporate income twice, provides a preference for corporate debt over equity (because interest is deductible, but dividends are not), taxes inflationary gains, includes too many tax preferences that distort decisionmaking and creates a significant tax gap (i.e., the difference between taxes owed and taxes voluntarily paid). Also suggested is that the income tax is not sufficiently transparent, because of numerous deductions, credits and exemptions, as well as the effect of the alternative minimum tax, making it difficult for taxpayers to know their marginal tax rate.

#### **Student assignments:**

1. Find three government reports that provide evidence supporting the claim that today's income tax is too complex. Consider looking for reports by the Joint Committee on Taxation (JCT) and the IRS's

National Taxpayer Advocate. Be sure to cite your sources.

2. Give three specific examples of how to simplify today's income tax, without repealing it. Explain how each example would lead to simplification.

3. Find data from a report no more than two years old on the size of the Federal tax gap. Explain two remedies to reduce the gap, noting, for each, two challenges of implementing that solution.

4. Acting as a member of Congress, write a letter to your constituents explaining either why you do (i) not support tax reform or (ii) support tax reform.

### What Is "Fundamental" Tax Reform?

A point often overlooked in fundamental tax reform discussions is that most proposals call for replacing the income tax with a consumption tax. Some of the proposals, such as the flat tax proposal introduced by former Congressman Dick Armey (R-TX), look like an income tax, but are really a consumption tax. Students need to know the basic differences between income and consumption taxes and how to determine the system on which a proposal is based.

An *income tax* is based on revenue less cost of goods sold and allowable deductions. The formula is similar to financial accounting. Common questions that arise in creating an income tax include: What is income? Should a broad economic concept be used that would include items such as government-provided benefits, imputed rental value of owner-occupied housing and gifts received? Which expenses should be allowed to reduce income? Should rates be progressive or flat?

A *consumption tax* is one on spending rather than on income; income is taxed when spent (consumed), not when saved. Common forms are the sales tax and the VAT. A consumption tax exempts savings and allows businesses to deduct

## Students need to know the differences between income and consumption taxes.

investment in capital (such as land, buildings and equipment) currently, rather than depreciating it. Such expensing removes from taxation the expected future income from that investment.

A commonly cited economic benefit of a consumption tax over an income tax is that it does not penalize taxpayers who earn and save in early years and consume in later years, relative to taxpayers who do not postpone consumption. A consumption tax would treat taxpayers with either consumption pattern similarly. Unequal treatment under an income tax stems from the early savers paying tax on earnings from savings. Stated another way, early consumers will have less income over their lifetimes (i.e., less earnings from savings), which would affect lifetime income taxes, but not lifetime consumption taxes. Thus, the perceived benefit of a consumption tax versus an income tax is its ability to increase savings and investment.

Common questions that arise in designing a consumption tax include: Who is the taxpayer/consumer? For example, who is the consumer of a college education or child care? Is education an investment or a consumption? Should any type of consumption (such as medical care and food) be exempt?

Should rates be progressive or flat? How should regressivity concerns be addressed? A tax is regressive if a higher percentage of a lower-income taxpayer's income goes toward paying the tax, relative to a high-income taxpayer (e.g., taxes on sales and gasoline are regressive).

**Example:** Two individuals, *A* and *B*, each buy the same quantity of gasoline and pay \$100 of excise taxes. *A* has \$10,000 income, while *B* has \$100,000 income. For *A*, the gasoline tax represents 1% of his income, while it represents only 0.1% of *B*'s income.

In contrast, a tax is progressive if taxpayers with higher incomes pay a higher percentage of their income in taxes than lower-income taxpayers (for example, the current income tax system).

In explaining income and consumption taxes to students, it can be helpful to point out that annual income is either spent or saved:  $\text{Income} = \text{Consumption} + \text{Savings}$ . Consumption can be taxed directly, such as with a sales tax or by a formula:  $\text{Consumption} = \text{Income} - \text{Savings}$ . (Of course, this simple equation becomes complicated when a taxpayer borrows money for consumption.) Measuring consumption as income less savings can be done under either a (1) cashflow approach (which follows the formula of income less savings, but gets complicated when accounting for debt) or (2) tax prepayment approach, by exempting income from savings (such as with the flat tax). For more information, see JCT, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95, 6/5/95) (JCT 1995 Report), pp. 51-56, available at [www.house.gov/jct/s-18-95.pdf](http://www.house.gov/jct/s-18-95.pdf).

### Student assignments:

1. Should a Federal consumption tax apply to college tuition costs (is that a consumption or an investment)?
2. Should medical care be exempt under a consumption tax? List and

explain two reasons why it should be exempt and two reasons why it should be taxed.

3. Is all income subject to tax under today's Federal income tax system? Explain.

**How Do Some Reform Proposals Operate?**

The three broad categories of reform proposals are (1) a significantly modified income tax, (2) a consumption tax and (3) some combination of the two. (There are many government reports on tax reform. For an example of one that provides an overview to the many different proposals of the past decade, see Bickley, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, Congressional Research Service, November 2004; available at [www.fas.org/spp/crs/IB95060.pdf](http://www.fas.org/spp/crs/IB95060.pdf).)

**Income tax overhaul:** Significant modifications that could be made to the income tax include (1) compressing the rate structure, so there are fewer rates; (2) eliminating many credits and deductions, while lowering rates to allow for simplification and revenue neutrality; and (3) making the system return-free for many individuals. Information on these types of modifications can be obtained from the JCT's 2001 simplification study ([www.house.gov/jct/pubs01.html](http://www.house.gov/jct/pubs01.html)); the JCT's 2005 report on reforming tax expenditures ([www.house.gov/jct/s-2-05.pdf](http://www.house.gov/jct/s-2-05.pdf)); and Treasury's 2003 report on return-free tax systems ([www.treas.gov/offices/tax-policy/library/noreturn.pdf](http://www.treas.gov/offices/tax-policy/library/noreturn.pdf)).

**Consumption tax:** Proposals calling for a consumption tax include the flat tax, national retail sales tax, VATs or a system based on the formula of income less savings. As used in tax reform discussions, "flat tax" typically refers to a tax designed by economists Hall and Rabushka, which is a modified, subtraction-method VAT; see Hall and Rabushka, *The Flat Tax*, Hoover Institution Press, 2d ed., 1995. Former Congressman Armey based his flat-tax proposal on this model.

Under a subtraction-method VAT, the rate is applied to sales less purchases (i.e., the "value added" by a business). A significant component of the value added is wages. Under the flat tax, businesses can deduct wages paid to employees (but not fringe benefits). Under a pure subtraction VAT, there would be no wage deduction. Under the flat tax, employees are taxed on wages, but allowed significant personal and dependency deductions to address some of the tax's regressivity. Under the flat tax, there are two types of taxpayers—businesses (regardless of the form of entity) and wage earners. The same single rate applies to the tax base of both of these. Interest income and expense are omitted from the tax calculations.

A VAT is a tax on the value added at each stage of production and distribution of goods and services. There are three main types: (1) credit invoice method (commonly used in Europe), (2) subtraction method and (3) addition method. VATs are typically designed to be consumption taxes, in that businesses expense purchases of assets rather than depreciating them. A VAT yields the same amount of tax as a sales tax (assuming both use the same base). The difference is that the sales tax is collected at the consumer level. For examples of how each type of VAT works, see JCT 1995 Report, pp. 19–29.

A national retail sales tax would operate much like a state sales tax. Some proponents suggest that the states could administer and collect it for Treasury. The tax base would need to be defined, as there is no uniform tax base among the states.

An example of a formula approach to taxing consumption was the unlimited savings allowance (USA) tax introduced in 1995 by former Senator Sam Nunn (D-GA) and Senator Pete Domenici (R-NM) (S 722, 104th Congress, 1st Sess.). That proposal included a graduated rate structure for individuals and a USA deduction, a concept

similar to IRA deductions. This approach is also referred to as a consumed-income approach.

**Combination system:** A combination income and consumption tax system could involve a consumption tax for businesses and an income tax for high-income individuals.

**Student assignments:**

1. Use the Congressional website (<http://thomas.loc.gov>) to find a proposal from the current or prior three Congresses that calls for a flat tax. Review the proposal and create two tax calculation worksheets, one for individuals and one for businesses.
2. Under a flat tax, such as the one introduced by former Congressman Armey or Senator Richard Shelby (R-AL) (S 1040, 108th Congress, 2d Sess.), investment income is not taxable. What type of rule might be needed to distinguish between nontaxable investment income and taxable business income? For example, if an individual (not an art dealer) buys a painting for \$500 and sells it five years later for \$5,000, is the \$4,500 gain nontaxable investment income or taxable business income? What kind of rule can help distinguish between these two types of income?
3. Many low-wage individuals benefit from the earned income tax credit (EIC), which would disappear under a flat tax. How could similar relief be provided without complicating what is intended to be a much simpler system? Would the EIC still be needed under a flat tax?
4. How might a national sales tax operate in conjunction with a state sales tax when the tax bases would differ? Can you design a system that would enable the states to collect the national sales tax?
5. Explain the types of changes needed to the current income tax system to enable the IRS to compute the tax liability (a return-free system) for individuals using Forms W-4, W-2 and 1099. Explain whether such a system could be used

for all individuals?

6. Calculate today's income tax, as well as the flat tax under S 1040, for the following families, each with two children ages 5 and 16 and \$15,000 mortgage interest: (i) \$100,000 wage income and \$20,000 investment income; and (ii) \$20,000 wage income and \$100,000 investment income.

### Analyzing Proposals

There are many considerations in evaluating tax reform proposals. One approach considers 10 principles of good tax policy; see the exhibit at right. Additional considerations include:

1. What is the effect on state and local governments (incorporate into principle #10)? For example, will they owe the national sales tax on their purchases? Will costs of borrowing increase when interest income on all bonds is tax-exempt (rather than only on municipal bonds)? Will donations to charity decline, pressuring governments to provide some charitable services because charitable donations are no longer deductible? Will the tax gap increase for state sales tax systems when the sales tax rate becomes very high, due to the addition of a Federal sales tax?

2. How will nonprofit organizations be taxed?

3. Will the Federal government be able to raise the same amount of revenue (revenue neutrality)?

4. Will there be winners and losers in terms of changed tax liabilities?

5. How should the government transition from the old system to the new? Should relief be provided for loss and credit carryovers from the income tax system? Should spending from current savings be exempt under the assumption that it has already been subject to income tax when earned?

6. Does the proposal use a destination basis or an origin basis, and what is the likely effect (if any) on international competitiveness? (Under a destination basis, goods and services are taxed

### Exhibit: AICPA's 10 guiding principles of good tax policy

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

Source: AICPA's Tax Policy Concept Statement 1, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*. For further details, see [www.aicpa.org/download/members/div/tax/Tax\\_Policy\\_stmf1.pdf](http://www.aicpa.org/download/members/div/tax/Tax_Policy_stmf1.pdf).

where consumed; thus, imports would be taxed, but not exports. The destination principle is commonly used by countries employing a VAT and is supposed to prevent tax rates from influencing the decision of where to purchase goods and services. Under the origin basis, goods and services are taxed where value is produced.)

#### Student assignments:

1. Compare and contrast the flat tax and national sales tax systems as applied to individuals, using the principles of simplicity, transparency and minimum tax gap.
2. Which is more "fair," a flat tax or a progressive income tax? Explain your position.
3. List and explain two pros and cons for having your state conform to a national flat tax that replaces the Federal income tax.
4. Will a change from the current income tax system to a national sales tax system cause the price of housing to increase or decrease (e.g., due to the loss of deductions for mortgage interest and property taxes)? Look for government reports to get a better understanding of how taxes apply to housing and their likely effect.

#### References

There are numerous government reports on tax reform, particularly from the JCT and Congressional Research Service. There are also nonprofit tax organizations, such as the Center for Budget & Policy Priorities and various trade associations, which have position papers on

tax reform approaches. Many of the government reports, as well as links to legislative proposals, can be found at [www.cob.sjsu.edu/nellen\\_a/txrefupd.html](http://www.cob.sjsu.edu/nellen_a/txrefupd.html). A web search on tax reform and a particular issue (such as housing or international competitiveness) should yield papers from other organizations on these topics as well.

#### Student assignments:

1. Conduct a web search for a particular industry association and tax reform to find a position paper. Briefly summarize the organization's position and explain whether it considered the principles of good tax policy (see exhibit above).
2. Using information gained from this tax reform lesson, write an editorial suitable for your school newspaper on some aspect of tax reform, which includes your supported position on the matter.
3. Describe the current status of the work of the President's Advisory Panel on Federal Tax Reform.

#### Conclusion

A great deal of information is readily available from the Federal government and other sources on major tax reform. Due to media coverage, the topic is likely to pique the interest of tax and accounting students and, thus, presents a great opportunity to help them understand contemporary tax issues and to gain a better understanding of the types of taxes and principles of good tax policy.

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