

4-15-1980

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### Recommended Citation

Charles O. Galvin *The Value-Added Tax - A Proposal For The 80's*, 7 Pepp. L. Rev. 3 (1980)

Available at: <http://digitalcommons.pepperdine.edu/plr/vol7/iss3/1>

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# The Value-Added Tax—A Proposal For The 80's

CHARLES O. GALVIN\*

*Dean Galvin, long a proponent of the comprehensive tax base, examines the Tax Restructuring Act of 1979 which calls for a consumption type tax. The value-added tax currently being proposed in H.R. 5665 constitutes a major shift in tax reform thinking in this country and, in the author's opinion, would result in more complications and confusion than warranted, considering the existing alternatives for tax reform. The author concludes that what is needed is not a narrowing but rather a broadening of the tax base if government revenues are to keep pace with government expenditures.*

On October 22, 1979, Congressman Ullman, the Chairman of the Committee of Ways and Means of the House of Representatives, introduced the Tax Restructuring Act of 1979.<sup>1</sup> This measure, if passed, would constitute one of the most significant changes in tax policy since the adoption of the Sixteenth Amendment and the passage of the first income tax legislation in 1913, for it would mean that the federal government's reliance on income and payroll taxes as the principal source of revenue would shift to a tax on consumption.<sup>2</sup> In general, the bill would impose a retail sales

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1. H.R. 5665, 96th CONG., 1st SESS., 125 CONG. REC. 9492 (1979).

*Editor's Note:* As this issue goes to press, Congressman Ullman has introduced H.R. 7015 which, among other things revises certain aspects of the value-added tax proposed in H.R. 5665. Food, housing and medical costs would be exempted from the VAT, and the revenue estimates are revised downward from \$130 billion to \$115 billion. The new bill includes a provision to partially offset the marriage penalty tax and would significantly liberalize the rules for capital cost recoveries.

2. The concept of a tax on consumption, or expenditures, is not new. An argument advanced is that receipts of funds or accretions to wealth are not income until they are enjoyed or consumed, at which point the tax should apply. A basic

tax in the form of a value-added tax (VAT) on goods and services in exchange for substantial reductions in individual income, corporate income, and payroll taxes. It will be the intent of this article to: I) note some past assumptions regarding the income tax, II) certain economic statistics relative to the distribution of the tax burden, III) examine VAT's generally, IV) consider the current legislative proposals for a VAT, and V) comment on the options available in solving our fiscal needs.

## I. THE INCOME TAX PRINCIPLE

From the enactment of the first federal income tax legislation in 1913, this country has relied for its principal source of revenue on an income tax.<sup>3</sup> Taxable income has traditionally consisted of two bases: consumption and savings. Stated in these terms a taxpayer who earns 10x dollars, spends 7x dollars for personal or living expenses, and puts aside 3x dollars in savings and investment, has a taxable base of 10x dollars. Included, of course, in the consumption base is the tax itself. In other words, a taxpayer with income of 10x dollars must pay an income tax on that base; with the remainder after taxes available for either consumption or savings.<sup>4</sup> Over the years following the first income tax legislation, tax policy has moved to erode both the consumption base and the savings base. With respect to the former, outlays such as medical expenses,<sup>5</sup> charitable contributions,<sup>6</sup> state and local taxes on personal transactions,<sup>7</sup> interest on loans for personal and living ex-

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reference is N. KALDOR, *AN EXPENDITURE TAX* (1955). See Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); see also ADVISORY COMM. ON INTER-GOVERNMENTAL RELATIONS, *THE EXPENDITURE TAX* (Information Report M-84, 1974); P. MIESZKOWSKI, *THE CASH FLOW VERSION OF AN EXPENDITURE TAX* (U.S. Treas. OTA Paper 26, 1977); U.S. TREAS., *BLUEPRINTS FOR BASIC TAX REFORM 21-52*, 113-144 (1977). A recent assessment of consumption taxation is Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979). Bradford & Toder, *Consumption vs. Income Base Taxes: The Argument on Grounds of Equity and Simplicity*, 69 NAT'L TAX A. PROC. 25 (1976).

3. See R. PAUL, *TAXATION IN THE UNITED STATES* (1954); R. PAUL, *TAXATION FOR PROSPERITY* (1947); R. BLAKEY & G. BLAKEY, *THE FEDERAL INCOME TAX* (1940); RATNER, *AMERICAN TAXATION, ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY* (2d ed. 1967).

4. The classic Haig-Simons definition, which is the starting point for the proponents of the comprehensive tax base is that income is the net accretion in wealth between two points in time, plus consumption. Thus, assume that A's net worth at the first of the year is \$100 and at the end of the year is \$150 and that he spent \$75 in personal, living, and family expenses (including transfers by gift). His income is \$125 (\$50 net accretion plus \$75 consumption). H. SIMONS, *PERSONAL INCOME TAXATION* 61-62, 206 (1938); HAIG, *The Concept of Income — Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 7 (1921).

5. I.R.C. § 213.

6. I.R.C. § 170.

7. I.R.C. § 164.

penses,<sup>8</sup> and casualties not connected with business or profit seeking activities<sup>9</sup> are all generally regarded as personal or living expenses and are allowed partially or entirely as deductions. The savings or investment base has been eroded to an even greater extent by investment credits,<sup>10</sup> deductions for intangible drilling and development costs,<sup>11</sup> accelerated depreciation,<sup>12</sup> contributions to qualified pension and profit-sharing plans,<sup>13</sup> research and development expenditures,<sup>14</sup> and similar items.<sup>15</sup> Assorted arguments have been variously advanced for the adoption of these measures, but a recurring theme has been that incentives are necessary to encourage accumulations to achieve capital formation.<sup>16</sup>

The argument *au courant* is that individual income, corporate income, and payroll taxes must be cut deeply, and that any loss in revenue would be offset by a surcharge on consumption. In this manner, the taxpayer will opt for saving rather than for consumer spending.<sup>17</sup> The effect of a relatively moderate tax on consumption could be merely a one-time upward boost in the price structure. A heavy tax, on the other hand, could so deter general spending, or spending for certain goods, that a serious depression might well be triggered. The resolution of these matters must,

8. I.R.C. § 163.

9. I.R.C. § 165.

10. I.R.C. § 38(b).

11. I.R.C. § 263(c).

12. I.R.C. § 167.

13. I.R.C. § 404.

14. I.R.C. § 174.

15. *E.g.*, I.R.C. § 173 (circulation expenditures); § 175 (soil and water conservation expenditures); § 179 (additional first-year depreciation); § 180 (fertilizer expenditures); § 182 (expenditures for clearing land); § 616 (mine development expenditures).

16. Title II of H.R. 5665 is designated: Capital Formation, and contains proposals for deduction of up to \$1,000 per year for savings (§ 201 of the bill); deductions for dividends reinvested up to \$1,500 per year, or \$3,000 for joint filers (§ 202), liberalization of retirement savings provisions (§ 203); depreciation revision (§§ 211, 212), and liberalization of the investment credit (§ 213). The dividends and interest exclusion have been criticized in Manvel, *The Big Deal for Small Savers*, X TAX NOTES 8 (1980); Thuronyi, *The Dividends and Interest Exclusion—A Negative Vote*, X TAX NOTES 3 (1980).

17. Representative Ullman in presenting his proposal at a conference sponsored by the U. S. Chamber of Commerce on September 11, 1979, stated that the country is at the "end of a Keynesian era, where we have to change direction" and consider "major renovation" of both economic and tax policy. A VAT would be "the most dynamic incentive you could ever get." Ullman went on to say that his proposal would cut \$120 to \$150 billion in tax cuts to be replaced by a VAT. Brown, *Chilly VAT Reception Doesn't Daunt Ullman*, IX TAX NOTES 703 (1979); Note, *Ways and Means Will Hold VAT Hearings*, IX TAX NOTES 360 (1979).

therefore, result from careful consideration and delicate balancing.

Before analyzing proposed changes, however, what of the status quo? In this connection it seems appropriate to examine certain summary economic data concerning gross national product, national income, federal expenditures and sources of federal revenue. Thereafter, an examination will be made of the distributions of burdens within adjusted gross income brackets, as they have prevailed under the present system, and of what the effect of a consumption levy might be on burden distribution.

## II. STATISTICS WITH RESPECT TO REVENUES AND BURDEN DISTRIBUTION

### *A. The national output and the budget*

Table I reflects certain data with respect to gross national product, national personal income, and corporate profits for selected years:

	Table I <sup>18</sup>						
	1971	1972	1973	1975	1976	1979	1980
Gross National Product	1,050	1,152	1,267	1,498	1,686	2,343	2,565
Personal Income	861	936	1,018	1,232	1,365	1,894	2,078
Corporate Profits	83	94	108	115	145	227	237

Table II indicates the principal sources of federal revenues, total expenditures, and deficits for selected fiscal years 1972-1980:

	Table II <sup>19</sup>					
	1972	1973	1975	1976	1979	1980
Individual Income Tax	95	100	129	105	204	227
Corporate Income Tax	32	33	48	49	70	71
Social Security Tax	54	65	85	91	142	162
Excises	16	16	17	32	18	19
Other	12	11	9	21	22	24
<b>TOTAL</b>	<b>209</b>	<b>225</b>	<b>295</b>	<b>298</b>	<b>456</b>	<b>503</b>
Expenditures	232	250	304	350	493	532
Deficit	(23)	(25)	(9)	(52)	(37)	(29)
Expenditures/ Gross National Product <sup>20</sup>	20%	19.7%	20.3%	20.7%	21%	20.7%

Table III reflects the object categories of federal expenditures for 1970 and 1980.

18. THE UNITED STATES BUDGET IN BRIEF, FISCAL YEAR 1980 (1979).

19. *Id.*

20. It is interesting to note that in the selected years federal expenditures bear a relation to gross national product fluctuating narrowly between 19-21%.

Table III<sup>21</sup>

	1970	1980
Defense	\$78.6	\$125.8
International	4.3	8.2
Space	4.5	5.5
Energy	1.0	7.9
Natural Resources	3.1	11.5
Agriculture	5.2	4.3
Commerce, Housing	2.1	3.4
Transportation	7.0	17.6
Community Development	2.4	7.3
Education	8.6	30.2
Health	13.1	53.4
Income Security	43.1	179.1
Veterans	8.7	20.5
Justice	1.0	4.4
General	1.9	4.4
Revenue Sharing	.5	8.8
Interest	18.3	57.0
Offsets	-6.6	-19.0
<b>TOTAL</b>	<b>\$196.6</b>	<b>\$531.6</b>

One may observe that the five most significant items of federal expenditures in the 1980 budget in the order of gross amount budgeted are:

1. Income security	\$179.1
2. Defense establishment	125.8
3. Interest	57.0
4. National health	53.4
5. Education	<u>30.2</u>
<b>TOTAL</b>	<b>\$445.5</b>

These five items account for about eighty-four percent of the total expenditure budget, and none of these items is susceptible of reduction in the years immediately ahead. Expenditures for income security and national defense are expected to rise dramatically. Interest on the national debt, which is contractual and a function of the size of the debt and money market forces, will also increase. Furthermore, it is unlikely that any current or future President will take steps aimed at steadying or reducing expenditures for national health and education. Therefore, the prospect for significant budget reduction is minimal. Consequently, any efforts to balance the budget will necessarily require the collection of more revenue than is presently amassed—a *great deal more*.

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21. THE UNITED STATES BUDGET IN BRIEF, FISCAL YEAR 1980 (1979).

In this connection, however, some attention must be given to those brackets from which the revenues are now taken.

*B. Sources of revenue by income class*

Table IV, taken from the Commissioner's Statistics of Income, sets out individual income tax revenues collected from different adjusted gross income classes for 1970 and 1976.

Table IV <sup>22</sup>				
Individual Income Tax	1970	1976		
Returns	74.2 million		84.5	
AGI	\$631.7 billion		\$1,053.6	
TI	\$401.2 billion		\$ 674.4	
Tax	\$ 83.7 billion		\$ 141.9	
<u>Under \$10M - AGI</u>				
Returns	50.6 million	68%	43.2	51%
AGI	\$233.2 billion	37%	203.9	19%
TI	\$119.6 billion	30%	78.1	12%
Tax	\$ 20.3 billion	24%	10.9	8%
% of TI	17%		14%	
<u>Under \$20M - AGI</u>				
Returns	70.3 million	95%	68.9	82%
AGI	\$499.6 billion	79%	578.3	55%
TI	\$298.4 billion	74%	316.7	47%
Tax	\$ 54.1 billion	65%	51.4	36%
% of TI	18%		16%	
<u>Under \$50M - AGI</u>				
Returns	73.8 million	99%	82.8	98%
AGI	\$596.8 billion	94%	957.3	90%
TI	\$371.5 billion	93%	589.2	88%
Tax	\$ 71.6 billion	85%	110.0	78%
% of TI	19%		19%	
<u>Under \$100M - AGI</u>				
Returns	74.2 million	99. %	83.8	99.1%
AGI	\$619.9 billion	97.7%	1,109.5	96.2%
TI	\$389.9 billion	97.3%	637.5	95.3%
Tax	\$ 78.2 billion	93.2%	126.3	89%
% of TI	20%			

*C. Burden distribution—an analysis*

The data gleaned from Table IV are significant in demonstrating how the burden is distributed under the present structure.

22. U.S. DEP'T. OF THE TREASURY, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 1970, INDIVIDUAL INCOME TAX RETURNS 7 (1974); U.S. DEPT. OF THE TREASURY, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 1976, INDIVIDUAL INCOME TAX RETURNS 7 (1979).

**In 1970:**

1. Twenty-four percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes under \$10,000,
2. Forty-one percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes in the \$10,000 to \$20,000 bracket,
3. Twenty percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes in the \$20,000 to \$50,000 bracket, and
4. Over eight percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes in the \$50,000 to \$100,000 bracket.

Thus, in 1970, 93.2 percent of all individual income taxes came from brackets with adjusted gross incomes under \$100,000, and almost two-thirds came from those with adjusted gross incomes under \$20,000.

These statistics for 1970, insofar as the percentage relationships are concerned, are surprisingly constant year by year as reflected in the Reports of the Commissioner's Statistics of Income going back to the early 1950's.<sup>23</sup> Note, however, the dramatic shift between 1970 and 1976.

**In 1976:**

1. Eight percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes under \$10,000,
2. Twenty-eight percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes in the \$10,000 to \$20,000 bracket,
3. Forty-one percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes in the \$20,000 to \$50,000 bracket, and
4. Eleven percent of the total individual income taxes collected came from returns reflecting adjusted gross incomes in the \$50,000 to \$100,000 bracket.

Thus, in 1976, eighty-nine percent of all individual income taxes came from brackets with adjusted gross incomes under \$100,000 as contrasted with ninety-three percent from these brackets in 1970, a difference of only four percentage points. In the lower and middle brackets, however, the shift in burdens is dramatic.

In 1976, those under \$10,000 paid 66 $\frac{2}{3}$  percent *less*, expressed as a percentage of the total burden, than they did in 1970, but those in the \$20,000 to \$50,000 bracket paid over 100 percent *more*, expressed as a percentage of the total burden, than they did in 1970.

If these data indicated a comparable increase in real income

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23. See, e.g., U.S. DEPT. OF THE TREASURY, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 1955, INDIVIDUAL INCOME TAX RETURNS (1958).



with a corresponding increase in standard of living, there would be cause for rejoicing. Unhappily, however, reality paints quite a different picture. The parallel columns in Table IV mirror the unfortunate effects of inflation on the United States economy. From 1970 to 1976, as the dollar depreciated in value, wages and salaries were pushed from the lower brackets to the middle brackets to match higher consumer prices.<sup>24</sup> Many of those who reported in the first \$10,000 AGI bracket in 1970 moved to the \$10,000 to \$20,000 bracket in 1976 with perhaps little, if any, perceptible change in their standard of living. Yet this upward push tends to squeeze, or bulge, in the middle. Comparing the years 1970 and 1976, it can be seen that if the AGI's of \$100,000 and above were taxed at 100 percent, the increased revenue is only about 10 percent of the total; hence, in both of these years it is the middle group that bears the load. Moreover, when the statistics are compiled for 1979, the shift to the middle will be more accentuated because of the increases in zero brackets and exemption deductions.<sup>25</sup>

Burden distribution is affected by other factors. In the fall of 1979, the Commissioner released a report on the underground economy which demonstrated that large chunks of unreported income may be found in the bottom and top brackets.<sup>26</sup> The middle brackets—largely an employee group—are tied to withholding and reporting systems that ensure a higher degree of compliance. Therefore, this group tends to pay a higher percentage of its real economic income in income taxes. In addition, state and local taxes claim a higher percentage of middle bracket income.<sup>27</sup> In the past the progressivity of the federal system has tended to balance the regressivity of the state and local systems, yet a shift in national policy to a federal sales tax would tend to aggravate an already existing condition of disproportionately higher taxes on the middle group.

The proponents of VAT have responded to these redistribution problems with various proposed ameliorative measures, such as zero rates on certain transactions and reduced rates on food, housing, and medical care. Furthermore, they propose to soften

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24. Between 1970 and 1975, the Consumer Price Index (CPI) rose from 116.3 to 161.2, an increase of 38%. U.S. BUREAU OF CENSUS, DEP'T. OF COMMERCE, THE STATISTICAL ABSTRACT OF THE UNITED STATES 439 (1977).

25. The Revenue Act of 1978 increased the zero bracket from \$3,200 to \$3,400 for joint returns, \$2,200 to \$2,300 for single individuals and heads of households, an exemption deduction from \$750 to \$1,000.

26. U.S. DEP'T. OF THE TREASURY, INTERNAL REVENUE SERVICE, ESTIMATES OF INCOME UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS (1979); see Washington Post, Sept. 1, 1979, at 1, col. 1.

27. See Gabler, *A Reconsideration of Local Sales and Income Taxes*, NATIONAL TAX ASSOCIATION—TAX INSTITUTE OF AMERICA, PROCEEDINGS OF THE 67TH ANNUAL CONFERENCE, 1974, 281 (1974).

the impact of VAT on lower incomes by amendments to the income tax rules which would provide further extension of the zero bracket, earned income credits, refundable credits for the elderly, a reduction in payroll taxes, and wider brackets.<sup>28</sup> These measures would necessitate even higher taxes in the middle and upper-middle brackets, however, assuming that there is a serious intent to balance the budget through increased revenues.<sup>29</sup>

### III. THE VAT PRINCIPLE

#### A. In general

A VAT is a retail sales tax which is collected at each stage as goods and services move through the production and distribution process.<sup>30</sup> Thus, assume that a raw material costing \$100 is processed at its first stage and has added to its cost the use of the factors of production (land, labor, capital, the protection of government, and entrepreneurial risk) along with their concomitant charges on the productive process (rent, wages, interest, taxes,

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28. Title I of H.R. 5665 contains proposals for rate reductions (§ 101 of the bill); increases in zero brackets from \$2,300 for single and heads of households to \$2,600 and \$3,400 for joint returns to \$4,000 (§ 101(b)); increase in earned income credit from 10% to 15% and an increase in the maximum from \$500 to \$750 (§ 102); refundable tax credits for the elderly (§ 103); reduction in social security taxes (§ 111-112).

29. See Note, Brannon, *Is the Regressivity of the Value-Added Tax an Important Issue?*, IX TAX NOTES 879 (1979); Brown, *Chilly VAT Reception Doesn't Daunt Ullman*, IX TAX NOTES 703 (1979); Kingson, *VAT: It's Broccoli, Dear*, VIII TAX NOTES 283 (1979); McClure, *Thoughts on a Value-Added Tax*, IX TAX NOTES 539 (1979); Miller, *Statement Before the House Comm. on Ways and Means on the Value-Added Tax*, IX TAX NOTES 651 (1979); Schenk, *A Value-Added Tax as a Replacement for the Corporate Income Tax*, IX TAX NOTES 767 (1979); Note, *Editorials Urge Caution on VAT*, IX TAX NOTES 411 (1979); Tait, *The Value-Added Tax: A World-Wide Problem of Solution?*, IX TAX NOTES 611 (1979).

30. The economic accounting and legal literature is replete with articles on the subject. One of the best analyses with references to many of the extant sources is A.B.A. SECTION OF TAXATION, REPORT OF THE SPECIAL COMM. ON THE VALUE-ADDED TAX (1977), a collection of 5 committee essays: *Report of the Special Subcommittee of the Committee on General Income Tax Problems of the Value-Added Tax*, 24 TAX LAW. 419 (1971); *Should the United States Adopt the Value-Added Tax: A Survey of the Policy Considerations and the Data Base*, 26 TAX LAW. 45 (1972); *Technical Problems in Designing a Broad-Based Value-Added Tax for the United States*, 28 TAX LAW. 193 (1975); *The Choice Between Value-Added and Sales Taxation at Federal and State Levels in the United States*, 29 TAX LAW. 457 (1976); *Evaluation of An Additive-Method Value-Added Tax in the United States*, 30 TAX LAW. 565 (1977). See also J. DUE, SALES TAXATION (1957); D. SMITH, J. WEBBER & C. CERF, WHAT YOU SHOULD KNOW ABOUT THE VALUE-ADDED TAX (1971); Cohen, *Foreign Experience with the Value-Added Tax*, 24 NAT'L TAX J. 399 (1971); Smith, *Value-Added Tax: The Case For*, 48 HARV. BUS. REV. 77 (1970); Surrey, *The Value-Added Tax for the United States — A Negative View*, 21 TAX EXEC. 151 (1968).

and profits). If these charges total \$75, then the value of the product after its first stage is \$175. Stated in income tax terminology the sale price of the product is \$175, the cost of goods sold is \$100, and the gross profit margin is \$75, out of which rent, wages, interest, taxes, and a profit to the owner is paid. If the VAT is ten percent, the processor pays \$10 upon purchase of the materials and collects \$17.50 upon sale. He claims a credit for the \$10 VAT paid at purchase and remits the net, \$7.50, as the VAT imposed on the net value added by him. This process is repeated through the chain of production until the last purchaser, the consumer, pays the final tax, for which there is no refund. A retail sales tax operates in the same fashion, except that the imposition is at the final transaction of consumption. Thus, the total tax is the same under either method, but the VAT imposes the tax in increments of value rather than at final value; its impact is more nearly coincident in time with the economic activity attendant upon the processing of the product than is the usual retail sales tax.

VAT is used among the members of the European Economic Community so that each country may tax the value added within its borders.<sup>31</sup> In the case of a transaction in which ore is mined in Italy, passes into Germany for processing into a product, then moves into France and England for distribution and sale, a single retail sales tax at the selling point would distort revenues between processing countries and consumption countries. In an ideal world in which each country mines, or processes, or consumes in equal relationship with its trading partners, the import-export accounts would be in balance each to the other and a single retail sales tax at the same rate in each country would garner the same as the VAT system. This assumes far too much, and it is more nearly consonant with the activity in each country that each one taxes the increments in value of products moving through production stages within its own borders. When the product reaches the border, the exporting country may remit to the exporter that which would have been the VAT had the product been sold within the country, thereby taxing only the increment in

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31. The basis for the use of VAT's is the European Common Market contained in the First and Second Directives of the Council of the European Economic Community, which established the European Common Market by the Treaty of Rome of 1967. *The Common System of Tax on Value-Added*, in 7 EUROPEAN TAXATION, Nos. 7 & 8 (1967); *The Turnover Tax on Value-Added in Europe*, in 8 EUROPEAN TAXATION, Nos. 11 & 12 (1968). See A. ANDERSEN & Co., VAT IN OTHER COUNTRIES (1980); A. ANDERSEN & Co., PERSPECTIVES ON THE VALUE-ADDED TAX (1979); *The European Experience with Value-Added Tax. Hearings on H.R. 5665 Before the House Comm. on Ways and Means, 96th Cong., 1st Sess. 136 (1979)* (Statement of Richard A. Hoefs).

value to the border.<sup>32</sup> The importing country then taxes the product as it moves from its border through processing or distribution within its jurisdiction.

A single rate VAT applied to all products and services is the most easily administrable. As shall be noted later, if rates vary or if certain persons or transactions are excluded from the system, the system may become inordinately complicated.

### *B. Terminology*

VAT's are classified as (1) the gross product type, (2) the net income type, and (3) the consumption type. The differences turn on the treatment of the industrial plant (depreciable property).<sup>33</sup> In the gross product type, the VAT paid at the time of purchase of plant is not allowed as a credit in the sales of merchandise. This has the effect of imposing a VAT on the gross annual output of goods and services in the economy. The net income type allows an amortization of the VAT paid on plant as a credit over the depreciable life of the plant. This has the effect of imposing a VAT on the net national income. The consumption type allows a credit for VAT paid on plant in the same manner as all other goods and services. This has the effect of imposing a VAT on net expenditures. Under this last type a major surge in investment in capital goods in a given year could produce substantial credits against the VAT imposed on the output from such capital investment. For example, \$1,000,000 of new machinery producing \$100,000 of product would earn a credit (or refund) of \$90,000, which is the difference between \$100,000 VAT paid to acquire the machinery and \$10,000 VAT collected from purchasers of the products of the machinery. However, if capital investments in plant and facilities are more or less evenly distributed over time, the total VAT under this system and the VAT of the net income type would produce approximately the same revenue.

Additional terminology is connected with the computation of the tax.<sup>34</sup> The additive method measures value added (salaries, wages, rent, interest) as business activity is conducted, rather than at the point of delivery of goods or services. The subtractive,

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32. 7 EUROPEAN TAXATION 160-61 (1967).

33. COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC., VALUE-ADDED TAX—A BUSINESS VIEW 34 (1970); A. ANDERSEN & CO., PERSPECTIVES ON THE VALUE-ADDED TAX 5 (1979).

34. A. ANDERSEN & CO., PERSPECTIVES ON THE VALUE-ADDED TAX 5 (1979).

or credit, method measures the tax on the basis of differences between net purchases in and net sales out. The invoice method used in the European Economic Community requires the VAT to be identified on sales invoices. Total invoices on sales for the taxable period represents the total VAT due from the seller, from which he subtracts the VAT paid on total invoices on purchases for the period.

#### IV. THE TAX RESTRUCTURING ACT OF 1979

##### A. *In General*

The Tax Restructuring Act of 1979 (H.R. 5665) proposes certain major changes in the individual and corporate income tax and in payroll taxes which will sharply curtail the revenue from those sources. These changes include: broader brackets, eight in number, ranging from ten to fifty percent; with a corresponding reduction of the maximum capital gains rate from twenty-eight percent to twenty percent;<sup>35</sup> increases in the zero bracket;<sup>36</sup> increase in the earned income credit;<sup>37</sup> refundable credits for the elderly;<sup>38</sup> a reduction in social security taxes;<sup>39</sup> a deduction for contributions up to \$1,000 to a tax deferred saving account;<sup>40</sup> exclusion up to \$1,500 for dividends reinvested;<sup>41</sup> increase in maximum allowable contributions to individual retirement accounts (IRA) from \$1,500 to \$2,000;<sup>42</sup> reduction of corporate taxes;<sup>43</sup> liberalization of depreciation;<sup>44</sup> and increases in the investment credit.<sup>45</sup> All of these measures will produce about a \$130 billion tax cut, which is to be made up out of a wholly new broad-based consumption tax, or VAT.

The VAT would impose a 10 percent tax on each stage of production and distribution for the value added in that stage. The rate would reduce to 5 percent for food, housing, and medical care, and would reduce to zero for other transactions such as those involving exempt organizations, exports, non-retail sales of farmers and fishermen, mass transit, and others. Small businesses with taxable transactions of \$10,000 or less could be ex-

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35. H.R. 5665, 96th CONG., 1st SESS., 125 CONG. REC. 9492 (1979) (§§ 101(a)(d) & (e) of the proposed Act).

36. *Id.* § 101(b).

37. *Id.* § 102.

38. *Id.* § 103.

39. *Id.* §§ 111-112.

40. *Id.* § 201.

41. *Id.* § 202.

42. *Id.* § 203.

43. *Id.* § 121.

44. *Id.* §§ 211-212.

45. *Id.* § 213.

empted from the tax. A "taxable person" would pay VAT's on sales and take a credit for VAT's paid on purchases. All this would be done by separate identification on invoices. The system, therefore, would be self executing and returns would be filed each month.

Goods moving through the production process entirely within the country would be taxed at each stage as explained above. Goods moving beyond our borders would under international agreements have a refund of the VAT at the border. Thus, the item passes into the international market free of United States VAT but subject to whatever VAT might be imposed by the importing country. Such goods passing beyond our borders without a VAT would compete at parity with, or below the scale of, our international competitors and thereby give us a "leg up" in the international market. Imports coming into our borders would have a VAT imposed on the importer who would claim a credit as he sold the goods into the domestic economy.

*B. The operative rules of the proposed statute.*

Under the proposed statute, a new Chapter 30 would be introduced into the Internal Revenue Code, divided into five sub-chapters: 1) the imposition of the tax; 2) the taxable transaction; 3) the taxable amount, rate of tax for certain transactions, and the credit against the tax; 4) administration; 5) definitions and special rules; and treatment of certain transactions.<sup>46</sup>

The House Committee used the following example:

1. Chair manufacturer buys wood from a lumber mill for \$110.00 composed of \$100.00 for the lumber and a separately identified \$10.00 VAT shown on the invoice.

2. Chair manufacturer adds \$100.00 of value to the wood, this being the increment of value of the chair manufacturer's wages paid, rental on facilities, interest on capital, property taxes, and a fair profit. He sells the chair to retailer for \$220.00, composed of \$200.00 selling price of the chair and a separately identified \$20.00 VAT shown on the invoice to his purchaser.

3. Chair manufacturer makes a monthly accounting for his net VAT's. In this instance, if this were the only transaction in the

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46. H.R. 5665, 96th CONG., 1st SESS., 125 CONG. REC. 9492 (1979) (§§ 101-302) will hereinafter be referred to by the proposed Internal Revenue Code section numbers.

month, the chair manufacturer would owe a \$10.00 VAT (\$20.00 received from the retailer less \$10.00 paid to the lumber mill) payable to the government.

4. Retailer pays \$220.00 for the chair, \$200.00 for the merchandise plus \$20.00 VAT, adds \$50.00 of value attributable to his economic outlays for wages, rental, interest, taxes, and a fair profit, and sells it to a consumer for \$275.00 (the chair sales price being \$250.00 with a 10 percent VAT). The retailer has a net VAT of \$5.00, the difference between the \$20.00 VAT he paid on purchase and the \$25.00 VAT collected on the sale.

5. The sale to the consumer is the end of the production line at which point a \$25.00 tax is collected. This tax has been remitted, however, in three segments—\$10.00 from the lumber mill, \$10.00 from the manufacturer, and \$5.00 from the retailer.

Particular sections of the Act would be responsible for the above result. Section 4001<sup>47</sup> imposes a tax of ten percent of the taxable amount of each taxable transaction. Section 4003<sup>48</sup> defines a taxable transaction as a sale of property in the United States, the importing of property into the United States, or the performance of services in the United States by a taxable person in a commercial-type transaction. Section 4004<sup>49</sup> defines a com-

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47. Proposed I.R.C. § 4001. IMPOSITION OF TAX.

- (a) GENERAL RULE.—A tax is hereby imposed on each taxable transaction.
- (b) AMOUNT OF TAX.—Except as otherwise provided in this chapter, the amount of the tax shall be 10 percent of the taxable amount.

*Id.*

48. Proposed I.R.C. § 4003. TAXABLE TRANSACTION.

For purposes of this chapter, the term 'taxable transaction' means—

- (1) the sale of property in the United States,
- (2) the performance of services in the United States, and
- (3) the importing of property into the United States, by a taxable person in a commercial-type transaction.

*Id.*

49. Proposed I.R.C. § 4004. COMMERCIAL-TYPE TRANSACTION.

(a) GENERAL RULE.—For purposes of this chapter, the term 'commercial-type transaction' means a transaction engaged in by—

- (1) a corporation, or
- (2) any person (other than a corporation) in connection with a business.

(b) SALES AND LEASES OF REAL PROPERTY; IMPORTS.—For purposes of this chapter—

- (1) IN GENERAL.—The term 'commercial-type transaction' includes—
  - (A) any sale or leasing of real property, and
  - (B) any importing of property,

whether or not such transaction is described in subsection (a).

- (2) CERTAIN IMPORTED ARTICLES.—Notwithstanding paragraph (1)(B), the importing of an article which is free of duty under part 2 of schedule 8 of the Tariff Schedules of the United States shall not be treated as a commercial-type transaction unless such transaction is described in subsection (a).

*Id.*

mercial-type transaction as one engaged in by a corporation, or any person (other than a corporation) in connection with a business. Section 4005<sup>50</sup> defines a taxable person as a person who engages in a business or in a commercial-type transaction. Section 4006<sup>51</sup> provides that the sale of property shall be treated as occurring when delivery takes place. Section 4011<sup>52</sup> provides, among other things, that the taxable amount is the money consideration, including costs of transportation and other items payable to the seller. Section 4021<sup>53</sup> fixes liability for the section 4001 tax on the seller, and section 4022<sup>54</sup> requires the seller to give the purchaser

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50. Proposed I.R.C. § 4005. TAXABLE PERSON.

(a) GENERAL RULE.—Except as otherwise provided in this chapter, for purposes of this chapter, the term 'taxable person' means a person who engages in a business or in a commercial-type transaction.

(b) TREATMENT OF EMPLOYEES, ETC.—For purposes of this chapter, an employee shall not be treated as a taxable person with respect to activities engaged in as an employee.

*Id.*

51. Proposed I.R.C. § 4006. TRANSACTIONS IN THE UNITED STATES.

(a) SALES OF PROPERTY.—For purposes of this chapter—

(1) IN GENERAL.—Except as provided in paragraph (2), the sale of property shall be treated as occurring where delivery takes place.

(2) REAL PROPERTY.—The sale of real property shall be treated as occurring where the real property is located.

(b) PERFORMANCE OF SERVICE.—For purposes of this chapter—

(1) IN GENERAL.—Except as otherwise provided in this subsection, a service shall be treated as occurring where it is performed.

(2) SERVICES PERFORMED INSIDE AND OUTSIDE UNITED STATES.—If a service is performed both inside and outside the United States, such service shall be treated as performed—

(A) inside the United States, if 50 percent or more of such service is performed inside the United States, and

(B) outside the United States, if less than 50 percent of such service is performed inside the United States.

*Id.*

52. Proposed I.R.C. § 4011. TAXABLE AMOUNT.

(a) AMOUNT CHARGED CUSTOMER.—For purposes of this chapter, the taxable amount for any transaction for which money is the only consideration shall be the price charged the purchaser of the property or services by the seller thereof—

(1) including all invoiced charges for transportation, and other items payable to the seller with respect to this transaction, but

(2) excluding the tax imposed by section 4001 with respect to this transaction and excluding any State and local sales and use taxes with respect to this transaction.

*Id.*

53. Proposed I.R.C. § 4021. SELLER LIABLE FOR TAX.

The person selling the property or services shall be liable for the tax imposed by section 4001.

*Id.*

54. Proposed I.R.C. § 4022. TAX INVOICES.



a tax invoice. Such an invoice is necessary for the purchaser to claim a credit and must be furnished not later than 15 business days after the tax point for such transaction. Section 4014<sup>55</sup> provides a credit mechanism by which the seller pays in the net VAT, that is, the difference between the VAT due from him arising out of the sale and the VAT which he has paid evidenced by his purchase invoices. If the difference results in a credit, he claims the amount as an overpayment. Section 4024<sup>56</sup> provides for filing returns before the first day of the second calendar month follow-

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(a) **SELLER MUST GIVE PURCHASER TAX INVOICE.**—Any taxable person engaging in a taxable transaction shall give the purchaser a tax invoice with respect to such transaction if the seller has reason to believe that the purchaser is a taxable person.

(b) **CONTENT OF INVOICE.**—The tax invoice required by subsection (a) with respect to any transaction shall set forth—

- (1) the name and identification number of the seller,
- (2) the name of the purchaser,
- (3) the amount of the tax imposed by section 4001, and
- (4) such other information as may be prescribed by regulations.

(c) **NO CREDIT WITHOUT INVOICE.**—

(1) **IN GENERAL.**—Except as provided in paragraphs (2) and (3), a purchaser may claim a credit with respect to a transaction only if the purchaser—

- (A) has received from the seller and has in his possession a tax invoice which meets the requirements of subsection (b), and
- (B) is named as the purchaser in such invoice.

*Id.*

55. Proposed I.R.C. § 4014. CREDIT AGAINST TAX.

(a) **GENERAL RULE.**—There shall be allowed as a credit against the tax imposed by section 4001 the aggregate amount of tax imposed by section 4001 which has been paid by sellers to the taxpayer of property and services which the taxpayer uses in the business to which the transaction relates.

(b) **EXEMPT TRANSACTIONS, ETC.**—If—

- (1) property or services are used partly in the business and partly for other purposes, or
- (2) property or services are used partly for taxable transactions and partly for other transactions,

the credit shall be allowable only with respect to the property and services used for taxable transactions in the business. No credit shall be allowable for any transaction occurring when the taxpayer was a nontaxable person.

(c) **EXCESS CREDIT TREATED AS OVERPAYMENT.**—

(1) **IN GENERAL.**—If for any taxable period the aggregate amount of the credits allowable by subsection (a) exceeds the aggregate amount of the tax imposed by section 4001 for such period, such excess shall be treated as an overpayment of the tax imposed by section 4001.

(2) **TIME WHEN OVERPAYMENT ARISES.**—Any overpayment under paragraph (1) for any taxable period shall be treated as arising on the later of—

- (A) the due date for the return for such period, or
- (B) the date on which the return is filed.

*Id.*

56. Proposed I.R.C. § 4024. TIME FOR FILING RETURN AND CLAIMING CREDIT.

(a) **FILING RETURN.**—Before the first day of the second calendar month beginning after the close of each taxable period, each taxable person shall

ing the month in which taxable transactions having a tax point occurred. The taxable period may be a calendar quarter or month. The tax point is the time when the income is received or accrued in accordance with the taxpayer's accounting system.

The foregoing summary demonstrates the application of the appropriate Code sections to the transactions involving the lumber mill, chair manufacturer, retailer, and consumer. Let us now assume several separate and independent alternatives in the facts which will illustrate the impact of other sections. Suppose that the retailer imports the chair from a manufacturer in England. Section 4032 (e)<sup>57</sup> treats the transaction of importing as both a

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file a return of the tax imposed by section 4001 on taxable transactions having a tax point within such taxable period.

(b) CREDIT ALLOWED FOR TAXABLE PERIOD IN WHICH PURCHASER RECEIVES INVOICE.—

(1) IN GENERAL.—Except as provided in paragraph (2), a credit allowable by section 4014 with respect to a transaction may be allowed only for the first taxable period by the close of which the taxpayer—

(A) has paid or accrued amounts properly allocable to the tax imposed by section 4001 with respect to such transaction, and

(B) has a tax invoice (or equivalent with respect to such transactions

(2) USE FOR LATER PERIOD.—Under regulations, a credit allowable by section 4014 may be allowed for a period after the period set forth in paragraph (1).

(c) TAXABLE PERIOD.—For purposes of this chapter—

(1) IN GENERAL.—The term 'taxable period' means a calendar quarter.

(2) EXCEPTION.—

(A) ELECTION OF 1-MONTH PERIOD.—If the taxpayer so elects, the term 'taxable period' means a calendar month.

(B) OTHER PERIODS.—To the extent provided in regulations, the term 'taxable period' includes a period, other than a calendar quarter or month, selected by the taxpayer.

(d) TAX POINT.—For purposes of this chapter—

(1) CHAPTER 1 RULES WITH RESPECT TO SELLER GOVERN.—Except as provided in paragraph (2), the tax point for any sale of property or services is the earlier of—

(A) the time (or times) when any income from the sale should be treated by the seller as received or accrued (or any loss should be taken into account by the seller) for the purposes of chapter 1, or

(B) the time (or times) when the seller receives payment for the sale.

*Id.*

57. Proposed I.R.C. § 4032. SPECIAL RULES.

(e) IMPORTING TREATED AS SALE AND PURCHASE.—For purposes of this chapter, the importing of any property into the United States shall be treated as both a sale and purchase of such property by the person importing such property.

*Id.*

sale and a purchase. Therefore, he pays a VAT on the import value and then claims a credit when he sells to the consumer. Section 4024 (d) (2)<sup>58</sup> provides that the tax point occurs when the property is entered, or withdrawn from the warehouse, for consumption in the United States. The economic effect of these rules is to tax imports on the same basis as domestic goods.

Suppose that the manufacturer exports the chair to a retailer in England. Section 4013 (5)<sup>59</sup> provides for a zero rate on exports. Therefore, the manufacturer has zero liability on the sale but may claim a credit for the VAT paid to the lumber mill, thus effecting a refund of all VAT's paid to the point of export. If corporate taxes are reduced and there is no VAT on exports, the economic effect should be to make American goods more competitive in the world market.

Suppose that the retailer purchases the chair and used it in his office as part of the equipment of his business. We have already observed that section 4014 provides for a credit for the VAT paid. As the retailer continues in his trade or business, a portion of the value added by him to his products includes the use of plant and facilities, of which the office chair is a part. Accordingly, the VAT collected by him on the sale of chairs out of inventory affects the VAT paid on the chair used in the business. If the retailer had taken the chair home for personal use, no credit would be allowed, because he would then be in the position of the ultimate consumer.

Suppose that the manufacturer sells the chair as a flawed second to a tax exempt organization such as Goodwill Industries, which in turn resells it to a consumer. Section 4013(3)<sup>60</sup> zero rates the sale by Goodwill. Therefore, Goodwill owes no tax and

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58. Proposed I.R.C. § 4024. TIME FOR FILING RETURN AND CLAIMING CREDIT; DEPOSITS OF TAX.

(d) TAX POINT—For purposes of this chapter—

(2) IMPORTS.—In the case of the importing of property, the tax point is when the property is entered, or withdrawn from warehouse, for consumption in the United States.

59. Proposed I.R.C. § 4013. ZERO RATING . . . .

The rate of the tax imposed by section 4001 shall be zero with respect to the following:

(5) EXPORTS, Exports of property.

60. Proposed I.R.C. § 4013. ZERO RATING . . . .

The rate of the tax imposed by section 4001 shall be zero with respect to the following:

(3) SECTION 501 (c) (3) ORGANIZATIONS—Any taxable transaction engaged in by a section 501 (c) (3) organization other than as part of an unrelated business.

*Id.*

claims a credit for the tax paid to the manufacturer. The economic effect is that goods passing through a tax exempt organization in a transaction not part of an unrelated business are free from the VAT.

Suppose that the manufacturer sells the chair to a grocery store, a residential housing unit, or a hospital to be used as part of their regular operation in dispensing medical care. These are entities whose sales are subject to a five percent VAT under section 4012.<sup>61</sup> For example, a grocery store would pay a ten percent VAT to the manufacturer of the chair and on its sales of groceries it would collect a five percent VAT and claim credit for the 10 percent VAT paid to the chair manufacturer. This illustrates the effect of having different VAT rates in the production chain. The last rate applied (in the above example, five percent) becomes the effective rate applied to all value added in the chain.

Suppose that the consumer sells the chair to a second-hand furniture dealer. The consumer is not a taxable person, and the second hand dealer upon his sale of the chair will be governed by section 4011(d),<sup>62</sup> which taxes him the *net* amount in the transac-

61. Proposed I.R.C. § 4012. 5-PERCENT RATE OF TAX FOR FOOD, HOUSING, AND MEDICAL CARE.

(a) 5-PERCENT RATE FOR FOOD, HOUSING AND MEDICAL CARE.— The rate of the tax imposed by section 4001 shall be 5 percent with respect to the following:

(1) FOOD.—The retail sale of food and nonalcoholic beverages for human consumption.

(2) HOUSING.—The sale and renting of residential real property for use by the purchaser or tenant as a principal residence.

(3) MEDICAL CARE.—Medical care.

(b) DEFINITIONS.—For purposes of subsection (a) —

(1) NONALCOHOLIC BEVERAGES.—The term 'nonalcoholic beverages' does not include any article which is taxable under chapter 51.

(2) MEDICAL CARE.—The term 'medical care' means the performance of any service, and the retail sale of any property, payment for which by the purchaser would constitute medical care within the meaning of section 213.

(3) MOBILE HOMES, ETC., TREATED AS REAL PROPERTY.— A mobile or floating home shall be treated as real property.

*Id.*

62. Proposed I.R.C. § 4011. TAXABLE AMOUNT.

(d) SPECIAL RULE IN THE CASE OF SALES OF CERTAIN USED CONSUMER GOODS.—For purposes of this chapter, if—

(1) a taxable person acquires any tangible personal property in a transaction which was not a taxable transaction, and

(2) such property had been used by an ultimate consumer before such acquisition, the taxable amount in the case of any sale of such property by such taxable person (determined without regard to this sub-

tion, that is, ten percent of the difference between what he paid and the amount for which he sells the chair.

Suppose that the consumer sells the chair in a garage sale. In such case the consumer holding the sale is not a taxable person.<sup>63</sup> Moreover, even if sale were held by one who could be a taxable person, section 4023<sup>64</sup> provides that one whose aggregate transactions do not exceed \$10,000 for the year may elect not to be a taxable person.

Other provisions relevant to the production chain include the provision that interest is zero rated,<sup>65</sup> and the provision that, in the case of insurance the VAT is imposed only on the difference between the portion of the premium attributable to insurance and

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section) shall be reduced by the amount paid for such property by such taxable person.

*Id.*

63. Proposed I.R.C. § 4005, *supra* note 50.

64. Proposed I.R.C. § 4023. SMALL BUSINESS EXEMPTION.

(a) IN GENERAL.—Under regulations, a person—

(1) whose aggregate taxable transactions for the calendar year do not exceed \$10,000, and

(2) whose aggregate taxable transactions for the next calendar year can reasonably be expected not to exceed \$10,000, may elect to be treated as a person who is not a taxable person for the next calendar year.

(b) EXCEPTIONS.—Subsection (a) shall not apply—

(1) to any sale or leasing of real property, and

(2) to any importing of property.

(c) TERMINATION OF ELECTION.—Any election under subsection (a) for a calendar year shall terminate if the aggregate taxable transactions—

(1) for the first calendar quarter in such year exceed \$3,500,

(2) for the first 2 calendar quarters in such year exceed \$6,000, or

(3) for the first 3 calendar quarters in such year exceed \$8,500.

Such termination shall take effect on the first day of the second month following the close of the first period in which the requirements of paragraph (1), (2), or (3) are met.

(d) TAXABLE AMOUNT TREATED AS ZERO FOR ZERO-RATED TRANSACTIONS.—For purposes of this section, the taxable amount of any zero-rated transaction shall be treated as zero.

(e) CONDITION OF ELECTION.—In the case of a person who is a taxable person for any period, an election under subsection (a) may be made for succeeding periods only with the consent of the Secretary. Such consent shall be conditioned on placing such person, for all succeeding periods, in the same position with respect to the tax imposed by section 4001 (and the credit allowed by section 4014) he would have been in if all property and services he holds at the time he becomes a nontaxable person had been acquired as a nontaxable person.

(f) CASUAL SALES AND LEASES OF REAL PROPERTY EXCLUDED.—For purposes of this section, the term 'taxable transaction' does not include a transaction which is treated as a commercial-type transaction solely by reason of section 4004(b)(1)(A).

*Id.*

65. Proposed I.R.C. 4013. ZERO RATING

.....  
(6) INTEREST—Interest.

*Id.*

the actuarial cost of the coverage.<sup>66</sup>

### C. Unresolved Matters

New tax legislation often introduces words and phrases which may deviate from established constructions of prior legislation.

Section 4004(a)<sup>67</sup> imposes the tax on a commercial-type transaction engaged in by a corporation or a person in connection with a business. This language is confusing; it would seem more appropriate to use the already existing definitions of Internal Revenue Code section 7701(a).

Section 4006(a)(1)<sup>68</sup> defines a sale as occurring with delivery, apparently irrespective of the passage of title. Sometimes equipment or specially fabricated goods are delivered to a representative of the purchaser who accompanies the item in transit. If that occurs and the item is transported abroad, is this a sale within the United States or an export sale which is zero rated?

Section 4012<sup>69</sup> imposes a five percent tax on the retail sale of food. Is a restaurant that purchases, cooks, and serves food, the retail purchaser? If so, the restaurant will pay a five percent VAT and charge a ten percent VAT based on the value of its services in cooking and serving. This illustrates one of the anomalies of multiple rates. The tax paid by the last person in the chain is the tax collected by the government. Rate variations in the intermediate steps merely shuffle the net VAT finally collected from one stage to another.

Section 4013<sup>70</sup> provides for zero rating in the case of sales by

66. Proposed I.R.C. § 4036. SPECIAL RULE FOR INSURANCE CONTRACTS.

In the case of any contract of insurance, for purposes of this chapter, the taxable amount is the excess of—

- (1) the portion of the premium attributable in insurance coverage, over
- (2) the actuarial cost to the insurer of providing such insurance coverage.

*Id.*

67. See note 49 *supra*.

68. See note 51 *supra*.

69. See note 61 *supra*.

70. Proposed I.R.C. § 4013. ZERO RATING FOR FARMERS, FISHERMEN, MASS TRANSIT. SECTION 501(c)(3) ORGANIZATIONS, THE EDUCATIONAL ACTIVITIES OF GOVERNMENTAL ENTITIES, EXPORTS, AND INTEREST.

The rate of the tax imposed by section 4001 shall be zero with respect to the following:

- (1) Sales by Farmers or Fishermen.—The sale (other than at retail) of—

farmers or fishermen, the performance of mass transit services in urbanized areas, transactions of section 501(c)(3) organizations other than unrelated business, educational activities of government, exports of property and interest.

Farmers and fishermen who purchase goods and services subject to VAT will be required to file VAT returns in order to obtain refunds. A farmer or fisherman who consumes his own product would be subject to the personal consumption rules of section 4033.<sup>71</sup> With regard to these two groups, the rule seems wholly illogical and illustrates why a broad based single rate VAT is preferable.

Charities, governmental institutions, and other tax exempt organizations are handled in an unnecessarily complex manner. Governmental entities, except for public education, and exempt organizations other than section 501(c)(3) organizations are ex-

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(A) Agricultural commodities by the producer of such commodities, or

(B) fish (or other form of aquatic animal life) by a person in whose business such fish (or other forms) were caught.

(2) MASS TRANSIT.—The performance of mass transportation services in urbanized areas.

(3) SECTION 501(c)(3) ORGANIZATIONS.—Any taxable transaction engaged in by a section 501(c)(3) organization other than as part of an unrelated business.

(4) EDUCATIONAL ACTIVITIES OF GOVERNMENTAL ENTITY.—The providing by a governmental entity of property and services in connection with the education of students.

(5) EXPORTS.—Exports of property.

(6) INTEREST.—Interest.

*Id.*

71. Proposed I.R.C. § 4033. PERSONAL USE BY OWNER OF BUSINESS PROPERTY OR SERVICES.

(a) GENERAL RULE.—If any business property or services are used by an owner of the taxpayer for personal purposes, for purposes of this chapter such use shall be treated as a taxable transaction.

(b) TAXABLE AMOUNT.—In the case of a use described in subsection (a), for purposes of this chapter, the taxable amount shall be—

(1) except as provided in paragraph (2), the fair market value of the property or the services, or

(2) if such use is only the temporary use of property, the fair rental value of such use.

(c) DEFINITIONS.—For purposes of this section —

(1) BUSINESS PROPERTY OR SERVICES.—The term ‘business property or services’ means any property or services if a sale of such property, or the performance of such services, by the taxpayer would be a taxable transaction.

(2) OWNER.—The term ‘owner’ means—

(A) in the case of a sole proprietorship, the proprietor.

(B) in the case of any other business enterprise, any holder of a beneficial interest in the corporation, partnership, or other entity, and

(C) any member of the family (within the meaning of section 267(c)(4)) of an individual described in subparagraph (A) or (B).

*Id.*

empt from tax if they charge no separate fee for services.<sup>72</sup> They are fully taxed as any other entity if a separate fee is charged. Education, mass transit in urbanized areas, and section 501(c)(3) organizations not engaged in unrelated business are zero rated.<sup>73</sup> A section 501(c)(3) organization engaged in an unrelated business is fully taxed. Tax exemption means that the organization pays a VAT on its purchases but collects no VAT on its own services. Zero rating, on the other hand, means that the organization files a VAT return and pays no tax but claims a credit for the VAT paid on its own purchases.<sup>74</sup>

Regarding exports, if the policy is to encourage exports, then exports of services should be on parity with exports of property. Curiously, however, only property exports are zero rated.

## V. CONCLUSION

In a presidential election year in which the problems of inflation, budget deficits, energy policy, and an uneasy international

### 72. Proposed I.R.C. § 4037. GOVERNMENTAL ENTITIES: EXEMPT ORGANIZATIONS.

(a) TAXABLE TRANSACTIONS FOR GOVERNMENTAL ENTITIES ONLY WHERE SEPARATE CHARGE IS MADE.—For purposes of this chapter, the sale of property and the performance of services by a governmental entity shall be a taxable transaction if (and only if) a separate charge or fee is made therefor.

(b) SECTION 501(c)(3) ORGANIZATIONS.—For purposes of this chapter, a section 501(c)(3) organization shall be treated as engaged in a business with respect to all of its activities.

(c) OTHER EXEMPT ORGANIZATIONS.—For purposes of this chapter, the sale of property and the performance of services by any exempt organization other than a section 501(c)(3) organization shall be a taxable transaction if (and only if) a charge or fee is made for such services.

(d) DEFINITIONS.—For purpose of this chapter—

(1) GOVERNMENTAL ENTITY.—The term 'governmental entity' means the United States, any State or political subdivision thereof, the District of Columbia, a Commonwealth or possession of the United States, or any agency or instrumentality of any of the foregoing.

(2) SECTION 501(c)(3) ORGANIZATION.—The term 'section 501(c)(3) organization' means an organization described in section 501(c)(3) which is exempt from tax under section 501(a).

(3) OTHER EXEMPT ORGANIZATION.—The term 'other exempt organization' means any organization (other than a section 501(c)(3) organization) which is exempt from tax under chapter 1.

*Id.*

73. See note 70 *supra*. Proposed I.R.C. § 4037(b) provides that a section 501(c)(3) organization shall be treated as engaged in business with respect to all its activities. This ensures that such an organization may obtain refunds on its transactions that are not unrelated business. Proposed I.R.C. § 4013(3).

74. See note 70 *supra*, § 4013(5).



tension vie with each other for congressional and executive attention, responsible citizens are rightly concerned about the course and direction which the national fiscal policy may take. Statements by all candidates and public officials support the proposition that the national budget should be in balance, for this would demonstrate to our friends and allies abroad our capacity to live within our means and thereby strengthen the dollar in the international currency market. At home it would demonstrate our willingness to prepare ourselves for the rigorous and perhaps painful transition from runaway inflation to a measured and orderly growth.

Yet how is it all to be done? Reduce government expenditures and increase government revenues, obviously. As has already been noted, the reduction of expenditures to any significant degree is so remote as not to constitute a viable option. This leaves the alternative of increasing revenues, concerning which there are three general areas of debate.

First, there are those who advocate deep reductions in taxes to encourage capital formation. Lower rates, more liberalized depreciation and investment credits would impel investment in new plant and more efficient technology with a consequent increase in jobs, an overall increase in output, and eventually, more tax revenues. These proponents would tolerate even greater deficits in the short run to achieve greater gains in the long run.<sup>75</sup> Indeed, a cursory reading of congressional committee reports accompanying revenue acts of the last thirty years reflects how often the argument has been advanced that, although a particular proposal might cost the Treasury a certain quantum of revenue, the long-range feedback, or multiplier, effect would overcome the loss. It is difficult to test the validity of these arguments in retrospect because we have not permitted the tax rules to remain static long enough to develop comparable data through periods of time. However, the repetition each year of mounting deficits bespeaks some dubiety about the feedback, or multiplier, contention.

Second, there are those who would retain the traditional income tax principle, but return more nearly to its purist beginnings, that is, a comprehensive tax base with low, gently graduated, rates.<sup>76</sup> These proponents would eliminate much of

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75. Note, *Greenspan Supports \$18-\$20 Billion Tax Cut*, IX TAX NOTES 293 (1979); Lawrence, *Tax Cuts Suggested to Battle Inflation*, L.A. Times, Mar. 9, 1980, § 1, at 13, col. 1. Note, *Business Tax Cuts Pushed*, IX TAX NOTES 59 (1979).

76. See B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, A COMPREHENSIVE INCOME TAX? A DEBATE (1968), also in Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967), Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967), Pechman, *Comprehensive Income*

the gimmickry and gamesmanship of the present system in favor of a more simplified structure in which the exercise of choice in investment and business arrangement would be influenced by economic considerations rather than the interplay of complex tax rules. Statistical studies already extant indicate that such a broad-based, low-rate system could produce the same, or greater, revenues, and would be subject to more efficient administration and compliance.<sup>77</sup>

Third, there are those who would shift to a consumption base as the primary source of revenue. Two general types have been discussed: the VAT proposal as discussed in this article and a consumption tax using something akin to the present income tax system with allowances for savings and investment. In either case, the extent to which the burden shifts to consumption becomes merely a function of rates. In the VAT system, the VAT rates could be increased as income tax rates are reduced. In the consumption tax the rates on the consumption base could be so sharply progressive as to reduce substantially consumption above a certain level.<sup>78</sup> As has been discussed in this article, a shift to a consumption base would more heavily impact upon the middle income group whose consumption outlays generally represent a higher percentage of their total positive, or real, income. Therefore, it would be a particularly difficult package to sell politically. Moreover, without some kind of "clean up" of the present income tax system, the mind boggles at the prospect of the blizzard of paper with which rank and file taxpayers would have to cope in

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*Taxation: A Comment*, 81 HARV. L. REV. 63 (1967); Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR*, 81 HARV. L. REV. 1016 (1968); G. BREAK & J. PECHMAN, *FEDERAL TAX REFORM—THE IMPOSSIBLE DREAM?* (1975); C. GALVIN & B. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* (1969); J. PECHMAN, *COMPREHENSIVE INCOME TAXATION* (1977); SURREY, *PATHWAYS TO TAX REFORM* (1973); COMMISSION TO REVISE THE TAX STRUCTURE, *REFORMING THE FEDERAL TAX STRUCTURE* (1973); Galvin, *Tax Reform and Simplification*, U. SO. CALIF. 30TH TAX INST. 853 (1978). The Canadian government in a commendable show of courage to face the issue of comprehensive taxation appointed an independent commission to analyze the issues involved and make legislative recommendations. See *REPORT OF THE ROYAL COMM'N. ON TAXATION* (Canada) (1966). In a similar show of gutsiness, the U.S. Treasury under Secretary William E. Simon published at the close of the Ford administration its own recommendations for a comprehensive income tax in U.S. TREAS., *BLUEPRINTS FOR BASIC TAX REFORM* (1977).

77. U.S. TREAS., *supra* note 76.

78. Thus, H.R. 5665 proposes to reduce the rate in the highest bracket to 50% from the present 70%; this could be further reduced to 40%, 30%, or even 20% by corresponding increases in the VAT rate.

complying with a VAT having multiple rates and exemptions superimposed on the existing system. Consider the case of a middle bracket business or professional person attempting to do some tax planning and making calculations of regular tax liability, minimum tax, alternative minimum tax, and value-added tax. The investment of what would otherwise be productive time in such matters becomes enormous.<sup>79</sup>

Finally some comment should be made regarding the role of corporate income taxes. A VAT could replace the corporate income tax; yet there is evidence that the corporate tax already functions as a kind of sales tax. An historic review of the rate of return on corporate investment shows that, although adjustments in the corporate rates may have short run effects, over the long run the rate of return moves to equilibrium. Accordingly, the corporate tax influence on corporate investment is transitory, because among oligopolistic enterprises it may function as an excise, a cost of doing business, largely shifted to consumers in the price structure. On this premise it may be argued that a corporate income tax or a VAT operate similarly.<sup>80</sup>

Reflecting on these alternatives and a generation of tax reform watching, this author maintains that the comprehensive base, if not the best of all worlds, must surely be, in our present state of fiscal doldrums, the least worst of all worlds. It has the advantage of the use of concepts well established in construction, operation, and enforcement, and it has the further advantage of providing substantial simplification.

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79. The factor of deadweight loss to society in the present system has not been often discussed. See COMMISSION TO REVISE THE TAX STRUCTURE, REFORMING THE FEDERAL TAX STRUCTURE 13 (1973) in which the deadweight loss was estimated to be 4% of revenue collected.

80. See Schenk, *The Value-Added Tax as a Replacement for Part of the Corporate Income Tax*, IX TAX NOTES 767 (1979). Whether the corporate income tax is shifted forward in the price structure or backward on employees in setting wages, or downward on investors in determining rates of return is a continuing debate. See Slitor, *The Enigma of Corporate Tax Incidence*, 18 PUB. FINANCE 328 (1963); Ratchford & Han, *The Burden of the Corporate Income Tax*, 10 NAT'L TAX J. 310 (1957); Smith, *The Value-Added Tax As An Alternative to the Corporate Income Tax*, PROC. OF THE 54TH ANN. CONF. NAT'L TAX ASS'N 424 (1964); Lerner & Hendriksen, *Federal Taxes on Corporate Income and the Rate of Return on Investment in Manufacturing, 1927 to 1952*, 9 NAT'L TAX J. 193 (1956); KLEIN, POLICY ANALYSIS OF THE FEDERAL INCOME TAX CH. 7 (1967). Professor Musgrave has gone so far as to assert that one-third of the corporate tax is shifted forward to consumers, one-eighth was shifted backward to workers, and the rest fell on the shareholders, Musgrave, *Distribution of Tax Payments by Income Groups: A Case Study for 1948*, 4 NAT'L TAX J. 1, 16 (1958). Assume that the value-added or gross profit, is \$100 and that gross profit reduced by operating expenses, or net profit, is \$20. A 10% VAT or a 50% corporate income tax each produce \$10; in either case the sales price of the product includes the amount necessary to produce the \$100 gross profit (i.e., value added) or the \$20 net profit.

The outgoing Ford administration in 1977 published a thought-provoking study centered on a comprehensive tax base.<sup>81</sup> The Carter administration has called for substantial base broadening.<sup>82</sup> It is evident therefore, that the issue commands a bipartisan support, and it may be earnestly hoped that in this, a presidential year, there could develop the broadest possible debate of these serious fiscal matters with a view toward seeking resolution of them in the best interests of the nation.

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81. U.S. Treas., *supra* note 76.

82. President's Tax Message to Congress, 14 WEEKLY COMP. OF PRES. DOC. 158 (Jan. 30, 1978).

